THE PCAOB'S INTERNATIONAL FOCUS – THE US PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD'S ACTIVITY ABROAD

The watchdog for auditors of US public companies has been focused for some time on audits of foreign issuers on US exchanges—especially foreign issuers whose principal auditors are outside the United States. The US Public Company Accounting Oversight Board ("**PCAOB**" or "**Board**"), under oversight by the SEC, was established by the Sarbanes-Oxley Act of 2002 to "oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports." This mandate includes issuing rules and guidance, conducting inspections, and enforcement.

The PCAOB's strategic plan emphasizes a focus on non-US audit firms, and the PCAOB's public pronouncements—available here, here, here, and here—highlight its activity with respect to emerging and other non-US markets. The PCAOB specifically reports on the number of inspections conducted outside the United States—at last report, in over 51 countries since 2004. The PCAOB's Enforcement Division has reported numerous resolutions of enforcement matters with non-US firms and individuals, with such proceedings representing approximately 33% of enforcement activity between 2015 and 2019 by number of reported disciplinary orders.

In short, PCAOB inspections and enforcement activity involving non-US audit firms have been extensive and will continue, and non-US firms should be aware of and act to mitigate the compliance and enforcement risk of this scrutiny. And not only firms are at risk—PCAOB enforcement actions focus equally on individual auditors, including imposing individual practice bars and penalties in the thousands of dollars. The pandemic-related business and travel interruptions do not reduce this risk—indeed, they enhance it. The PCAOB has continued to publish disciplinary orders during the crisis, and both the SEC and PCOAB have emphasized that they view audit firms and audit quality as protectors of investors during the disruption. On April 21, 2020, in the midst of the disruption, the SEC and PCAOB issued a joint statement warning of the risks that emerging markets pose to investors and the challenges to PCAOB oversight in those markets.

This note will (i) briefly discuss the PCAOB's mission with a focus on registered non-US accounting firms; (ii) discuss the recent joint public statement regarding the SEC and PCAOB's focus on investor risk arising out of emerging markets; and (iii) examine the PCAOB's enforcement record outside the US over the past five years, looking at the number and type of

Key issues

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enforcement proceedings that the PCAOB has brought against non-US audit firms and individuals.

The PCAOB's International Reach

The PCAOB has four principal duties: (i) registering accounting firms that prepare audit reports for issuers and broker-dealers; (ii) establishing related rules and standards; (iii) inspecting registered auditing firms; and (iv) overseeing registered firms and their associated persons. Like other US financial regulators, the inspection and enforcement processes are closely aligned with referrals from the inspection team to the enforcement team, with inspections triggering investigations that can result in a settled or adjudicated enforcement outcome.

The PCAOB has jurisdiction over non-US auditing firms that have registered with the Board and has a statutory mandate to conduct inspections of all registered public accounting firms, both domestic and foreign, that issue audit reports or play a substantial role in the preparation of them. In furtherance of this mandate, the PCAOB has entered into formal cooperation arrangements with local regulators in 24 jurisdictions to minimize the administrative burdens and mitigate legal impediments to operating outside the US. "In many cases, cooperation under these agreements includes the PCAOB regularly carrying out inspections jointly with the home-country regulators." The PCAOB also participates in a number of international organizations, including principally, the International Forum of Independent Audit Regulators, the purpose of which "is to enable independent audit regulators to share among each other their knowledge and experiences, with a focus on inspections of auditors and audit firms."

PCAOB publications over the past several years have emphasized an interest in inspecting non-US audit firms subject to PCAOB oversight:

- PCAOB "inspection priorities" routinely note that the PCAOB's mandate includes inspecting multinational audits, including the work conducted by non-US auditors.
- Since the inception of the PCAOB's international inspection function, it has carried out inspections in 51 jurisdictions outside the United States.
- For 2018, the PCAOB reported that its inspections team conducted inspections of non-US auditors in 30 jurisdictions and inspected 60 non-US based firms. This number represented approximately 36% of the PCAOB's inspections that year.

