



International Forum of Independent Audit Regulators
(IFIAR)

IFIAR Reference Guide

**Establishing Independent Public
Oversight Systems of Auditors/
Audit Firms**

www.ifiar.org

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I. ABOUT IFIAR

The International Forum of Independent Audit Regulators currently brings together 51 organisations charged with audit oversight. The core aim of IFIAR is to improve audit quality globally.

It undertakes this mission through:

- Sharing knowledge of audit markets and practical experience of independent audit regulatory activity with a focus on inspections of auditors and audit firms;
- Promoting collaboration and consistency in regulatory activity; and,
- Providing a platform for dialogue with other international organisations that have an interest in audit quality.

Given the technical experience and expertise represented within the membership of IFIAR, the forum is well suited to conduct outreach with non-member jurisdictions to help them establish strong systems of audit oversight. IFIAR's membership is geographically diverse, which has been central in establishing its membership criteria and core principles. It is important that the numerous systems represented within IFIAR, all reflect common principles which are paramount to achieving effective independent audit regulation, while maintaining the flexibility of the jurisdictions domestic business culture. In encouraging this flexibility, IFIAR promotes the establishment of competent audit oversight which is appropriate for the local market while recognising international practices.

This reference guide has been created to share key principles identified by IFIAR to ensure adequate safeguards and regulatory independence in the establishment of non-members' oversight systems. Given the global nature of business and trade, IFIAR members and non-members all benefit from consistent and strong audit oversight.

II. WHY SET UP AN INDEPENDENT PUBLIC OVERSIGHT SYSTEM FOR AUDIT?

The globalisation of financial markets has enabled investors to access investment options from a wide range of different jurisdictions and markets. Not only has this helped investors to make knowledgeable decisions for capital allocation, it has also helped to improve the liquidity of domestic financial markets. There is a need for trustworthy and reliable financial information. This is where strong systems of public oversight play an important role to foster confidence in investment. The three major benefits of public oversight of audits are discussed below. Although the establishment of strong systems of public oversight can initially be costly, an increasing number of countries, including most leading economies, have concluded that in establishing these systems the benefits have far exceeded the costs.

1. Public and Independent audit oversight improves audit quality and thus enhances economic growth

High quality audit is essential to the effective and efficient allocation of capital and resources. The independent audit of corporate reporting supports successfully functioning capital markets and assists smaller companies in gaining access to capital from other sources. The ability to attract capital helps business to grow and contributes to wider economic growth, job creation and long-term poverty reduction. High quality audits and strong corporate reporting standards promote confidence in final reporting that may cultivate investment domestically and enhance foreign direct investment.

Historically, the audit profession has been largely self-regulated. However, following well-publicised corporate failures in a number of leading markets (Enron (2001), WorldCom (2002), Parmalat (2003), Ahold (2003)), the ability of the audit profession to effectively regulate itself has increasingly been brought into question. These crises have not only affected the companies' stakeholders but have had an impact on national and international economies. As a result, independent oversight of the audit profession in the public interest has been quickly and widely established, as evidenced by the independent oversight systems in IFIAR's member jurisdictions.

The main common activity of IFIAR's regulators is the independent external quality control review (i.e. inspections) of auditors and audits of public interest entities, though many also oversee the overall audit profession to some extent. Independent audit inspection is instrumental in raising audit quality.

2. Supporting the globalisation of business by meeting international practices

Following the large corporate failures mentioned above, a number of high quality and internationally recognised oversight practices in audit and corporate reporting have been developed and implemented with a view to enhance the regulatory regime of companies and auditors. Following major pieces of legislation, such as the Sarbanes-Oxley Act of 2002¹ as amended in 2010

¹ http://pcaobus.org/About/History/Documents/PDFs/Sarbanes_Oxley_Act_of_2002.pdf

by the Dodd-Frank Wall Street Reform and Consumer Protection Act² in the US and the EU 2014 Statutory Audit Regulation³ and Directive⁴ which is an update of the EU 2006 Statutory Audit Directive, the establishment of independent audit oversight and regulation in the public interest, with a focus on investor protection, has been given increasing international attention.

Globalisation of trade and business has led to the establishment of multi-national companies, and the provision of audit services has evolved in a similar multi-jurisdictional manner. As a result, national jurisdictions are facing challenges with regulating an increasingly global audit market. Cooperation between audit regulators is imperative to effectively oversee the quality of audit provided by international audit networks. In jurisdictions where effective independent oversight has not been established, this means that oversight of these networks may be restricted.

IFIAR serves as the leading international forum for improving audit quality. IFIAR assists countries in establishing public oversight and supports subsequent cooperation with international peers, both bilaterally and through IFIAR. It allows regulators to exchange international practices and expectations with the shared aim of increasing confidence in the business environment in each member's jurisdiction.

Newly established public oversight systems may in some cases wish to compare their practices against international peers, namely IFIAR member jurisdictions. Information learned through IFIAR about various regulatory approaches and practices can provide useful reference points for regulators seeking to establish, further develop, or improve their systems for auditor oversight. This will, in the long term, establish and enhance confidence in the quality of auditor oversight systems in other countries and facilitate cross-border cooperation.

3. Independent public audit oversight directs and assists further development of the audit profession

The establishment of independent audit oversight benefits the audit profession. Through a robust quality review and inspection regime, the oversight body works to maintain high quality audits, to ensure that the audit profession is working in the public interest and to increase the overall standards of the audit industry. An independent oversight body also provides a focal point for policy issues which can be integral to developing and promoting audit work. Inspections in particular are vital tools to improve internal quality control systems and identify shortcomings in individual audit engagements.

