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*Mr. Stavros Thomadakis*

Professor of Financial Economics at the University of Athens  
Former Chairman of the Hellenic Capital Market  
Commission

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# STRENGTHENING THE CREDIBILITY AND RELIABILITY OF FINANCIAL AUDITS: PUBLIC INTEREST OVERSIGHT

Stavros B. Thomadakis

Professor of Financial Economics, University of Athens  
Former Chairman, Hellenic Capital Market Commission

## A. The Limits to Self-regulation of Auditors and Auditing

During the last five years we have witnessed many failures or near-failures in the audit function of major listed entities. Corporate scandals have damaged investors, the reputation of markets, and the perception of effectiveness of the preexisting arrangements for the audit of accounts. By and large the system inherited from the last decade of the twentieth century was one of self-regulation of the auditors and the auditing function. Even if in a few specific jurisdictions there were public regulations of auditors, these were either incapable of covering cross-border or multinational activity, or limited by law within specific national borders. On the other hand, we also inherited from the late twentieth century very serious initiatives and a significant body of work for the harmonization of accounting and auditing standards, notable examples of which are well known to the IOSCO membership. The International Financial Reporting Standards and the International Auditing Standards are the notable examples. These were developed by bodies associated with and empowered from the self-regulatory organizations of auditors. They responded to the pressing need for homogenization of standards and practices around the globe. Thus, I would frankly say that self-regulation proved successful in producing common standards usable in a global context, and also proved successful in producing sufficient grounds to the community of regulators and policymakers to work towards the adoption of these standards.

The scandals and the failures we have witnessed testify to the limits of self-regulation. It is worthy to ask: Has self-regulation proved to be a “fair weather system”, that is a system which seems to work as long as things are going well, but fails when things go wrong? A fair answer is in the affirmative, in my view. Self-regulation has many advantages the main of which is that the community of auditors who know details about behavior, conditions and requirements can impose informed and proportional self-restrictions on its members. However, when crisis or financial distress emerges, the incentives of individual auditors and audit activities become distorted. IOSCO and many other policymakers the world over have stressed the need for “auditor independence”. This independence meets its most severe stress test during the times in which audited firms experience financial distress. Distress always creates incentives for nondisclosure sometimes for legitimate reasons, but mostly not. The relationship of auditor and audited entity becomes difficult and the audited entity exerts all possible influence to have a “cooperative” auditor. How much possible it is to obtain “auditor cooperation” in such circumstances depends on several factors. Auditor independence has at least two dimensions. One is a structural dimension. It is tied to the extent of other business links

between the auditor and the audited firms, such as consulting relationships, joint interests in third parties, indirect links through cross-stockholdings, non-arms-length fee arrangements. All these elements encourage non-independent auditor behaviors. There is a second dimension. It is tied to the values, the reputation and the general organizational culture of the auditor. This is an ethical dimension. Both the structural and the ethical dimensions are necessary for the realization of independence. Both come under stress during times of financial difficulty. Both therefore need to be bolstered by public policy.

The complexity of corporate structures, the complexity and variety of financial products, and the variety of national legal reporting requirements have also played a significant role in the failure of self-regulation. Complexity and variety of treatment always leave gray areas and create windows of opportunity for non-transparent practices. That is why the homogenization of standards was necessary and formed a successful aspect of the self-regulatory regime. That is also why the homogenization of practice and standard enforcement continue to be high priority items in the present regulatory agenda of auditing standards and practices.

#### B. The Goals of Public Interest Oversight

The audit function needs to become more reliable. It must be performed well in both good times and in hard times. It must be able to give timely signals of impending distress. It must be able to provide transparency in individual as well as consolidated accounts, in single jurisdiction as well as in multiple-jurisdiction activities. It must offer sufficient comparability from one period to the next, and especially over the cycle of good and bad times. These high requirements must naturally build upon the existing system. They clearly also need to go beyond the existing system. They must make increased use of common standards of accounting and of auditing. They must also be met by a much higher ability and willingness to enforce standards than we observe in the present day.

