The Complex World of International Auditing Regulation

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Executive Summary

The contemporary development of international audit regulation is connected to the growing significance of international investors who demand financial reports that are prepared and audited in accordance with globally accepted international standards. International Standards on Auditing (ISAs) are set by the International Auditing and Assurance Standards Board (IAASB), an independent standard-setting board working within the International Federation of Accountants (IFAC) and subject to public oversight by international regulators. ISAs have been adopted in more than 100 countries, but their practical impact depends centrally on how they are implemented and enforced. In recent years, there has been a greater emphasis on such issues.

Introduction

The development of international audit regulation is closely linked to the development of international accounting regulation. Both have been significantly associated with the globalization of capital markets and growth in importance of international investors. Such investors expect the financial reports of the companies they are investing in to be fair and reliable, with auditors playing a critical role—famously categorized by Paul Volcker in 2002—as the "guardians of truth in markets".

Audit regulation is centrally concerned with the issue of ensuring that auditors are competent and independent. These attributes ensure that auditors are capable of both detecting significant errors and omissions in financial status (competent), and faithfully reporting these to investors/stakeholders in the enterprise (independent).

Broadly defined, audit regulation has the same four basic elements of any regulatory system—namely a concern and involvement with the setting, adoption, and implementation of standards and, through monitoring and enforcement processes, ensuring that such standards are applied in practice.

Following this introductory section, the chapter reviews the setting of international auditing standards (ISAs). This includes the role of international regulatory bodies in supporting this process, and the demands they have made of the standard-setting body and the international accounting profession more generally. In the third section, issues of compliance and oversight are discussed, including recent developments in international coordination through the International Forum for Independent Audit Regulators (IFIAR). The fourth section examines the role of the big audit firms in international audit regulation, and the final section presents conclusions and some thoughts for the future.

Setting Global Standards

International Standards for Auditing (ISAs) are set by the International Auditing and Assurance Standards Board (IAASB), which is situated within the International Federation of Accountants (IFAC) —a private organization whose member bodies are the national associations of professional accountants in each country. At April 2009, there were 157 member bodies of IFAC, representing 122 countries and around 2.5 million professional accountants worldwide, with a current operating budget of US$18 million. IFAC recently celebrated its 30th anniversary, having been formed in 1977, four years after the International Accounting Standards Committee (IASC), which was the predecessor of the International Accounting Standards Board (IASB).

The members of the IAASB are a mixture of practicing professional accountants (especially members of the large audit firms) and persons from outside the profession. A number of important global organizations have supported the development and application of ISAs, which are now used in more than 100 countries around the world.[1] These include the Financial Stability Forum (FSF), a body set up by the G7 Finance Ministers and central bank governors in 1999 in the wake of the financial crisis in Asia in 1997/8.[2] The objective of the

FSF/FSB is to strengthen financial systems and ensure the stability of international financial markets, and, as part of this remit, it designated 12 key standards and codes as most relevant to strengthening financial systems. Both International Accounting Standards (IASs/IFRS and ISAs were included in this group (the only private standard-setters to be included).[3] These 12 standards and codes were seen as “best practices” associated with the legal, regulatory, and institutional framework for financial systems.

The International Organisation of Securities Commissions (IOSCO) is another important organization in this respect. Despite the FSF’s inclusion of ISAs in its leading globally recognized standards and codes, the endorsement of ISAs by IOSCO has proven to be a more problematic and longstanding issue. In 2008, one can find IFAC and other accounting bodies such as the ACCA, PwC and Institut der Wirtschaftsprüfer in Germany urging IOSCO to move promptly to endorse ISAs on the grounds that they are already in widespread, international usage (see IOSCO, 2008). IOSCO does appear to support the development of high quality, internationally accepted auditing standards by the IAASB (which it considers as beneficial to global capital markets), and to be actively monitoring the situation. Public speeches by staff involved[4] have suggested that IOSCO will formally endorse ISAs for cross-border purposes once IAASB has completed its Clarity Project, with the 2008 annual report of the IAASB stating that liaison with IOSCO continues on the issue of ISA endorsement and that a “positive solution” is looked forward to in 2009 (p. 12).

IAASB’s Clarity Project, started in 2004, was completed in February 2009.[5] The project’s aim was to ensure that ISAs have clear objectives and that each standard distinguishes what the auditor absolutely shall do when carrying out an audit, from guidance on how to achieve this. In the process of clarification, some standards have ultimately been revised quite considerably (and more than was originally anticipated). In total, the Clarity Project has produced 36 updated and clarified ISAs, and a clarified International Standard on Quality Control (ISQC). The standards are to be applied to audits of financial statements for reporting periods beginning on or after 15 December 2009.

The EU similarly continues to review the feasibility of a formal EU endorsement of ISAs. In 2003, the European Commission issued a communication titled *Reinforcing the statutory audit in the EU*, announcing that it intended that ISAs would apply to all statutory audits in Europe. It emphasized, though, that this required the public interest to be fully taken into account in the IAASB’s standard-setting processes, with a subsequent communication reiterating that the EU needs to be content that ISAs are “developed with proper due process, public oversight and transparency”, and that IFAC’s governance arrangements are adequate to ensure the pursuit of the public interest, specifically that the standards are “conducive to the European public good”. In the Statutory Audit Directive issued on May 17, 2006, it repeated this message, while at the same time the text of the directive indicated that it was expected that ISAs should become EU’s auditing standards, ultimately to be legally binding in all member states.