Overall, solid oversight helps to create and maintain trust in the work of auditors by providing safeguards for companies and investors. It also highlights the importance of audit as a core function of the audit profession.

² http://pcaobus.org/About/History/Documents/PDFs/Dodd_Frank_Title_IX.pdf

³ <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0537&from=EN>

⁴ <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0056&from=EN>

III. COMMON CHARACTERISTICS OF INDEPENDENT PUBLIC OVERSIGHT SYSTEMS FOR AUDITS

Observed international practices highlight the need for independent audit oversight systems. However, the establishment of such systems may take many different forms to serve the same objective. IFIAR does not specify or favour any specific system; however, the public oversight system of a potential member must meet IFIAR's membership criteria, and regulators are encouraged to incorporate the Core Principles where appropriate while evolving their systems of oversight. This is discussed in more detail below.

1. IFIAR's Membership Criteria and Core Principles - Foundation for independent public oversight

The IFIAR Membership Criteria as set out in the IFIAR Charter⁵, must be fulfilled by any authority or body who wishes to join IFIAR, and throughout the duration of their membership. IFIAR Membership Criteria are the absolute minimum requirement for any independent public audit oversight authority that seeks to be an IFIAR member.

IFIAR membership criteria (Sec. 2.1 of the IFIAR Charter):

IFIAR members are regulators who are both:

- Independent of the audit profession, which means that a majority of the relevant governing body should be non-practitioners (with appropriate cooling-off periods) and funding should be free of undue influence by the profession; and
- Engaged in audit regulatory functions in the public interest and in particular; be ultimately responsible for the system of recurring inspection of audit firms undertaking audits of public interest entities, and exercising that responsibility either directly or through oversight of inspection undertaken by professional bodies.

Profession includes, for example, audit firms, professional bodies and bodies or other entities governed by or associated with the profession.

The Core Principles of IFIAR⁶ should be used as a benchmark in establishing new oversight authorities. IFIAR members currently are from countries that represent approximately 68% of global GDP and 80% of global capital markets. With such a diversity of systems, IFIAR has sought to encourage elements of good practice in audit oversight through its membership criteria and by promoting the core principles for audit regulators.

⁵ <https://www.ifiar.org/IFIAR/media/Images/IFIAR-Charter-Approved-7-26-13.pdf>

⁶ <https://www.ifiar.org/IFIAR/media/Documents/General/Final-Core-Principles.pdf>

The IFIAR core principles cover:

➤ **The structure of audit oversight:**

- **Principle 1:** The responsibilities and powers of audit regulators should serve the public interest and be clearly and objectively stated in legislation.
- **Principle 2:** Audit regulators should be operationally independent.
- **Principle 3:** Audit regulators should be transparent and accountable.

➤ **The operations of audit oversight:**

- **Principle 4:** Audit regulators should have comprehensive enforcement powers which include the capability to ensure that their inspection findings or recommendations are appropriately addressed; these enforcement powers should include the ability to impose a range of sanctions including, for example, fines and the removal of an audit license and/or registration.
- **Principle 5:** Audit regulators should ensure that their staff is independent from the profession and should have sufficient staff of appropriate competence.
- **Principle 6:** Audit regulators should be objective, free from conflicts of interest, and maintain appropriate confidentiality arrangements.
- **Principle 7:** Audit regulators should make appropriate arrangements for cooperation with other audit regulators and, where relevant, other third parties.

➤ **Audit inspection principles:**

- **Principle 8:** Audit regulators should as a minimum, conduct recurring inspections of audit firms undertaking audits of public interest entities in order to assess compliance with applicable professional standards, independence requirements and other laws, rules and regulations.
- **Principle 9:** Audit regulators should ensure that a risk-based inspections program is in place.
- **Principle 10:** Audit regulators should ensure that inspections include effective procedures for both firm wide and file reviews.
- **Principle 11:** Audit regulators should have a mechanism for reporting inspections findings to the audit firm and ensuring remediation of findings with the audit firm.

The Core Principles were created to assist members and non-members in developing their own national arrangements/oversight systems giving them the means to draw on and benefit from other members' experience. They are not binding on IFIAR members, however they encourage the widespread adoption of high quality oversight practices which foster high quality audits and

promote public trust in the financial reporting process. The Core Principles represent international practices as agreed by IFIAR's membership. As one could expect, the differences in audit markets in terms of size, risk profile and complexity of firms, will alter how these principles are implemented. Some of the implications resulting from jurisdiction sizes will be discussed later in this paper.

In summary, the Membership requirements and Core Principles highlight that audit regulators should be independent, transparent, accountable and serve the public interest. They should have sufficient oversight powers, including the power to impose sanctions, have competent and independent staff, be objective and maintain confidentiality and cooperate with other regulators. They should also conduct recurring inspections on a risk-based program, inspecting both firm-wide and individual files, and ensuring that findings are properly addressed by the auditor.

2. Structure of Public Oversight

a) Legal framework and defining the public oversight system

Given the many differing systems, one of the main elements of public oversight authorities is their responsibility for external quality control of audits, usually through inspections. In most cases, the system also holds direct or ultimate responsibility for:

- audit performance, including the setting or adoption of audit and ethical standards;
- auditor/audit firm licensing and registration; and
- investigation and discipline of auditor misconduct, which includes sanctions.