The function of oversight can be valuable only if it creates pressures and incentives for more objective, independent and reliable audits. Oversight cannot be limited to a simple examination and approval of preexisting self-regulatory practices. It cannot limit itself to attempting to increase the credibility of erstwhile self-regulatory arrangements by simple “rubber stamping” of these arrangements. In order to enhance the independence of audits and auditors, the oversight function itself must wield independence of judgement and of action. It must be endowed with powers to reexamine and reevaluate critical aspects of the auditing system. It must be endowed with sufficient powers to impose reforms and to monitor the implementation of these reforms.

The overall goal of oversight will be successfully achieved when audits acquire a higher quality, and at the same time audits acquire greater credibility among their natural users – investors, regulators, analysts, credit raters and others. To achieve this goal, the overseeing body or bodies must maintain a highly visible and transparent policy on rules, limitations, requirements and sanctions that they impose on audit firms and on the audit relationship.

The notion of public interest in the context of oversight requires specific comment since it puts a special color and a particular viewpoint on the function of oversight. The unreliability of audited information creates negative externalities. Not only does it harm the specific audited entity to which it refers. It also creates a general harm through the erosion of confidence in audited information generally. Thus, the cost from a flawed audit of firm “x” will in fact spread to many other firms, irrespective of whether their audits conform to a high standard or not. This spillover effect on the reputation of audits and auditors is the main reason why oversight is in the public interest and the achievements of oversight will create a general increase in value and welfare, not specific benefits to specific firms.

### C. The Architecture of Oversight

Oversight can and must be organized at various levels. First of all, at the most fundamental level, stockholder interest oversight must become an integral part of corporate governance reform in every jurisdiction. The creation and functioning of audit committees within the structure of listed firms but with independence and a clear capability to oversee and intervene in the audit process is a building block in the process of strengthening the reliability and credibility of the audit function. The oversight accomplished by audit committees is in the interest of the shareholders of a particular entity. As such, it is the most well placed oversight to eliminate commonality of interest between auditors and company management or auditors, management and major shareholders, for example. It is also the best positioned oversight able to achieve transparency in the consolidation of accounts of firms with multi-level or multi-country subsidiaries. Thus, in short the oversight which functions in shareholders interests forms one of the foundations for a balanced system of activities that buttress the reliability of reporting and audits.

At the other end of the spectrum of interests, oversight in the public interest cannot of course reside in any particular firm but must of necessity be formulated as a centralized function. In many jurisdictions already, there forms a strong tendency to create a centralized oversight body that will occupy itself with quality and reliability of audits. The abandonment of self-regulation in these jurisdictions is a significant step which signals the ‘political will’ of regulators and policymakers to avert a new round of corporate accounting scandals and failures. We have of course the eminent example of the establishment of public interest oversight with the PCAOB in the US, numerous examples in other countries including the Committee of Standardization and Enforcement in my own country, Greece, and a strong prescriptive recommendation in the last draft of a European Directive on “statutory audit of annual accounts and consolidated accounts” for the creation of national authorities of oversight and enforcement within the European Union by its member states.

In the global environment with a growing share of cross-border and international economic activities and financial reporting needs, IOSCO has proposed the creation of a global PIOB for audit companies and activities which will superimpose itself to the

functions and activities of the International Federation of Accountants. This is a forward-looking proposal in several respects. First of all, it recognizes the fact that global oversight is a response to converging international standards of accounting and auditing. Secondly, it recognizes the fact that the supply of auditing services has become itself increasingly global through the operation of multinational auditing firms which undertake cross-border, consolidated and coordinated audits across national boundaries. Thirdly, it recognizes the fact that the creation of many national authorities of public oversight generates a new space and a new need for coordination and cooperation among these newly emerged regulatory organizations. Fourthly, it recognizes the fact that IFAC had already formulated the basis for self-regulatory initiatives and codes of ethics and behavior on a global setting and that the oversight of such a body of rules requires a truly international oversight body. Fifthly, it recognizes the fact that world standards of accounting and auditing are converging to a common basis in an unprecedented manner, after the experiences of scandals and audit failures.

As oversight bodies emerge and multiply at various levels, it is important to avoid the usual pitfall of complex architectures: duplication of effort, multiplication of costs of regulation and monitoring, confusion on the responsibilities and powers of the various levels of oversight, even conflicts between various oversight bodies. There is a clear requirement of efficiency in the operation of oversight, so that operation and monitoring can be done at minimum cost, no duplication and greater effectiveness. Therefore, coordination and cooperation must be on the agenda of especially the global PIOB so as to avoid the creation of avoidable regulatory costs.

