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IOSCO RESPONSE TO ACCOUNTING SCANDALS

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A healthy accounting and auditing profession is fundamental to a healthy capital market.

Investors base their investment decisions on information in published audited financial reports. It is important that they can rely on the veracity of those reports and the credibility of their endorsement by the auditor. The ability for investors to have faith in these reports lies at the very core of disclosure regimes and is vital for building and maintaining confidence in the capital markets.

Confidence in the integrity of capital markets has been at risk of being deeply shaken by the highly publicized collapses and scandals which began with Enron in 2001. Accounting and auditing irregularities were revealed in many of these, as they often are in enforcement matters that come before regulators. Enforcement actions in areas such as insider trading and corporate fraud frequently have fundamental issues relating to the validity of the financial reporting and auditing processes.

Today I want to tell you about the responses by the International Organisation of Securities Commissions – IOSCO – to strengthen and protect confidence in financial markets and stimulate international capital flows in the wake of these scandals.

First though, let me introduce you to IOSCO.

IOSCO and the *Principles*

IOSCO has over 100 member agencies that regulate more than 90% of the world's capital markets. It is recognised as the international standard setter for securities regulation by such august bodies as the World Bank, the International Monetary Fund and the Financial Stability Forum. This recognition flows from IOSCO's *Objectives and Principles of Securities Regulation* which were endorsed by members in 1998. This very significant document was the fruit of years of collaborative work by regulatory bodies across the globe.

The 30 IOSCO *Principles* support the fundamental purposes of securities regulation which are investor protection, fairness, efficiency and transparency in the operation of the markets and the reduction of systemic risks.

The *Principles* are flexible and can be applied in a variety of jurisdictional structures and regulatory environments. They are the fundamental reference for benchmarking and assessing a jurisdiction's securities regulation. The *Principles* are used by the IMF and the World Bank in the Financial Sector Assessment Programme.

How IOSCO works

IOSCO members work together for better regulation at both domestic and international levels to maintain just, efficient and sound markets. IOSCO achieves its goals through cooperation and is remarkably successful in this respect. The work of IOSCO is carried out by committees – the Presidents' Committee which encompasses all members, the Technical Committee, the Emerging Markets Committee, and the Executive Committee which oversees the work of IOSCO and of which I am the current chairman. IOSCO closely monitors developments in the international securities markets, identifies issues as they arise and sets up working groups and project teams to address particular issues.

Responses to corporate collapses and scandals

IOSCO has responded very effectively to international issues and corporate scandals of recent years. For example, on 12 October 2001, IOSCO announced a Project Team to explore actions that securities regulators should take in view of the events of 11 September and their aftermath. This led to the development of the *Multilateral Memorandum of Understanding concerning Consultation and Cooperation, and the Exchange of Information* – the IOSCO MOU.

Endorsed by members in 2002, the IOSCO MOU enhances the ability of securities regulators to conduct cross-border investigations of securities fraud. It has proved to be a very timely and useful instrument for combating international financial misbehaviour.

Another IOSCO Task Force was set up in early 2004 to identify potential issues arising from recent corporate collapses and suggest suitable regulatory initiatives to address them. The ensuing *IOSCO Report on Financial Fraud* highlighted two key weaknesses of the international regulatory system. The first was that internationally accepted regulatory principles were not universally applied; and the second was that regulators and law enforcement agencies were hampered in their enforcement actions by the inability to exchange information and coordinate investigations across borders.

New Strategic Direction

This led to the bold step taken this year when members adopted a new strategic direction for IOSCO. It has a two pronged approach with clear aims to directly address the weaknesses identified by the Task Force. The first is to encourage and assist all jurisdictions to implement the IOSCO *Principles* and thus raise the standard of securities regulation worldwide. The second is to increase the number of jurisdictions that are signatories to the IOSCO MOU, and thereby enable effective cross-border enforcement actions. IOSCO members appreciated the urgency with which this is needed and agreed to a deadline for members to become signatories, or to commit to becoming signatories, by 2010.

Before members can become signatories, they undergo a rigorous screening process to ensure they have the legal capacity to fully comply with the terms of the IOSCO MOU. This can present challenges for jurisdictions. However, on the other hand the benefits of joining may bring greater credibility for their capital markets, recognition by international bodies and increased capital flows. Members who meet the IOSCO MOU requirements also demonstrate that they have implemented certain parts of the IOSCO *Principles*.

The IOSCO MOU has already created a valuable cross-border network for efficient and timely information exchange by regulators. There are 28 signatories to the MOU and an additional nine listed on Appendix B which is a commitment to remove legal obstacles to becoming a signatory. More than 300 information requests were made between signatories in 2004 and similar trends are evident this year. New Zealand was accepted as a signatory in

2003 after rigorous scrutiny and has benefited from the assistance it has received from counterparts overseas in a number of inquiries.

There is no doubt that cross-border cooperation is critical to the successful investigation and prosecution of securities violations at the domestic level. The IOSCO MOU facilitates this cooperation. There is also strong international interest in the IOSCO MOU and its value for closing regulatory gaps between national jurisdictions.