Though not the only examples of legal frameworks for public oversight systems, the EU 2014 Statutory Audit Regulation and Directive⁷ and the US 2002 Sarbanes-Oxley Act are commonly used for comparative purposes. A summary of these two systems and two other examples of legal frameworks are included within the annexes.

b) Independence from the profession

There has been much debate among governments and regulators on what constitutes independence. It differs between jurisdictions and will depend on cultural and economic factors. IFIAR has determined independence to mean at least having a majority of non-practitioners within the relevant governing oversight body and having funding that is free of undue influence by the profession. There may be other factors that either reinforce or diminish independence, but the decision making processes and the funding are key indicators. The IFIAR Core Principles should serve as references for international practice in helping to further define independence.

IFIAR's definition of independence highlights the fine balance between independence and competence. If an oversight system was unable to take advantage of the experience of (former) members of the profession, this would likely result in a lack of expertise. Some jurisdictions believe

⁷ This is the updated and amended EU 2006 Statutory Audit Directive. These changes will not come into effect until late 2016.

that inspections, for example, are most effective with the involvement of experienced audit professionals, including former audit partners (with appropriate safeguards in place to avoid conflicts of interest). Achieving a balance between expertise and independence is a major challenge in establishing and operating an oversight system, especially in jurisdictions with limited numbers of qualified auditors.

There are diverse funding mechanisms within IFIAR. Some IFIAR member jurisdictions require that costs of the necessary oversight mechanism are covered by the profession. This is often established in the form of a levy which ensures that the profession can exert no influence over the oversight system. Safeguards are needed to ensure that the oversight budget can be determined without any undue intervention from the profession. Other jurisdictions use public funding or impose fees on companies or public interest entities audited by the regulated public accounting firms. Ultimately, it is important that funding is sufficient to undertake the necessary oversight tasks and to attract qualified staff.

3. Elements of Audit Oversight

a) Enabling inspections and enforcing compliance

Audit quality inspections are the primary tool of oversight systems in enforcing compliance with auditing standards and thus maintaining audit quality in the public interest. This is the core objective of public oversight systems. To be effective, inspections need to be backed by appropriate measures to enforce such adherence.

IFIAR's Core Principles set out guidelines for effective oversight systems. However, a well-developed legal and corporate governance framework is also necessary to support high quality corporate reporting and auditing. Elements of this framework will cover the following important aspects:

- comprehensive and well-defined accounting and auditing principles and standards that are generally accepted;
- legal requirements for the preparation and publication of financial statements according to those principles and standards;
- an enforcement system for preparers of financial statements to ensure compliance with accounting standards (e.g. fines, shareholder redress or penalties on responsible managers for non-compliance);
- corporate governance arrangements and practices that support high-quality corporate reporting and auditing practice; and
- effective educational and training arrangements for accountants and auditors.

Audit regulators should aim to make the stakeholders aware of shortcomings in these frameworks which potentially impact the effectiveness of their oversight.

As detailed in the IFIAR Core Principles, powers and conditions to promote effective audit inspection include:

- adequate resources, competence and capability of inspection staff. If audit inspection is conducted by a third party, adequate resources are necessary to effectively oversee the inspection and set appropriate standards for the inspection work (Principle 5)
- an audit inspection methodology that is suitable for consistent and challenging inspections, matching the sophistication of the leading PIE auditors to be inspected (Principles 8-11)
- a range of proportionate and adequate sanctions, including the ultimate sanction of removal of the audit licence (Principle 4)

b) Analysis of optional/choice elements

In the initial establishment period of a newly formed oversight system, certain elements can remain 'optional'. This degree of choice should be based upon the characteristics of the jurisdiction, including its size, its audit market, the development of its audit profession, the legal considerations in the jurisdictions and the level of resources available to the regulator. These 'options' include:

- whether to perform the audit quality inspections directly or to oversee the inspections performed by others, e.g. a professional body or contractor.
- whether a certain degree of involvement of the audit profession in oversight tasks is acceptable without compromising the independence of the regulator,
- the scope of audit oversight – e.g. focus on listed entities, definition of 'public interest entities'

IV. EFFECTIVENESS OF STRUCTURES: EXAMPLES OF PUBLIC OVERSIGHT SYSTEMS

In the establishment of public oversight systems, jurisdictions have faced different challenges, which have led to differences among national systems. This section will look at these differing characteristics and see how current IFIAR members have dealt with these issues and addressed the choices. This includes the location of the oversight system, funding and resourcing issues, finding the right balance of independence from the profession and the skills required of staff.

In order to have a comprehensive view of the different structures of public oversight systems, we recommend to view the IFIAR Member Profiles. These profiles are available on the IFIAR website at www.ifiar.org.

1. Situating the oversight authority

One fundamental characteristic is the determination of where the public oversight authority should be situated in the regulatory landscape. Normally, the authority will be established as an independent body, as part of the securities or financial services regulator or as a part of the government. An analysis of IFIAR's membership highlights the differing approaches undertaken by jurisdictions as described below⁸:

- Independent body:
 - e.g. The United Kingdom (FRC), the US (PCAOB), France (H3C)
- Part of the securities or financial services regulator:
 - e.g. The Netherlands (AFM), Australia (ASIC), Thailand (SEC), Malaysia (AOB)
- Part of the Government:
 - e.g. Austria (ASA), Hungary (APOA), Japan (JFSA/CPAAOB).
- Independent body/Supervisor of a professional body⁹:
 - e.g. Germany (AOC), Poland (AOC)

Other systems also represent a hybrid of the structures mentioned above. There is no single system which fits all, and every system has its benefits as they are usually designed according to the specifics of national circumstances. The advantages of being a part of a wider functioning body, such as government or a larger regulator, could mean greater influence and synergies with other market functions. Advantages of lone-standing authorities include increased or sole focus on audit issues, freedom from civil service (government) constraints (e.g. on pay). There are no clear preferences within IFIAR between the different structures of audit regulation. Those audit regulators that are integrated within the securities authorities are members of IOSCO, the international organisation of securities regulators, which addresses audit issues as a non-core activity.