The Joint Statement

The SEC and PCAOB have observed that non-US markets, in particular emerging markets, pose particular investor risk as well as challenges to the PCAOB's oversight functions, and the agencies are focused on controlling that risk. On April 21, 2020, the Chairmen and senior officials of the SEC and PCAOB issued a joint statement related to emerging market investments observing that the SEC and PCAOB are limited in their ability to promote and enforce high-quality disclosure standards in emerging markets, and that their limited ability to do so depends heavily on local authorities. With respect to the PCAOB and China, the joint statement (i) highlights that the PCAOB's inability to inspect audit work and practices of PCAOB-registered accounting firms in China regarding their audit work of US reporting companies poses significant risks for investments in China; and (ii) notes that "issuers with operations in China should make clear disclosures regarding these risks, including highlighting these limitations as a risk factor."

As part of the effort to address issues of financial reporting and audit quality in emerging markets, the PCAOB has met with senior representatives of six US audit firms and representatives of their global networks to discuss "audit quality across their global networks and the importance of effective and consistent oversight of member firms globally, including those operating in China and other emerging markets." The joint statement cautions, though, that these discussions "are not intended to be a substitute for the PCAOB inspecting audit work and practices of PCAOB-registered accounting firms in China with respect to their audit work of U.S.-listed companies," and reminds audit firms of the PCAOB's "expectations" that firms will "fulfill" their "responsibilities as auditors" including by ensuring "consistent audit methodologies across their global networks."

By the Numbers

Between 2015 and 2019, the PCAOB entered into 202 settled Orders and achieved finality in 13 adjudicated enforcement proceedings ("**Disciplinary Orders**"). Of these 215 Disciplinary Orders, 70 were against non-US audit firms, representing approximately 33% of the total number. Year-by-year numbers are as follows:[1]

Year	Total Disciplinary Orders	Non-US Disciplinary Orders	Non-US as a Percentage of Total
2015	48	2	4%
2016	58	26	45%
2017	58	23	40%
2018	20	7	35%
2019	31	12	39%

Of the non-US Disciplinary Orders Between 2015 and 2019, the most common type of violation was for modifying/altering audit workpapers after the conclusion of the audit (usually in connection with a PCAOB inspection or enforcement proceeding), followed by audit evidence/documentation/timeliness issues and quality control considerations:

Category	2015	2016	2017	2018	2019	Total
Add/Delete/Alter Work Papers	-	15	7	2	3	27
Audit Evidence/Documentation/Timeliness	-	12	4	2	2	20
Quality Control	1	5	6	1	5	18
PCAOB Reporting Obligation Violation/Pay Fees	1	2	9	-	5	17

[1] Analysis of Disciplinary Orders was conducted using publicly available information published on the PCAOB's website. The "total number" of Disciplinary Orders is the sum of each individual published order, irrespective of whether such order is against a firm, an individual, or a combination of a firm and one or more individuals. The assignment of orders into categories reflects judgment, and because many orders include more than one category of finding the category count exceeds the total order count for each year and in total.

Category	2015	2016	2017	2018	2019	Total
Failure to Comply with a PCAOB Discovery Order	-	7	5	1	-	13
Substantive Audit Failures	-	4	5	1	1	11
Professional Skepticism	-	4	3	1	1	9
Independence	-	2	3	1	1	7

Of the non-US Disciplinary Orders between 2015 and 2019 in which a financial penalty was assessed, amounts ranged between $1,000 USD and $8,000,000 USD. Just 10 of the non-US Disciplinary Orders included a penalty of $100,000 USD or more.

Year	Total Penalties	High Penalty	Average Penalty	No Penalty
2015	$15,000 USD	$10,000 USD	$7,500 USD	None
2016	$9,218,500 USD	$8,000,000 USD	$658,464 USD ($93,731 USD w/o largest fine)	14
2017	$2,067,500 USD	$1,000,000 USD	$108,816 USD	7
2018	$530,000 USD	$350,000 USD	$88,333 USD	3
2019	$1,322,500 USD	$500,000 USD	$77,794 USD	None

For non-US Disciplinary Orders with a financial penalty, the average amount was $226,784 USD. Without including the 10 largest penalties, the average was $16,740 USD. No financial penalty was levied in 24 non-US Disciplinary Orders.