Assistance programmes

IOSCO backs up its ideals and aspirations with assistance programmes. It has a practical *Methodology for Assessing the Implementation of the IOSCO Principles.* This is used to assess a jurisdiction's implementation of the *Principles* and identify reforms needed for full implementation.

The IOSCO General Secretariat in Madrid runs training courses in using the methodology. It also arranges for experts from other IOSCO members to help jurisdictions with their assessment and implementation processes, and with the reforms needed to become a signatory to the IOSCO MOU.

Funding can be a problem for jurisdictions wanting to undertake the regulatory reforms needed to implement the *Principles* and become a signatory to the MOU. IOSCO assists by arranging external funding for this work.

Communication and dialogue

An essential part of the new strategic direction is IOSCO's commitment to communicate with key stakeholders and global players in the securities markets. It has a comprehensive website www.iosco.org, publishes its reports, and releases information to the international news media. A new venture has been to hold conferences in New York and Frankfurt, bringing together professional associations, business and industry representatives, academics and regulators.

These have been highly successful in promoting dialogue and sharing ideas on the effective regulation of the world's securities markets. The next of these forums is in London in

November 2006. With this commitment to openness and discussion, the cooperative spirit of IOSCO is permeating to a wider group, a feature that augers well for the future.

IOSCO Responses Relating to Accounting and Auditing

IOSCO has long acknowledged the critical importance of high quality accounting principles and high quality audits of public companies. It has encouraged the improvement of International Financial Reporting Standards and to this end has worked closely with the International Accounting Standards Committee and more recently the International Accounting Standards Board.

In October 2003 IOSCO members endorsed two statements on auditing - *Principles for Auditor Oversight* and *Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence*. They noted that oversight of auditors can occur in several ways but stressed that "*within a jurisdiction auditors should be subject to oversight by a body that acts and is seen to act in the public interest*".

The nature of the auditor oversight body and the way it carries out its activities may differ among jurisdictions. However, the body should be independent of the profession and it must have an appropriate membership, a charter of responsibilities, and adequate powers and funding to carry out those responsibilities.

It should have processes to review the audit procedures and practices of firms that audit listed public companies; it should be able to stipulate remedial measures for problems, and to initiate disciplinary proceedings to impose sanctions on auditors and audit firms where appropriate.

All round the world we have seen independent oversight established. At the international level IOSCO, the World Bank, the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors and the Financial Stability Forum, in conjunction with the International Federation of Accountants, have established the Public Interest Oversight Board. This oversees the work of IFAC's auditing, ethics and education standard-setting committees. This is an example of the accounting profession recognizing the importance of both actual and perceived independence of the profession.

The PIOB is setting up its headquarters in the same building in Madrid as the IOSCO General Secretariat – another example of worthwhile cooperation!

Yet another example is my appointment, in my IOSCO role, to the International Accounting Standards Committee Foundation's Trustee Appointments Advisory Group. The other appointees are from the Financial Stability Forum, the African and Asian Development Banks, Inter-American Development Bank, IMF, European Central Bank, and the World Bank. The Advisory Group will help the IASC Foundation's Trustees discharge their responsibility for nominating and appointing highly qualified and interested individuals as Trustees.

Also working at the international level is the Audit Oversight Roundtable Group of independent audit regulators. This Group is trying to bring structure and clarity to audit oversight, given that not all IOSCO members have audit oversight roles. It includes the Financial Stability Forum, the World Bank, IOSCO, the Basel Committee, the PIOB and the European Commission.

Last month the Group met to discuss progress on establishing audit regulators independent of the accountancy profession, arrangements for cross-border exchange of information, concentration in the audit market, the independence of auditors, and issues raised by the multi-jurisdictional structure both of audit firms and the entities they audit.

The Group also discussed a global approach to supervision of the Big 4 audit firms. The number of truly global audit firms has reduced as a result of mergers and the loss of Andersens. This is of real concern. These firms are needed to audit the very large global corporates.

Some national auditor oversight structures are the Public Company Accounting Oversight Board in the United States and the Professional Oversight Board for Accountancy in the United Kingdom. Australia has the Auditing and Assurance Standards Board responsible for setting auditing standards which have force of law, and the Financial Reporting Council which monitors auditor independence.

It should be noted that this call for oversight bodies is not a reflection on the integrity of the profession. International auditors are welcoming oversight bodies and the actual and perceived independence they provide. The profession in New Zealand should also welcome such a body.

Survey on the Regulation and Oversight of Auditors

In 2004 IOSCO developed a *Survey on the Regulation and Oversight of Auditors*. The goal was to obtain a baseline picture of the structures and processes used to regulate and oversee auditing around the world.