⁸ August 2015

⁹ e.g. a Chamber of Public Accountants

2. Funding public oversight systems

Effective funding without undue influence from the profession is a key element to the establishment of efficient systems of oversight. It is often the most difficult consideration, and most IFIAR members have had to push for adequate levels of funding at some stage during their establishment. Two key considerations are the sources of these funds and the amount.

a) Sources of funding

There are a range of different funding sources and these funding arrangements differ between the members of IFIAR. Some are wholly funded by the government, others are funded by fees/levies whilst others are financed by a mixture of sources including the government and the profession.

b) Amount of funding

The amount of funding IFIAR members receive varies depending on the jurisdiction's size and market. It is often difficult to determine the appropriate amount for a budget dedicated to audit oversight due to the differences in scopes, structures and activities. However, below are some approximate funding figures for current IFIAR members. It also compares the jurisdictions population, the number of public interest entities and the number of registered auditors.

| Country size by Resource | Funding of Public Oversight System ¹⁰ | Population | Estimated number of Public Interest Entities (PIEs) | Number of registered auditors |
|--------------------------|--------------------------------------------------|------------|-----------------------------------------------------|-------------------------------|
| Small | € 1.75m | 5.4m | 600 | 1,398 |
| Medium | € 6.5m | 51.2m | 402 | 4,281 |
| Large | € 5.6m | 82m | 777 | 21,698 |
| Large | € 8.5m | 66m | 3,628 | 19,300 |
| Large | € 25m | 63m | 2,866 | 24,198 |

3. Division of roles and responsibilities with the professional body(ies)

Currently there are three broad approaches adopted by IFIAR members with regard to the division of roles and responsibilities with the professional bodies in their jurisdiction:

1. The oversight authority conducts the inspections of PIEs auditors and some non-PIEs auditors
2. The oversight authority conducts the inspection of PIE auditors – while the professional bodies inspect those of non-PIEs
3. The professional bodies conduct all inspections, but the oversight authority has ultimate responsibility.

¹⁰ Figures from 2014 financial years

There is a clear preference for oversight authorities to conduct direct inspections of auditors of PIEs. However, oversight authorities which are still developing their systems often oversee the professional bodies or peer review inspection systems for a number of years before establishing their own inspection teams and directly taking on the inspections of PIE auditors.

Of the 51 Members of IFIAR, 39 perform inspections on auditors of public interest entities directly and 12 oversee others performing the inspections¹¹.

Most IFIAR Members only have direct responsibility for the oversight of the auditors of PIEs, often leaving auditors of non-PIEs to the professional body(ies). However, many oversight systems also have oversight responsibility for the professional body(ies). This will typically include supervising how the professional body educates, registers, inspects and disciplines its auditing members, with ultimate responsibility in these areas.

4. Characteristics for the governing boards¹² of public oversight systems

Oversight systems have a wide range of board sizes. Their board members normally have a wide range of backgrounds, which often reflect the history and development of audit and other professions in that jurisdiction. The average board size among IFIAR jurisdictions is typically 6-8 members¹³ (either full- or part-time) with the majority of the board being independent from the profession, i.e. governed by non-practitioners.

While IFIAR membership criteria require the majority of the board to be non-practitioners, a few IFIAR members also have practicing auditors on their governing boards. Some would argue that having professionals with competent and relevant experience, represented in the decision making body, as long as it is in the minority, works better to serve the public interest while others would contest that practicing auditors should not be on the board as it threatens independence and may cause leaking of confidential information into the profession.

The composition of governing boards of IFIAR members may include, for example:

- Former audit professionals
- Other professionals such as lawyers
- Magistrates
- Bankers
- Directors or former directors of leading corporates
- (former) civil servants

¹¹ These statistics are dated August 2015. By June 2016, this will change following the implementation of the 2014 EU Audit Directive and Regulation which requires a stronger role for the independent audit oversight authorities in the European Union/EEA.

¹² While it is recognised that oversight authorities may have different structures in place that do not always include a „board“, this is one of the more common structures represented within IFIAR. What is outlined refers mutatis mutandis also to other governing bodies (such as e.g. commissions).

¹³ As correct of August 2015

- Representatives of other (related) regulators (such as the securities regulators) or government departments
- Academics
- Representatives from the Central Bank

However, board composition normally reflects the level of development and size of the auditing and other professions in the jurisdiction and the availability of larger pools of experts willing to serve on the oversight authorities' boards. Where auditing and other professions are less established, greater reliance on government, regulatory and academic board members is characteristic.

5. Transitional and interim solutions

The ultimate goal of all oversight systems is to have complete operational independence from the profession. However, in some cases this may be difficult to achieve in the earlier stages of inception.

Oversight systems in larger jurisdictions with long-standing experience are not necessarily well suited for smaller jurisdictions, given the differences in the size and maturity of the markets, the different stakeholder groups, the possible lack of resources and access to international practices.

