

FEE Conference on Audit Regulation
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Closing Keynote Speech
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(France)

Ladies and Gentlemen,

It is indeed a great pleasure and honour to be with you this afternoon and I would like to thank Jacques POTDEVIN for this invitation to offer some closing remarks at this meeting organised on Audit Regulation. As I have been involved in this matter for many years, I would like to share with you my analysis on the progress we have made collectively and the issues we still need to address.

When I joined the club of securities regulators, end of 1995, audit quality and audit supervision were quite hot issues and views would radically differ among professionals and regulators. Nonetheless, globalisation, together with a series of crisis which took place at the beginning of the Millennium, have speeded up a process of converging reforms which have been implemented both at the national and the international level, as it appeared to all market participants that audit quality was key for the good functioning of fair and efficient markets. Today, we can take stock of what has been achieved in the field of standard setting and international cooperation.

But we should also recognise that a lot remains to be done with regard to audit quality.

- Let me first remind you of the most significant improvements we have seen and which are indeed still in progress in the field of standard setting and audit supervision.

- With regard to standard setting, the reform of the IAASB, which started in 2003, has recently been completed by the E.U. 's decision to formerly be part of the new architecture by joining the Monitoring Group which gathers the main international regulatory organisations and monitors the whole process. We now have an institution which is composed of a well balanced group of skilled practitioners and non practitioners and which delivers audit standards according to a process which is supervised by a Public Interest oversight board, appointed by the Monitoring group. This new organisation provides technical quality, accountability and legitimacy.

We can therefore be optimistic with regard to the “clarity project” whereby the IAASB has undertaken to update and complete the International Standards for Audit. As ISAs have gained in credibility, it is good news that the E.U. Commission has recently announced its initiative to consider the merits of using ISAs in Europe. Before the end of this year, it will launch a study on the costs and benefits of introducing ISAs

as well as on the differences between international and US auditing standards.

By the same token, on the occasion of the meeting of the technical Committee of IOSCO in Tokyo, three weeks ago, IOSCO adopted a public statement on International Auditing Standards and is currently evaluating under what conditions it could endorse the use of ISAs for cross border purposes. This initiative is quite similar to the one we took ten years ago, which ended up with the endorsement of the core standards of the IASC in the year 2000.

While the US SEC has recently recognised the International accounting standards, having both internationally recognised accounting and auditing standards is no more a utopia and would be a major progress for global financial markets. I'm not sure many of us would have bet on such an outcome 10 years ago.

- Standard setting is one thing, implementation is another story. Hence the importance of the parallel efforts which are developing all over the world to better organise the supervision of audit firms and audit practice, starting with the creation of the US PCAOB

Independent oversight is essential to improving audit quality and strengthening public confidence and the days of self regulation are clearly over, even if this does not mean that the professional organisations should not participate in promoting good practice among their members.

Europe has committed itself to this global effort and has required member states to implement its 2006 Directive and set up public oversight bodies and efficient external quality assurance systems to ensure high audit quality through out the Community. The European group in which oversight bodies meet regularly is, of course, an important tool to achieve this objective in a consistent way.

We have also seen a welcome initiative at the Global level, with the setting up of the IFIAR and I personally favour the participation of this new grouping in the global framework which aims at improving audit standard setting and implementation.

All these initiatives should pave the way to international cooperation and mutual recognition.

In Europe, the 8th directive addresses this question and empowers the Commission to assess the equivalence of the oversight systems of third countries with a view to, if they are deemed equivalent, entitle member states to rely on third country oversight. Of course equivalent systems does not mean identical.

This process will obviously take time. Criteria need to be consistent and transparent, and based on clear principles: firstly the independence of the public oversight bodies, which requires an appropriate nomination procedure, governance by a majority of non practitioners, and an adequate funding. Secondly, a robust quality assurance process which should

be independent, under the ultimate responsibility of the oversight body.

Bilateral discussions have started among the key global players and Europe and the US have agreed, in March 2007, to launch roadmap discussions on the equivalence of their respective auditing systems.

The equivalence mechanism has proven to be fruitful on the accounting side. Recent events have shown that radical changes may take place at a remarkable pace. IFRSs have recently been accepted without reconciliation in the US for foreign private issuers presenting their financial statements under IFRS as published by IASB. This decision was adopted by the American authorities in less than five months after issuance of a proposal for comments. Moreover, although it was originally anticipated that they would only be applicable from 2009 or 2008, these new measures are in fact already applicable to the 2007 year-ends. Based on this very promising evolution, I hope that the equivalence mechanism will shortly be brought to a successful issue for audit regulation so that we may avoid costly overlaps without reducing investor protection.

- Let me now move on to the wider issue of audit quality. The ENRON traumatism has led to a transformation of the audit profession and the audit regulation.

