

CONVERGENCE AND AUDIT REGULATION

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Ladies and gentlemen, good morning.

I want to congratulate FEE for organizing this very timely and important conference. My thanks go to the organizers of the conference for the invitation to speak to you today.

My subject, “convergence and audit regulation” includes two pillars, each of which is of great importance to the many debates that have developed since the financial reporting scandals of the early 21st century (Enron, Worldcom and others). “Audit Regulation” arose largely as a response to these crises: they were perceived as – and actually were – big audit failures. “Convergence”, on the other hand, has been a goal of high priority as world markets have continued to become global, and especially since this trend intensified visibly during the financial boom that followed the crisis of 2000.

Needless to say, these issues closely relate to the PIOB’s experience over the last four years, gained during the process of overseeing international standard setting in the areas of audit, ethics and education. Moreover, and perhaps more importantly, the discussion about “convergence and audit regulation” is closely connected to new policy debates about the current, very serious crisis and the methods for tackling not only the consequences of this crisis but also its causes.

New regulation, convergence and globalization: the role of standards

I would start with two premises which capture essential aspects of the current situation and the response to crisis.

The first is that the failure of market discipline that has so obviously led to the financial crisis provides ample justification for applying external regulation. Self-regulation is widely perceived to have failed in areas such as financial competition, over-the-counter markets and credit rating. By implication, financial activity will be subjected to a high degree of scrutiny, and supervision will become far more intrusive than it has been in the last three decades.

The second premise is that financial crisis will inevitably precipitate a set of unique local responses. Despite an existing number of international arrangements for cooperation, policy coordination, and global initiatives, the bulk of decisions on how to tackle the crisis are emphatically national. If we look at either measures for bolstering the financial system or at fiscal stimulus packages, this assertion is as self evident as the previous one.

As the combination of these two premises implies a new era of heightened national regulation, with no guarantee that this trend will lead naturally to consistent or harmonized national regulatory regimes. The need to achieve convergence in regulation will emerge more strongly

Having said that, I should acknowledge that the European Union has in place many structures and institutional pressure points to ensure achievement of harmonized regulations. Yet, as those of us who have worked with European policymaking well know, harmonization is neither easy nor automatic but on the contrary requires a great deal of energy and commitment. Furthermore, if we look at the global picture where the institutional arrangements for harmonization are far less present and far less demanding than within the European Union, the most likely outcome will be a set of regulatory arrangements that can prove to be quite divergent. Thus, a pessimist would come to the conclusion that, when this crisis has run its course, the emerging order will be one of great diversity, creating a breeding ground for new barriers to international activity, trade, investment and economic mobility.

In short, a reversal of globalization as we now know it.

Nevertheless, there are also sufficient grounds for long-term optimism. In the era of new locally focused regulation, divergence can have a clear limit. If local regulation is built on common precepts, subscribes to common principles and implements common standards, then divergence may occur in form but not in substance. Globalization as we know it will change but will not be reversed: it will simply operate under a more highly governed, institutionalized and supervised process. The development of precepts, principles and standards that can serve a new globalized order stands out as the main buttress of this optimistic view and as an indispensable element of the infrastructure of the international economy.

Consequently, no one should doubt that the process of developing common precepts, principles and standards has acquired new importance and has become more pressing because of the present crisis. Many official pronouncements, including the statement of the G-20, allude to this and stress the need for standards that have global legitimacy and applicability.

What makes good regulation?

The rise of new regulation brings back to center stage an old question: What makes good regulation?

My immediate response to this question is actually very simple: “Good Regulation serves the public interest through supporting the building and maintenance of confidence in processes, such as the market process, in which the public participates and in activities, such as auditing, on which the public relies”. Regulation can thus be seen as the mechanism providing confidence in the reliability of financial markets and services generally, and financial reporting in particular.

For good regulation to deliver public interest results it must take into account different and often competing aims and objectives. This necessitates that general precepts must be agreed that may help to assess whether particular regulation is “good”. It has unfortunately become a truism nowadays that markets function more effectively when supported by an underlying sense of trust. I don’t need to justify this statement in the present context when we are witnessing massive consequences from the lack of trust.