If complete operational independence from the profession is difficult to establish, a jurisdiction may choose to undertake a form of oversight that involves resources provided by the profession, but obviously, without creating the danger of undue influence.

In the start-up phase, especially where resources and funding are limited, a common approach observed is a form of oversight designed to ensure that an independent oversight body is ultimately responsible for audit regulatory tasks, specifically overseeing the conduct and follow-up of inspections. Many IFIAR members including the larger jurisdictions operated such regimes in their early stages.

In some countries, as part of the start-up phase, authorities may choose to contract with an audit oversight authority in another country. This can be a means to begin audit oversight activities before the local authority is able to hire and train staff, for example to establish its inspection program.

V. CONCLUSION

As demonstrated by the growing number of IFIAR members, more and more jurisdictions all over the world have moved away from minimal or self-regulation of the audit profession, towards auditor oversight by independent, public authorities. Apart from being beneficial for the reasons outlined in Section 1, this has developed into practice which increasingly is recognised as a minimum standard in the mid- and long term. Hopefully, this reference guide illustrates that implementing independent auditor oversight can be adapted to the individual systems and may, to a certain degree, integrate current oversight practices.

There is a range of possibilities and choices which enable jurisdictions to establish a system that will be suitable given their domestic legal, technical, historical and cultural environment. Sometimes it may be necessary to introduce the different elements of independent oversight gradually. However, it is imperative to hold a long term vision which foresees the establishment of an authority which reflects widely recognised international practices for independent oversight of auditors. This will avoid the need to re-introduce additional structures or measures which could be hindered by a lack of political motivation.

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Annex 1: Summary of the Requirements under Title I of the U.S. Sarbanes-Oxley Act of 2002, as amended

Established Public Oversight System

The Public Company Accounting Oversight Board (“PCAOB”) is a non-profit corporation established by Congress to oversee the audits of public companies in order to protect investors and further the public interest in the preparations of informative, accurate, and independent audit reports. The PCAOB also oversees the audits of brokers and dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection. The Sarbanes-Oxley Act of 2002 (the “Act”), which created the PCAOB, required that auditors of U.S. public companies be subject to external and independent oversight for the first time in history. Previously, the profession was self-regulated.

Governance

The five members of the PCAOB Board, including the Chairman, are appointed to staggered five-year terms by the U.S. Securities and Exchange Commission (“SEC” or “Commission”), after consultation with the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury. The SEC has oversight authority over the PCAOB, including the approval of the Board's rules, standards, and budget. The Board shall have five members appointed from among prominent individuals of integrity and reputation. Two members, and only two, shall be or have been certified public accountants (CPAs). If the Chairman is a CPA he or she may not have been a practicing auditor for at least 5 years prior to appointment. Board Members serve on a full-time basis and may not be employed by any other person or engage in any other business or professional activity. No Board Member may share in the profits, or receive payments from, a public accounting firm other than fixed continuing payments on retirement (e.g. pension).

Responsibilities (‘Duties’) of Public Oversight System

Under Section 101(c) of the Act, the Board shall:

- (1) register public accounting firms that prepare audit reports for issuers (essentially, companies with reporting obligations to the SEC), in accordance with section 102;
- (2) establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers, in accordance with section 103;
- (3) conduct inspections of registered public accounting firms, in accordance with section 104 and the rules of the Board;
- (4) conduct investigations and disciplinary proceedings concerning, and impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms, in accordance with section 105;

- (5) perform such other duties or functions as the Board (or the Commission, by rule or order) determines are necessary or appropriate to promote high professional standards among, and improve the quality of audit services offered by, registered public accounting firms and associated persons thereof, or otherwise to carry out the Act, in order to protect investors, or to further the public interest;
- (6) enforce compliance with the Act, the rules of the Board, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, by registered public accounting firms and associated persons thereof; and
- (7) set the budget and manage the operations of the Board and the staff of the Board.

Inspections of Registered Firms

Under Section 104 of the Act, The Board shall conduct a continuing program of inspections to assess the degree of compliance of each registered public accounting firm and associated persons of that firm with this Act, the rules of the PCAOB, the rules of the SEC, or professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers.

In conducting an inspection the Board shall:

- (1) inspect and review selected audit and review engagements of the firm performed at various offices and by various associated persons of the firm, as selected by the Board;
- (2) evaluate the sufficiency of the quality control system of the firm, and the manner of the documentation and communication of that system by the firm; and
- (3) perform such other testing of the audit, supervisory, and quality control procedures of the firm as are necessary or appropriate.

The rules of the Board shall provide a procedure for the review of and response to a draft inspection report by the registered public accounting firm under inspection. The text of any such response, appropriately redacted to protect information reasonably identified by the accounting firm as confidential, shall be attached to and made part of the inspection report.

The report shall be made available in appropriate detail to the public subject to the confidentiality restrictions set out in Section 105(b) (5)(A) of the Act and the proviso that criticisms of the firm's system of quality control shall not be made public if they are addressed by the firm to the satisfaction of the Board within 12 months of the report date.

Frequency of Inspections:

Inspections under Section 104 are conducted annually for registered accounting firms that regularly provide audit reports for more than 100 issuers, and at least once every three years for firms that regularly provide audit reports for 100 or fewer issuers.

Funding:

The Act, as amended by the Dodd-Frank Act, established funding for PCAOB activities, primarily through the annual accounting support fees assessed on public companies based on their relative average, monthly market capitalization and on brokers and dealers based on their relative

average, quarterly tentative net capital. Funds generated from the collection of monetary penalties shall be used to fund a merit scholarship program for accounting degree students.