The PCAOB also regularly fines individual respondents, often the audit partner, though other audit professionals are not immune from sanction. PCAOB statistics for 2019 note that, in a year in which 30 settled disciplinary orders were issued, the PCAOB sanctioned 27 individuals. Financial penalties for individuals typically range from $5,000 USD to $50,000 USD, and they are accompanied by a censure and, oftentimes, a bar from being an associated person of a registered public accounting firm with the ability to petition the Board for consent to associate with a registered public accounting firm after a specified number of years.

Year	Total Penalties	High Penalty	Average Penalty
2015	None	-	-
2016	$150,000 USD	$50,000 USD	$18,750 USD
2017	$200,000 USD	$75,000 USD	$33,333 USD
2018	$155,000 USD	$50,000 USD	$38,750 USD
2019	$60,000 USD	$10,000 USD	$8,571 USD

Areas of Emphasis

Review of the Disciplinary Orders provides insight into the areas of emphasis for the PCAOB. A number of situations comprise each of the categories above—although we note that the settled Orders generally include a clause stating that the audit firm does not admit the allegations. Examples of cited violations include:

- *Add/Delete/Alter Work Papers.* Some of the largest penalties involve cases in which the PCAOB claimed audit firms backdated, altered, or manufactured documentation presented to the PCAOB—another area of emphasis. The largest penalty—$8,000,000—involved a matter in which auditors altered work papers in advance of a PCAOB inspection and provided false and misleading information to the PCAOB. In another instance, a firm and multiple partners were sanctioned for their involvement in devising and implemented a plan to alter previously archived work papers in advance of a PCAOB inspection.
- *Audit Evidence/Documentation/Timeliness.* Examples of violations related to audit evidence, documentation and timeliness include the failure to perform tests needed to obtain sufficient evidence for a conclusion and failure to timely assemble audit documentation for retention. In one Order, for example, the respondents were alleged to have failed to test the accuracy of a classification that was critical to the client's loan reserve calculation and failed to perform retrospective reviews of the loan reserve, thus failing to obtain sufficient evidence that the loan reserve was reasonable. Here again, auditors often state that they did conduct the testing at issue, but were cited both in inspections and enforcement proceedings because their documentation did not satisfy the PCAOB.
- *Quality Control.* The PCAOB has "increased [its] emphasis on firms' systems of quality control." Indeed, upon finding a substantive audit violation, the PCAOB often draws the conclusion, with little analysis, that the firm's quality control policies and/or procedures were deficient, on the apparent assumption that a satisfactory quality control function would have prevented the violation. Examples of other specific quality control violations include partners serving as engagement quality reviewers for engagements on which they participated as auditors.
- *PCAOB Reporting Obligation Violation/Pay Fees.* PCAOB Rule 2203 requires firms to file a Form 3 to report events, such as resigning as principal auditor or the institution of certain legal proceedings, within thirty days of the event occurring. Non-US firms often overlook this requirement. A number of Disciplinary Orders sanction firms for failing to file a Form 3 to report the initiation or conclusion of disciplinary proceedings against the firm by local regulators. In fact, the enforcement numbers for 2017 reflect the results of a "Form 3 sweep" on the part of the PCAOB.
- *Failure to Comply with a PCAOB Discovery Order.* Another way to incur the ire of the PCAOB's enforcement staff is to fail to comply with PCAOB orders. Violations for failing to comply with PCAOB discovery orders included refusals by audit firm partners to respond to Accounting Board Demands or provide testimony. In one Disciplinary Order, for example, an engagement manager was sanctioned for repeatedly refusing to comply with Board demands and failing to respond to instructions from the PCAOB

to appear when PCAOB staff traveled to the engagement manager's country to take testimony.

- *Substantive Audit Failures.* The PCAOB has "placed a renewed emphasis on investigating significant audit failures" and identified "substantive audit violations" in numerous settlement orders. Cited audit failures run the gamut of violations of various Audit Standards; examples include the failure to perform procedures to test journal entries for fraud and failure to perform sufficient procedures to evaluate, for example, the reporting of certain stock transactions or the appropriateness of reporting certain costs as assets at year end. Anecdotally, auditors often complain that they in fact conducted relevant audit procedures but were cited, not only in inspections but also in disciplinary proceedings, for perceived failures to meet the PCAOB's standards.
- *Professional Skepticism.* In exercising professional skepticism, an auditor must have "an attitude that includes a questioning mind and a critical assessment of audit evidence." Examples of failure to exercise professional skepticism included audit firm partners who released audit reports despite knowing that significant analysis was still required to support lease accounting and authorized the release of audit reports without sufficiently supported lease analysis.
- *Independence.* The PCAOB has identified auditor independence as an enforcement priority, and the disciplinary orders reflect that focus. Examples of independence violations include audit firm partners with personal financial relationships with a client bank and firms that commenced audit work while fees for the previous year's work were still outstanding.