Although this profound reform took place a couple of years ago, the public's perception still appears to be mitigated and the

expectation gap has not yet been closed. This is one of the conclusions that may have shocked auditors present at the IOSCO Roundtable held on 1 June 2007 in Paris.

Recommendations suggested by some of the panellists to improve audit quality included the following: making auditors' reports more relevant and informative to investors, as some panellists felt that the current standard is not optimal; closing the "expectations gap" by improving fraud detection by auditors and the corresponding reporting; relying on internal auditors of large companies to aid in the external audit under the oversight of audit committees in order to minimise conflict of interests.

It is worth mentioning at this stage that earlier this year, CESR published a study regarding the communication of the auditors which confirms that auditors' report could usefully be enriched.

Implications of auditor liability and possibilities for reform were other issues considered during the Roundtable. The panellists focussed, in part, on introducing liability caps for auditors and debating whether adherence to transparency and corporate governance principles by audit firms should be a prerequisite to liability reform. Insuring risks incurred by audit firms appears to raise many problems linked to the lack of clear information provided by them and to the fact that their business model is not correctly understood by insurance and reinsurance companies.

The causes, extent and effects of audit firm concentration on audit quality from a variety of perspectives completed the discussions. While the current situation, where we have four big

truly global firms, is not ideal, it is not untenable. Noticing however that there is a lack of auditor choice in all major economies, the panellists recommended measures to prevent further concentration and loosen the current concentration among firms capable of auditing the largest listed companies. Suggestions included instituting an enhanced audit committee report, re-evaluating the effects of restrictions on audit services and joint auditor requirements. Regarding this latter point, it is seen by some not only as a means to open up the market and allow more firms to access the largest global audits, but also, and more importantly, as a help to promote audit quality.

There have been a number of recent initiatives with the objective of improving choice in the audit market; especially in the UK, where the idea has been mooted that ways should be found to open up audit firms from their current partnership-only investment model to a system where they could accept capital from outside investors. Although some have raised concerns with regard to the consequence of external shareholder pressure on the quality of audit, it is perceived by others as a quick way of enabling smaller and mid tier firms to grow and gain the sort of critical mass they will need if they are to challenge the Big 4 for some of the top-end audits. To audit the very biggest and most complex companies requires a huge and international capability that the many mid-tier firms or other new entrants would take years to develop. And to a certain extent, I do not believe that many of them even want to compete to audit the very largest companies. However, they are already competing for smaller

listed companies and we are encouraged by the growth taking place in firms outside the Big 4. Their continuing improvement in size and expertise is good for our markets and should allow the companies – in particular for small, medium and even larger issuers – to have additional choices, which I believe is important for the resilience of the audit profession.

The Commission services have recently published an independent study on the ownership rules that apply to audit firms and their consequences on audit market concentration. The study reiterates that an audit firm owned by external investors, instead of auditors, might take more easily the decision to expand into the market of large audits. One of the reasons given is that existing ownership structures may be estimated to increase audit firms cost of raising capital by perhaps as much as 10%. However, there is no silver bullet and restrictions on access to capital are only one of several potential barriers such as reputation or the need for international coverage that prevent smaller firms or new entrants from competing.

Another measure with a view to increasing choice in the audit profession is to require more information to be given to shareholders by audit committees regarding the reselection of auditors. It would be all the more so useful as the selection of an auditor sometimes appears to be the result of a passive tacit renewal rather than a thoughtful conscious decision. As a matter of fact, statistics show that certain listed entities have kept the same auditor for several decades...

Regulators are also called upon to consider a proportionate reaction to audit failures so that, in the words of Paul BOYLE ‘a toothache doesn’t become a brain tumour’.

In the US, the Treasury Secretary Paulson set up an Advisory Committee which stems from the capital markets competitiveness initiatives. The Treasury has charged the Committee with developing recommendations taking into consideration the issues impacting the sustainability of the auditing profession. The Advisory Committee met for the first time in October and is expected to deliver its report by June 2008. The outcome of this group, which I attend as an observer, promises to give food for thought.

Participants in the IOSCO Roundtable included representatives from the financial analyst and investor community, regulators, public companies and audit firms. The constructive dialogue and concrete ideas for improvement expressed at the Roundtable and in the various initiatives will help securities regulators to consider how to improve financial reporting and audit quality in the context of our investor protection mission. IOSCO is in the process of digesting this material and may well deliver a consultation document seeking the comments of market participants. We will, in particular, try to identify what are the main expectations regarding an audit and also the possible answers that regulators, the profession and others could provide to meet these expectations.

Finally, if we go deeper into the factors that contribute to audit quality, we, of course, arrive quickly at the auditing standards issue which I addressed earlier and where we can see on going progress.