Other Provisions of Title I of the Sarbanes-Oxley Act

The Act also:

- Expressly provides that all of its requirements, and the Board's authority, apply to non-U.S. public accounting firms that audit issuers to the same extent as they apply to U.S. public accounting firms that audit issuers.
- Authorizes the Board to adopt rules requiring the registration of non-U.S. firms that play a substantial role in issuer audits for which another auditor issues the audit report, which the Board has done.

Annex 2: Summary of the requirements under EU 2014 Statutory Audit Regulation and Directive

The EU 2014 Statutory Audit Regulation¹⁴ and Directive¹⁵ provides stricter requirements on EU member states than the previous 2006 Directive. The list below also identifies the legislative requirements under the regulation (to be applied in full and directly applicable) and the directive (requires transposition into national law to conform to the requirements).

Establish a public oversight system

Member States should organise an effective system of public oversight for statutory auditors and audit firms and shall designate a competent authority responsible for such oversight.

In order to enhance the credibility and transparency of the quality assurance reviews performed in the Union, Member States' quality assurance systems should be governed by the competent authorities designated by the Member States to ensure public oversight of statutory auditors and audit firms.

Audit oversight will continue to be conducted at national level. However, cooperation and coordination is to be carried out at European level by a committee of national auditing oversight bodies (CEAOB), an expert group that will take over the tasks of the existing European Group of Auditor Oversight Bodies (EGAOB). Its main task will be to ensure effective coordination of supervision of audit firms operating across the EU. A specific role is conferred on the European Securities and Markets Authority (ESMA) with regard to the cooperation between Member States and third countries in the field of public oversight of PIEs.

Governance

The public oversight authorities should be **governed by non-practitioners** and Member States should establish independent and transparent procedures for the selection of such non-practitioners.

“Non-practitioner” means any natural person who, during his or her involvement in the governance of the public oversight system and during the period of three years immediately preceding that involvement, has not carried out statutory audits, has not held voting rights in an audit firm, has not been a member of the administrative, management or supervisory body of an audit firm and has not been employed by, or otherwise associated with, an audit firm;’

In order to enhance the transparency of auditor oversight and to allow for greater accountability, each Member State should designate a single authority to be in charge of public oversight of statutory auditors and audit firms.

Member States shall ensure that, when the statutory auditor or the audit firm carries out the statutory audit, he, she or it maintains professional scepticism throughout the audit, recognising the possibility of a material misstatement due to facts or behaviour indicating irregularities, including fraud or error, notwithstanding the statutory auditor's or the audit firm's past

¹⁴ Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014

¹⁵ Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014, amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts

experience of the honesty and integrity of the audited entity's management and of the persons charged with its governance.

The statutory auditor or the audit firm shall maintain professional scepticism in particular when reviewing management estimates relating to fair values, the impairment of assets, provisions, and future cash flow relevant to the entity's ability to continue as a going concern.

For the purposes of the relevant Article, "professional scepticism" means an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.'

Responsibilities of the competent authority

The competent authority shall have the ultimate responsibility for the oversight of:

- (a) the approval and registration of statutory auditors and audit firms;
- (b) the adoption of standards on professional ethics, internal quality control of audit firms and auditing, except where those standards are adopted or approved by other Member State authorities;
- (c) continuing education, and the systems of quality assurance, investigation and sanctions for statutory auditors and audit firms;
- d) quality assurance systems;
- (e) investigative and administrative disciplinary systems.

Competent authorities shall be transparent and shall at least publish:

- (a) annual activity reports regarding their tasks under the Regulation;
- (b) annual work programmes regarding their tasks under the Regulation;
- (c) a report on the overall results of the quality assurance system on an annual basis. This report shall include information on recommendations issued, follow-up on the recommendations, supervisory measures taken and sanctions imposed. It shall also include quantitative information and other key performance information on financial resources and staffing, and the efficiency and effectiveness of the quality assurance system;
- (d) the aggregated information on the findings and conclusions of inspections. Member States may require the publication of those findings and conclusions on individual inspections.

The competent authority shall have the following responsibilities:

- (a) approval and amendment of the inspection methodologies, including inspection and follow-up manuals, reporting methodologies and periodic inspection programmes;
- (b) approval and amendment of inspection reports and follow-up reports;
- (c) approval and assignment of inspectors for each inspection.

Delegation:

Member States may delegate or allow the competent authorities to delegate any of the tasks required to be undertaken to carry out such tasks, except for tasks related to:

- (a) the quality assurance system of public-interest entities
- (b) investigations arising from that quality assurance system or from a referral by another authority; and

(c) sanctions and measures related to the quality assurance reviews or investigation of statutory audits of public-interest entities.

Any execution of tasks by other authorities or bodies shall be the subject of an express delegation by the competent authority. The delegation shall specify the delegated tasks and the conditions under which they are to be carried out. Where the competent authority delegates tasks to other authorities or bodies, it shall be able to reclaim these competences on a case-by-case basis.

Enforcement

In order to reinforce investor protection, it is important to strengthen public oversight of statutory auditors and audit firms by enhancing the independence of Union public oversight authorities and conferring on them adequate powers, including investigative powers and the power to impose sanctions, with a view to detecting, deterring and preventing infringements of the applicable rules in the context of the provision by statutory auditors and audit firms of auditing services.