#### D. The Basic Contents of Oversight in the Public Interest

Oversight in the public interest is multidimensional. Oversight in the public interest must embrace a number of aspects of the infrastructure for and the process of auditing that include a public interest component. I can list some indicative areas.

Auditors and audit firms must be subject to robust professional ethics. The starting point is necessarily the cogent code of ethics adopted by the Ethics Committee of the International Federation of Accountants (IFAC). Further specific rules may be necessary to elaborate the principles or to take into account recent experiences in markets around the world. Rules on confidentiality and professional secrecy are an integral part of the ethics of the profession. They are also very important for the protection of normal markets, but must nevertheless not stand in the way of enforcement of financial reporting requirements, or the exchange of relevant information between competent authorities when it comes to investigation and sanctioning of malpractice.

The basic principle of auditor independence implies that a statutory auditor or an audit firm must be independent from the audited entity and shall in no way be involved in management decisions of the audited entity. This means that the auditor must not be able to accept any audit engagement which would endanger his independence. An auditor must also be able and obliged to refuse any non-audit engagement which might compromise his independence as an auditor. The auditor must document all significant

threats to his independence as well as the safeguards which are applied to mitigate those threats. The Public interest oversight body can examine whether further measures are necessary that might lead to the total prohibition for an auditor to offer non-audited services to his audit client. It must also be considered that the fee for a statutory audit should be adequate to allow proper audit quality, but that the fee cannot be influenced by the provision of additional services to the audited entity. The respect of these principles, together with that of independence should be the central subject of audit quality assurance reviews by a Public Interest Oversight Body. In this context, the oversight body must also factor the existence, the strength, the independence and the contributions of entity-level audit committees which act for the benefit of shareholders.

Along with the principle of independence there is a need for special attention to be devoted to conflicts of interest and their influence upon the audit function and the quality of auditing. Auditors may face conflicts of interest from a variety of sources: stockholding relations with audited entities, parallel activities (consulting, advocacy) of companies associated with auditors, competitive circumstances with other auditors, auditor knowledge of clients, lenders or other service providers of the audited entity. All these circumstances may be conducive to conflict, although they do not necessarily prove that conflict actually exists. Rules for the elimination or at least the proper disclosure of possible sources of conflict are clearly within the purview of public interest oversight.

All audits should be carried out in accordance with International Standards on Auditing (ISA). At present, ISAs (International Standards on Auditing) are established by the International Auditing and Assurance Standards Board (IAASB), a private organization. In order to be able to endorse international standards on auditing, the Public Interest Oversight Body will determine whether the standards are accepted internationally and whether they have been developed with proper due process, and transparency. Furthermore, the standards must be assured of attaining high quality and clarity, and must contribute to the annual accounts and the consolidated accounts that show a true and fair view of audited entities. Finally, there must be a 'quick response' mechanism for the correction, adjustment, adaptation and enrichment of the standards as experience accumulates. The system of periodic review of standards appears to be a good starting point for such an undertaking.

There is finally the requirement for all statutory auditors and audit firms to be subject to a system of quality assurance. This entails at least two sides that must be subject to review from the standpoint of public interest. The first side is the quality of service provision, which relates to the education, the professional qualification of auditors, as well as the organizational, technical and governance features of the audit firms. These are elements that must be examined ex-ante, and must be reassessed periodically for auditors and audit firms in as uniform a manner as possible around the world. The second side relates to ex-post quality controls. The reexamination of performed audits requires a whole system of actions (selection, depth of reexamination, time frequency, sanctions) which must be expressly described, agreed upon and enforced. The criteria to be applied for such a quality assurance system including both ex-ante and ex-post activities are clearly within the priority areas for the activities of a Public Interest Oversight Body.

E. Concluding Remarks

The era of self-regulation for the oversight of auditing has come to an end. It is widely recognized that the protection of investors, the integrity of markets and the stability of financial systems demand a public interest function in the area of audit oversight. I believe that IOSCO will continue to be a strong advocate and a protagonist in the efforts for the formulation of oversight at all levels and in all jurisdictions, and a frontrunner in the plans for international oversight arrangements in the public interest.

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