Regulation is an outcome of the way society perceives and responds to risk and to excessive risk taking. Regulation may be defined as the combination of organizations, rules, and sanctions that result in behaviors consistent with orderly markets, accountability, transparency and stability. A major objective of regulation is to safeguard the public interest by maintaining protection of economies from systemic risks, and protection of market participants from unwanted, opaque or unacknowledged private risks. This applies especially to investors who feed the markets with

their savings, but also applies to others who trust financial intermediaries to safeguard their deposits, provide risk protection and ensure stable and reliable income for retirement. It is in that context that good regulation should be viewed as a driving force for reliable and high quality financial services.

Regulatory reform is a response to widespread perceptions of inadequacy of existing systems, and to crises when they happen, as in the present instance. Whether we like it or not, very clear problems do require urgent action to avoid a complete loss of trust and confidence that would undermine the entire market system. In the same way that air will move swiftly to fill a vacuum, regulation too increases swiftly to fill a perceived vacuum in governance, transparency, accountability or confidence.

In the context of regulatory reform, debate is always bound to arise about the relative merits of principles and rules; some suggest that the two approaches are mutually exclusive. This is certainly not the case. Principles often include rules to assist in their implementation. Similarly, rulebooks often contain options where different actions and potentially quite different results still meet the objectives of the rules.

We can be confident that some people will ignore legal requirements regardless of their form of expression. Others will look to circumvent the law by acting within its letter but ignoring its spirit, exploiting fine print and loopholes. However, the vast majority that aim to do the right thing will achieve that outcome equally well under a system guided by principles or by rules. My preference for principles stems from a desire for relationships based on trust rather than suspicion. If we trust someone simply because legal sanctions apply for breaking rules, we do not, in fact, trust them at all.

You can find a parallel to the principles versus rules debate in discussions focused on self versus external regulation. Some commentators suggest that the approaches are at opposite ends of a spectrum of desirable institutional arrangements. This thinking is fundamentally flawed. It does not necessarily follow that the more you have of one type of regulation the less you need of the other. The question should not be how much or how little of each type of regulation is necessary.

Rather, each type of regulation should complement the other. The aim is to establish a mix of policies and institutions that facilitate orderly functioning of the market, promote trust and build up confidence.

I mentioned before the broad precepts that might be used to assess whether regulation is indeed “good”. Let me enumerate those I consider sufficient and acceptable.

The first precept is *Transparency*. The making of regulation should be subject to rules of transparency and accountability.

The second precept of good regulation is *Proportionality*. Regulation should be designed to serve clear objective not diffuse agendas.

Effectiveness is my third precept of good regulation. Regulation should be subjected to evaluation especially with respect to implementation results.

Finally a good regulatory system must exhibit *Flexibility*. Regulation should allow room for honest judgment, even honest mistakes so as not to stifle initiative and innovation.

Any system of regulation imposes requirements on somebody in order to achieve a level of protection and reliability for somebody else. If we are truly looking for continuous improvement in the provision of services, then regulation must allow for innovation.

So, in summary, four precepts promote the development of good regulation: necessity, transparency, proportionality, effectiveness and flexibility. The acceptance of these precepts in various jurisdictions will maintain a global space in which convergence can remain feasible and efforts towards convergence can flourish.

Regulation and Audit Quality

Let me now come to the question of Audit Quality, how regulation can usefully promote it, and how will progress towards convergence in audit quality be supported.

It is well established international practice that regulation of audit quality takes place at two distinct levels and with two distinct processes.

The first major contributory factor to audit quality is the existence of standards of high quality, standards that underlie the practice of audit by auditors. The standards most people focus on relate to audit practice, better known as ISAs. These are currently being considered for adoption in the EU. However, audit practice is also supported by two other bodies of standards: professional ethics and professional education, which together with standards of audit practice create a system developed through the efforts of three independent international standard setting bodies. These boards operate under the auspices of IFAC but are also subject to direct oversight by the PIOB which works to ensure that standards are set consistently and with due regard for the public interest. Thus the regulation of standard setting is subject to international supervision, on which I will elaborate a little later in my remarks.

The second major contributory factor to audit quality is the way in which standards are implemented and directly applied in the field. The policies and actions that determine the quality of implementation are basically dependent on national bodies, including national audit regulators, which must coordinate internationally. I will also elaborate on this aspect of audit quality.