Sanctions

The new rules require Member States to provide for appropriate administrative sanctions and measures that can be applied to violations of EU audit legislation. For this purpose, the Directive requires Member States to comply with common minimum standards on:

- Types and addressees of sanctions
- The criteria to be taken into account by competent authorities when applying sanctions
- The publication of sanctions
- Mechanisms to encourage reporting of potential violations.

All these provisions are without prejudice to provisions of national criminal law.

Quality assurance system for auditors

Regular inspections are a good means of achieving a consistently high quality in statutory audits. Statutory auditors and audit firms should therefore be subject to a system of quality assurance that is organised in a manner which is independent from the reviewed statutory auditors and audit firms and is subject to public oversight.

Each individual auditor is to be subject to a quality assurance review at least every six years. In this respect, the funding for the quality assurance system should be free from undue influence.

Quality assurance should:

- be independent of the reviewed statutory auditors and audit firms and subject to public oversight;
- have quality assurance reviewers that have appropriate professional education and relevant experience in statutory audit and financial reporting combined with specific training on quality assurance reviews;
- quality assurance reviews shall take place on the basis of an analysis of the risk and, in the case of statutory auditors and audit firms carrying out statutory audits;

- quality assurance reviews shall be appropriate and proportionate in view of the scale and complexity of the activity of the reviewed statutory auditor or audit firm;
- reviewers shall have appropriate professional education and relevant experience in statutory audit and financial reporting combined with specific training on quality assurance reviews;
- a person shall not be allowed to act as a reviewer in a quality assurance review of a statutory auditor or an audit firm until at least three years have elapsed since that person ceased to be a partner or an employee of, or otherwise associated with, that statutory auditor or audit firm;
- reviewers shall declare that there are no conflicts of interest between them and the statutory auditor and the audit firm to be reviewed.

Funding:

Quality assurance should:

- have funding that is secure and free from any possible undue influence by statutory auditors or audit firms;
- have adequate resources;

Frequency of inspections:

Quality assurance reviews shall take place at least every six years.

Other requirements in the Statutory Audit Directive

The Directive also sets requirements for:

- auditors' qualifications (articles 3-13);
- registration of auditors (articles 15-20);
- auditors' professional ethics (articles 21-24);
- auditing standards (article 26);
- aspects of the audit process (articles 25, 27, 28);
- monitoring and investigation of auditors (articles 29-30);
- oversight of auditors by competent authorities (articles 32-36, 47); and
- regulation of third country auditors (articles 45-46).

There are also obligations in the Directive on audited entities, relating to:

- appointment of auditors (article 37);
- dismissal of auditors (article 38); and
- establishment of an audit committee (article 39).

Annex 3: Summary of the requirements for independent public oversight in Japan

Example: The Certified Public Accountants and Auditing Oversight Board (CPAAOB), Japan

Organization

The CPAAOB, an independent authority (Council) established within the Financial Services Agency (FSA), for the purpose of enhancing the audit system for the oversight of CPAs and audit firms in April 2004 based on the CPA Act amended in 2003.

The mission of the CPAAOB is to further enhance the quality and effectiveness of the auditing process, and to ensure the fairness and transparency of the Japanese capital market by fulfilling the following statutory responsibilities, thereby contributing to the enhancement of investor confidence:

- Reviews of “Quality Control Review” by the JICPA (the Japanese Institute of Certified Public Accountants), inspections of audit firms, CPAs, and the JICPA, and recommendation of administrative actions and other measures to the Financial Services Agency (FSA)
- Deliberation of disciplinary actions against CPAs and audit firms
- Implementation of CPA examinations

Governing Body Composition and Members

The CPAAOB consists of ten members, i.e. one Chairperson, and one full-time and eight part-time Commissioners. The members are appointed by the Prime Minister with the consent of both Houses of the Diet based on the viewpoint that the CPAAOB should be comprised of members from a wide range of relevant expertise on a fair and equitable basis in light of eliminating risk of biased management and ensuring public interest and independence from the professional audit society.

Due to the structure, there are no issues in terms of the majority of the Board members having to be non-practitioners. There is a restriction or recusal process that is applicable to members of the governing body who are current or former auditors/practitioners, as explained above. There is no specific requirement with regard to independence from the profession per se in a management or inspection function. Staff members of the FSA and the CPAAOB are segregated from the private sector entities as public servants. As a general rule, all CPAs at the FSA and CPAAOB are hired after leaving audit firms on a full-time basis. The CPAAOB secures prevention of conflicts of interest relating to inspection activities by composing an inspection team, made up of inspectors who have no interests in inspection firm, when approving its inspection plan of the relevant firms.

Funding Arrangements

The FSA’s budget including CPAAOB’s expenses is funded by the national budget and is unaffected by any affiliates of the public accounting profession.

Inspection System

The CPAAOB has the responsibility for recurring inspections of audit firms undertaking audits of public interest entities which are conducted directly and through oversight. The CPAAOB conducts inspections on audit firms, CPAs and the JICPA and receives and examines reports of quality control review by the JICPA and, by referencing those pieces of information, conducts on-site fieldwork at

the JICPA, audit firms and related locations. If the results of inspections show that the quality control review was not conducted properly, or CPAs/audit firms did not conform to laws, regulations and standards related to quality control of audits, etc., the Board will recommend that the Commissioner of the Financial Services Agency take administrative actions and other measures necessary for ensuring the proper operation of audit firms, CPAs and the JICPA.