- I cannot avoid closing my remarks without saying a few words on the turbulences which are affecting the global credit markets and which raise a practical issue of audit quality. Although it may be too early to draw lessons from recent events, it appears that this crisis derives from a series of causes. In the context of high liquidity and low interest rates, we have seen credit discipline deteriorating seriously, inadequate risk pricing and ambiguous risk transfer. When market participants became conscious of the situation, we saw and continue to see market paralysis, liquidity crisis and even interbank market disfunctionment.

The growth of the structured finance market was supported by a particularly strong demand from institutional investors looking for higher yields. This situation raises questions not only for prudential supervisors and central bankers but also for securities regulators and is an open invitation for us to review the robustness of our own standards and principles. With regards to the concerns of securities regulators, apart from the role of the credit agencies and the muddy transparency of the underlying assets of securitised products, the issue of the valuation of structured products is central and is particularly relevant to the audit profession. It leads to the broader issue of accounting

standards, risk modelling and the information given by financial institutions on their exposure to these products.

Let's focus on fair value accounting for a moment. If there are publicly available market prices, the auditor may verify that current values faithfully represent market values. However, the absence of liquidity and hence information on market prices means that the auditor becomes more dependent on managers' judgement and assurances about the values of some assets. Auditors may have to express an opinion on a 'mark to model' estimate which Warren BUFFET has suggested may become 'mark to myth'... How does a current value balance sheet, when some such values cannot be properly substantiated, contribute to adequate assessment of future cash flows for decision making? For financial statements to be useful to investors, they must be both relevant and reliable. They must be relevant in the sense that they give investors the type of information they need to decide whether to buy, sell or hold a security. They must be reliable in the sense that the numbers reflect the economic results and are accurate. Auditors play a key role in this respect. Advocates of fair value accounting maintain that it holds the promise of offering investors more relevant information, especially compared with historical data. This advantage may however be lost if the information is not necessarily reliable. The increased use of fair value poses a challenge for auditors. Firstly, valuation requires training. Secondly, auditors should be mindful that preparers can be biased, even if unwittingly so, in their assessment of fair value, and they may fail to consider

alternative scenarios. Thirdly, auditors should keep in mind that internal controls surrounding fair value measurements may be different from those over typical business transactions. In summary, fair value accounting represents an area of potential audit risk.

As the year-end approaches, everyone is asking what auditors are going to do about valuations in the hope of uniformity. The profession is very aware of being under scrutiny. The US Centre for Audit Quality issued last October statements to auditors outlining the relevant US accounting provisions on three topical subjects linked to market turmoil: valuation of illiquid financial assets, consolidation of commercial paper conduits and accounting for underwriting and loan commitments.

These recent events have revealed that good coordination exists amongst financial regulators around the world and demonstrated the reactivity of international organisations. The Financial Stability Forum has set up a working group of chairmen to analyse and draw lessons from the crisis. Among other initiatives, auditors have been asked by the FSF to undertake a similar study as that of the US but based on IFRSs rather than US GAAP. It is remarkable to have the whole profession work jointly on such a key issue. It would be highly welcome if this initiative could lead to the delivery of a document that would foster greater transparency and uniformity, in time for companies' 2007 year-end financial statements.

In order to contribute to the FSF's work, IOSCO has decided to set up a chairmen's task force on the subprime crisis that I have the privilege to chair. The Task Force, in conjunction with securities regulators and the financial services industry, will examine how they have responded to the recent crisis, the lessons that can be learned and what further work may need to be done by IOSCO. The Chairmen's Task Force will concentrate its work in the areas relating to Risk Management and prudential supervision; transparency and due diligence; and Credit rating agencies. It goes without saying that Valuation of assets and accounting issues will be of paramount importance. The Task Force, in order to evaluate potential problems raised by the accounting treatment of structured products, will also consider the special purpose vehicles issue in order to better analyse the mechanisms whereby SPVs are kept off balance sheet and the possible implications in terms of risk measurement and information to investors.

It is anticipated that the Task Force will present its final report to the Technical Committee in May 2008, during IOSCO's Annual Conference in Paris.

To conclude these remarks, allow me in this period of turbulence to express an optimistic opinion based on the progress we have seen since a decade in the field of market regulation.

Ten years ago, regulators and auditors were clearly opposed in endless conceptual battles on the merits and limits of self regulation, on the relevance of combining audit and non audit activities, on the very nature of independence.

Today we have a consistent global framework and a road map towards international standards, mutual recognition and effective cooperation. Obviously this will not put an end to the ever ending opposition between greed and fear, nor to the economic cycles which characterise free market economies.

Let us hope, nonetheless, it will provide a better management of globalising markets through the proper implementation of well accepted and more efficient standards to deal with the quality of financial information which is a core asset of free market economy.