Mitigating the Risk

The COVID-19 pandemic will likely impact the number of in-person PCAOB inspections of non-US auditors and related enforcement actions in the next 12 to 18 months, although we will likely continue to see Disciplinary Orders as a result of inspections that were performed in the months preceding travel restrictions. Nonetheless, in light of the PCAOB's demonstrated enforcement patterns and professed continued vigilance even during (and especially because of) the current environment, PCAOB-registered audit firms generally, and non-US audit firms in particular, should look at their PCAOB audit programs to strengthen areas that often trigger PCAOB inspection findings and enforcement referrals.

These practice points are of particular importance for non-US audit firms for whom PCAOB work is only a small portion of their overall audit portfolio and therefore who may be less accustomed to the PCAOB's specific areas of attention. The PCAOB is highly protective of the imprimatur that a PCAOB-regulated audit provides to US issuers, and the PCAOB pays particular attention to whether a firm ensures that it has auditors in place with PCAOB-specific training and competence—even (or perhaps especially) in jurisdictions that are subject to their own sophisticated regulatory regimes, where auditors might assume that adherence to local requirements suffices. Areas of focus include:

- *Firm Competency* – Ensure that the firm's audit infrastructure and policies and procedures account for the responsibilities of conducting PCAOB audit work in-line with PCAOB standards. Review policies and procedures for the specific items below as well as broader PCAOB requirements. Ensure that PCAOB-specific information is integrated in forms for PCAOB audit work.

- *Competency and Training of Personnel* – Ensure that personnel, including audit partners, engagement quality reviewers, and other personnel involved in elements of any PCAOB audit, have received training on the PCAOB's auditing standards, rules, and guidance. Document and retain records of any such training.
- *Tailored Audit Work Papers* – Ensure that work papers used for conducting a PCAOB audit are appropriately tailored to the PCAOB's auditing standards, rules, and guidance. Using generalized or non-US specific work papers (in particular papers that cite to non-US audit standards) may trigger criticism.
- *Independence* – Ensure that policies and procedures clearly meet the PCAOB's independence requirements, including all prescriptive elements of auditing standards, rules, and guidance like those contained within PCAOB Rules 3520–3526. This includes ensuring pre-approval by the audit client's audit committee of certain non-audit services, restrictions on the use of contingent fees, and restrictions on the types of tax services a firm can provide to an audit client. Provide specific related training to firm personnel.
- *Focus on Deadlines* – Ensure that policies and procedures clearly outline deadlines for audit documentation including work paper completion within PCAOB mandated timelines. For example, audit engagement management software should be configured to include the 45-day PCAOB audit completion deadline, even if local deadlines are different. Provide specific related training to firm personnel.
- *Focus on Integrity* – Ensure policies and procedures clearly outline expectations that personnel not modify workpapers after the PCAOB audit completion deadline. Specific attention should be given to the prevention of the impulse to "clean up" audit files in advance of or during a PCAOB inspection or in response to a PCAOB enforcement investigation request. Provide specific training on properly documenting prospective additions to audit files and on candor when subject to inspection and/or investigation.
- *PCAOB Reporting and Payments* – Ensure policies and procedures include necessary periodic filings with the PCAOB and registration fee payments like the PCAOB's Annual Reporting Form 2; Special Reporting Form 3; and Annual Fee payment deadlines. Firm personnel should be assigned responsibility for fulfilling these recurring obligations and practice management software should be configured to provide timely reminders.

Although attention to these pointers will not eliminate all risk – inspections will continue to occur, and inspection findings will continue to trigger enforcement – they can mitigate that risk by avoiding areas that have resulted in significant findings and penalties in the past.

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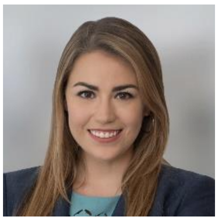

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