The CPA Act requires the JICPA to review the status of the operation of audit and attestation services provided by its members. In this regard, the JICPA established its bylaws to conduct its quality control review once every three years in principle. However, JICPA conducts its review on the big audit firms every two years. Under the CPA Act, the JICPA is required to report the results of the quality control review to the CPAAOB periodically or as necessary. In practice, CPAAOB obtains monthly reports from the JICPA. CPAAOB conducts regulatory inspections once every three years in principle (every two years for the big audit firms¹⁶), while the result of JICPA's quality control review is taken into account as an input for CPAAOB's inspection planning.

Audit and Financial Market

In Japan, public interest audits include those of listed companies (approx. 3,500 as of December 2015) as well as certain large non-public companies and non-public financial institutions and independent administrative institutions. As of December 2015, there are approximately 214 domestic audit firms and auditors that undertake audits of public interest entities which are subject to JICPA quality control review. In addition, 7 out of 89 notified foreign audit firms provide audit and attestation services to the companies listed on financial instruments exchange markets in Japan. The Big Four firms (Deloitte Touche Tohmatsu, KPMG AZSA, EY ShinNihon and PwC Aarata) account for about 73% of the listed companies audit market.

Main other tasks:

Other tasks of the CPAAOB include

(1) CPA Examination

Based on the CPA Act, the CPAAOB implements CPA Examinations every year for the purpose of determining whether a person has the necessary knowledge and applied skills to become a CPA.

(2) Deliberation of Disciplinary Actions against CPAs and Audit Firms

When the Commissioner of the FSA consults with the CPAAOB on the disciplinary actions against CPAs and audit firms, the CPAAOB conducts deliberation. To be specific, it examines the validity, severity, etc. of said sanctions pursuant to the applicable laws and regulations; and expresses its opinions to the Commissioner of the FSA.

(* Other tasks such as registration, investigation, enforcement and standard setting in the area of auditing are performed by the FSA

¹⁶ From mid-2016, CPAAOB will conduct inspection on the big audit firms annually, which is comprised of bi-annual full-scope inspection and follow-up inspection in the subsequent year.

Annex 4: Summary of the requirements for independent public oversight in Abu Dhabi

Example: Abu Dhabi Accountability Authority (ADAA), Abu Dhabi, United Arab Emirates

Organization

The ADAA was established in accordance with Law No. (14) of 2008. ADAA performs its duties through two groups; the Financial Audit & Examination Group (FAE) and the Performance and Risk Assurance Group (PRA). FAE comprises of three departments: The Financial Audit department, the Financial Examination Department and the Accounting and Auditing Standards Department. The Financial Examination Department carries out the audit oversight responsibilities.

Governing Body Composition and Members

ADAA is an independent authority of the Abu Dhabi Government under the authority and reporting directly to His Highness Sheikh Mohammed Bin Zayed Al Nahyan, the Crown Prince of Abu Dhabi. ADAA does not have a conventional board. Instead it is governed by a Chairman, His Excellency Riyadh Al Mubarak, appointed by an Emiri Decree issued by His Highness the Ruler of Abu Dhabi upon the recommendation of His Highness the Crown Prince of Abu Dhabi.

The independence of ADAA's Chairman and employees is governed and ensured by the following Articles of its law:

- Art. (10), which states *"The Chairman, his Deputy or any employee of the Authority must not hold any other public or private employment and must not engage in any financial or commercial or professional business that may conflict with their functions and duties or distort their appearance and integrity. Nor shall they, during the term of the employment, become members of the boards of directors of any of the subject entities."*
- Art. (11), which states *"The Chairman must act independently in the exercise and performance of his functions, duties and responsibilities and must be neutral and objective. The Chairman must ensure that all employees of the Authority maintain proper standards of independence, neutrality and objectivity."*

Due to the structure, there are no issues in terms of the majority of the Board members having to be non-practitioners. There is a restriction/recusal process that would be applicable to members of the governing body who are current or former auditors/practitioners. This includes a cooling-off period for former auditors (currently five years). No members of the profession are involved in the organization (e.g. in a management function or inspection function).

Funding Arrangements

The funding of ADAA comprises of the annual budget allocated to it from the Government of Abu Dhabi, the funds collected for services provided to non-subject entities, and other financial resources which are consistent with the objectives of ADAA and approved by the Crown Prince.

Inspection System

The ADAA has responsibilities for recurring inspections of audit firms undertaking audits of public interest entities. These are performed by the ADAA itself (and not through oversight of another party). They are carried out according to an annual plan prepared based on ADAA internal risk assessment processes, which considers the financial value of subject entities, its impact as well as findings noted in prior years' inspections and which is approved by His Highness the Crown Prince of Abu Dhabi.

Audit and Financial Market

There are around 110 statutory auditors registered in Abu Dhabi. According to the ADAA mandate, ADAA has around 260 subject entities. The Big 4 firms dominate the market with more than 95% share of the subject entities.

Main other tasks

Other tasks of ADAA include issuing letters of comments to reviewed audit firms, communicating inspection findings to subject entities' Board of Directors, Audit Committees and Executive Management on the performance of individual audits by their auditors, providing advice and recommendations in addition to other procedures and services to subject entities, training and qualifying UAE National university graduates and establish training centers accordingly, conducting investigations into complaints, being a member of the Board of UAE's bodies responsible for development and promotion of the audit profession, issuing monthly publications for updates on international standards, issuing professional oversight standards and publishing an annual report including summary information about the results of audit inspections performed in the previous year (without ascribing the results to individually named firms).