The survey also sought to identify the extent to which the auditor oversight arrangements in place in 2004 met the recommendations in IOSCO's *Principles for Auditor Oversight* and *Auditor Independence.*

The findings revealed that these IOSCO principles have been broadly implemented in most of the Technical Committee jurisdictions - that is, the US, Ontario and Quebec, Mexico, Japan, Hong Kong, Australia, the UK and many European countries. However, the Report concludes that *"…. a great deal remains to be accomplished to create auditor oversight structures and quality assurance processes that fully encompass the IOSCO principles."*

The picture provided by the Survey is a mixed and changing landscape of auditor oversight arrangements. There are many variations in the approach, structure, and methods used in member jurisdictions. However, the existence of such variations was taken into account in the general principles issued by IOSCO.

Nearly all jurisdictions that took part in the survey have laws and regulations to address the conduct of auditors and the oversight of the audit profession. Most have a formal body with direct oversight of auditors, but these bodies differ widely in their powers and responsibilities, source of funding, level of activity, degree of independence from the audit profession, and level of oversight by government.

Requirements for auditors, in terms of education and training, vary considerably around the world and in some cases vary within a jurisdiction. Requirements for supervision of audits of public listed companies also vary considerably, and there are significant differences between developed markets and emerging markets.

Many countries are examining and enhancing their legal frameworks, professional customs and practices, regulation of auditors, and corporate governance over financial reporting. Initiatives are underway in the European Union to strengthen auditor oversight and the quality of audits.

IOSCO encourages international organizations with responsibilities and interests in audit matters to use the information from the baseline survey to enhance auditor oversight and quality assurance.

IOSCO Committee of Chairmen on auditing - non-audit services

IOSCO recently set up a Chairmen's Committee to address auditing issues from the perspective of securities regulators. One particular area of interest is that of auditors providing non-audit services to audit clients.

The potential compromise to auditor independence when a firm provides non-audit services to an audit client is a primary area of concern emerging from corporate fraud and accounting scandals. When a firm provides non-audit services to an audit client it creates an environment that is ripe for actual and perceived conflicts of interest. These conflicts may damage auditors' objectivity and professional skepticism and consequently harm investors' confidence in the audit and the financial statements.

The ensuing harm to capital markets has resulted in new or strengthened laws, regulations and standards in many countries which restrict or eliminate the provision of non-audit services to audit clients of public accounting firms. The sharper focus on this aspect of auditor independence is a positive development for investors.

However, for capital markets to benefit from increased investor confidence, the rules need to be robust, well understood and complied with across borders. Each jurisdiction must ensure that there is understanding of, and compliance with, auditing requirements.

Different prohibitions on non-audit services in various jurisdictions create problems for regulators and for auditors. An auditor may provide a non-audit service to a client in a jurisdiction where that service is not restricted, but that client may issue securities in a jurisdiction where providing that service breaches securities law. The new IOSCO Chairmen's Committee on Auditing will examine these issues.

International Financial Reporting Standards

The adoption of IFRS in many jurisdictions and their use in cross-border transactions should help convergence towards high quality global accounting standards. IOSCO believes that a mechanism to share information that will promote consistency in implementing IFRS is vital.

To this end a system is being set up for IOSCO members and other enforcement organisations to share information. Each national regulator will deal with issues in its own right, but the system will facilitate consistency. IOSCO will provide a database of decisions made by regulators on application of IFRS. This will be a reference for future regulatory decisions. The database is expected to be operational in the second half of 2006. Participating regulators will also be able to contact each other to discuss decisions.

IOSCO will also monitor the implementation of IFRS and refer any indicators of likely issues to the International Accounting Standards Board or the International Financial Reporting Interpretations Committee.

IOSCO Task Force on Corporate Governance

IOSCO has also set up a task force on corporate governance. This is expected to focus initially on the issue of independence of the boards of listed companies and levels of conformity with the relevant OECD principle. It is currently finalising the outline of a survey of securities regulators.

Uncooperative jurisdictions

Finally, another important IOSCO initiative is to identify the jurisdictions that present the greatest risks to fair and efficient markets and financial stability, and to talk with them about compliance with IOSCO standards. The aim is to identify obstacles to cooperation and seek resolutions to problems. In some cases IOSCO will arrange for technical assistance. These dialogues are kept confidential.

In conclusion

IOSCO is a truly remarkable international organisation. Despite the disparity of its membership, it succeeds by cooperation and consensus. IOSCO has responded promptly and effectively to the financial scandals and corporate collapses of recent years. Its solutions in the form of the IOSCO *Principles* and MOU are raising regulatory standards and helping combat securities fraud.

IOSCO has contributed considerably to the debate and the body of research relating to accounting and auditing in recent years.

IOSCO has made tremendous practical progress on difficult issues that affect securities markets worldwide. True to form, IOSCO has developed practical assistance programmes that can be tailored for jurisdictions that help raise standards while respecting domestic characteristics. But the work is not yet done. The task of encouraging jurisdictions to raise their standards and join the MOU continues. There is also much work to be done in the areas of accounting and auditing.

IOSCO will continue to provide opportunities for dialogue between all market participants with the aim of achieving appropriate, efficient and fair standards for securities regulation. This in turn will increase the integrity of the markets and bring benefits for both investors and issuers of securities.

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