Let me first share with you insights and prospects from the international aspect of audit quality that we supervise at the PIOB: international standard setting. As many of you know the Clarity project of the IAASB is drawing to a close. In the last week, the PIOB deliberated on twelve standards finalized by the IAASB in September. We decided that the process followed for the crafting of these standards and the scope of the standards were consistent with the public interest and approved their eventual publication. This week, and as we speak, the IAASB is deliberating

on the final group of standards encompassed by the Clarity Project, and the PIOB is expected to consider those next February. With the completion of the Clarity project, several processes that involve the endorsement and adoption of standards will get on track. The European Commission will proceed with the evaluation of the studies commissioned earlier on as well as its final consultation. In due course, the European Parliament will consider a final vote on a resolution for the implementation of the 8th Directive. IOSCO will also consider a final endorsement of ISAs. In general, the completion of Clarity will fire up the adoption process in many jurisdictions.

This upcoming flurry of adoption activity will require attention both from the IAASB and the PIOB. From our side specifically, we will continue to devote additional effort and resources to public dissemination of our oversight activity and the process we employ so that international standards put together by a “private” body of standard setters can acquire wide legitimacy by being independently tested against the public interest.

There are some who still argue from a perspective that is not valid anymore: they say that international standards are standards controlled by the profession, by the big audit firms, by IFAC. All these are false. The standard setting bodies are composed of equal numbers of audit practitioners and non-practitioners. They include public members who provide a special breadth of public perspective, and non-voting observers who provide critical input from the perspective of the world’s major capital markets. The standards are subjected to scrutiny by Consultative Advisory Groups whose composition includes major regulatory and public interest organizations. They are subject to broad consultation and accountability. They are monitored on a continuous basis by the PIOB which, in addition, conducts its own independent reviews of due process. They operate under a due process that is transparent, inclusive and pre-approved by the PIOB. All these safeguards seek to obtain a quality of standards which incorporates technical expertise and also remains responsive to the needs of a broad range of stakeholders and the international public interest. The standards should therefore be evaluated from that perspective.

There are also some who argue that now the clarity project is almost over, public oversight of standard setting has fulfilled its mission. This, too, is false. The IAASB has a full agenda of post-Clarity projects, some involving the revision of clarified standards and others developing new

standards. I have no doubt that as the world comes to grips with the effects of the present crisis, both these needs will increase, and furthermore, public interest considerations for the formulation of revised or new standards will become even more demanding. Moreover, as I said at the outset, audit quality is not solely dependent on ISAs. It is also premised on ethical behavior and professional education. Therefore, standard setting in those areas will also remain a matter of high priority.

Lastly, I would like to address issues related to the other aspect of audit quality: the successful implementation of standards. Implementation will be the new field of policy effort as adoption proceeds. Convergence of audit practice and audit quality will clearly depend on multiple actors and the influence of multiple factors. Audit firms which develop methodologies for audit practice will shape the way their members approach their audit tasks. Large network firms must work to make sure that their methodologies are faithfully implemented across their networks. Smaller firms will shape their practice based on implementation guidance provided by the standard setting bodies which in many cases will be, or will be assisted by, national or regional accounting bodies. Audit regulators will also play an important role by ensuring compliance with the received standards and by developing common principles and standards for their own regulatory practice. The formation of an international forum of audit regulators – IFIAR – is a promising platform for this work on convergence of audit quality in major jurisdictions around the world.

Thus, implementation and convergence of audit quality is a complex international task that will require all of the features mentioned earlier during my remarks on the desirable characteristics of regulatory models. The use of principle based standards for audit and for regulation, the formation of an appropriate mix of external and self-regulation and the establishment of transparent, flexible, effective regulation are guarantees for the achievement of high quality in audit practice.

The PIOB is itself involved in an important aspect of implementation through its oversight of the IFAC member body compliance program. This program is now quite far advanced and is making good progress in its approval of action plans which member bodies put together to ensure alignment with their membership obligations. These include their “best endeavors” to implement

international standards of audit, ethics and education. This program can prove to be a very important support for worldwide implementation of international standards and convergence of audit practice and audit quality. As such, it should receive the support of policymakers, regulators, regional organizations such as FEE, and advanced country member bodies who can offer assistance to developing country bodies. I know that several members of FEE are offering such assistance already and want to encourage these initiatives.

Crisis, as we are living it today, always underlines the need for coordination. For some time, we at the PIOB have used our Public Reports to express our views on the need for cooperation and coordination to achieve measurable results in serving the international public interest in the area of financial reporting and audit quality. As noted in these same reports, we are committed to promote and participate in these efforts wherever appropriate and will continue to do this with even greater intensity as we go forward.

Thank you.