IFAC has moved towards satisfying these demands through establishing an active Public Interest Oversight Board (PIOB), and, as indicated above, has developed ISAs through the Clarity Project. The members of the PIOB have been selected by leading institutions in the international regulatory community, including IOSCO, the Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS), the European Commission, World Bank, and the FSF/FSB. Included in the activities of the PIOB is monitoring all the meetings of IFAC’s standard-setting committees, making this a very active process of oversight. Thus, IFAC appears to have satisfied one of the regulators’ requirements to improve governance arrangements by clearly including the public interest.

The ISAs are moving towards being the global standards for auditing, although the US is, as yet, not abandoning its own auditing standards. Up until 2002, the American Institute of Certified Public Accountants (AICPA) was responsible for setting standards for auditors, but, in the wake of the Enron scandal and others like it, that responsibility was removed from them and given to a new independent body under the supervision of the Securities and Exchange Commission (SEC). This Public Company Accounting Oversight Board (PCAOB) has its own processes for setting independent audit standards, and extraterritorial powers of regulatory reach in relation to audits of US-quoted companies. The SEC’s proposed roadmap for US-listed companies to move to IFRS is currently under consultation. Supportive action here could certainly aid the chances of ISAs becoming truly “world standards”, although there are signs that the Obama administration is less keen than its predecessor on IFRS adoption.[6]

It is also important to point out that, while scandals such as Enron regularly illustrate the international significance of both auditor independence and competence, international independence standards remain some way off. While IFAC's Code of Ethics for Professional Accountants[7] provides a potential international regulatory solution in this area, the lack of international consensus on the issue of auditor independence is such that regulation here is more likely to be of national or regional orientation, influenced strongly by related legal structures.

Compliance and Regulatory Oversight

As was noted at the start of this chapter, a regulatory system is not just about standard-setting but also the implementation and enforcement of such standards. Historically, issues of compliance with international auditing standards were not given enormous emphasis at the global level—reflecting a range of factors, including the desire to increase the number of countries adopting such standards, a limited level of available resources, traditions of self-regulation and professional peer review, and the clear positioning of responsibilities for compliance, regulation, and oversight activities at the national rather than the international level.

One of the most active and visible initiatives in this area has been the ROSC (Reports on Standards and Codes), program set up by the IMF and World Bank in 1999, which examines the degree to which emerging and developing countries are using key standards and codes (defined to include ISAs and IASs as benchmark standards for each individual country's reports on accounting and auditing practices). The formal remit is to: "annalyze comparability of national accounting and auditing standards with international standards"; and "assist the country in developing and implementing a country action plan for improving institutional capacity with a view to strengthening the country's corporate financial reporting regime".[8]

IFAC increased its focus on global compliance issues with the launch in 2004 of its compliance program, overseen by the Compliance Advisory Panel (CAP), which seeks to ensure that member bodies are meeting their membership obligations. Formally, this program has three main elements, comprising: an assessment by each member body of their country's regulatory and standard-setting framework; a self-assessment questionnaire of the extent to which each member body is using its best endeavors to adopt international accounting and auditing standards, and maintain quality assurance and enforcement regimes to ensure such standards are applied in practice; and the development of action plans to further the global accounting and auditing standards convergence process, and address any issues/weaknesses identified in the self-assessment questionnaire. IFAC, "in the interests of transparency", has chosen to post all the responses received from member bodies on its website, for full public access.[9]

These initiatives are dealing with the general issue of compliance, but not with the actual compliance of a particular audit firm with ISAs and other standards. In reaction to the problematic audits of Enron, Global Crossing, and other large companies, in July 2002, the passing of the Sarbanes-Oxley Act replaced the self-regulation of the US auditing profession with a system of independent inspection by the Public Company Accounting Oversight Board (PCAOB). Similar initiatives have followed in other countries, and there is a whole new international emphasis on auditor oversight as an essential feature of audit regulation. This oversight is, for obvious reasons, done at local level on a national basis. However, the Sarbanes-Oxley Act did not exclude foreign registrants on US stock exchanges from the requirement for oversight by the PCAOB. This appears to have encouraged a number of large countries to establish their own auditor oversight systems in the hope that there will be mutual recognition of each other's systems. This, however, has only occurred to a small extent, resulting in a considerable amount of extraterritorial activity by the PCAOB audit inspectors.

The issue of public oversight developed further on the international stage through the establishment in September 2006 of the International Forum of Independent Audit Regulators (IFIAR).[10] IFIAR is committed to sharing knowledge and experiences of the audit market and associated regulatory activities between independent national audit regulatory agencies. It seeks to promote collaboration and consistency in regulatory activity and to act as a platform for dialogue with other organizations with an interest in the quality of auditing. There are currently 28 independent national regulators who are members of this new international organization, including the PCAOB. Observers at IFIAR meetings include the FSF, IFAC's

PIOB, IOSCO, IAIS, World Bank, European Commission, and the Basel Committee, again reflecting the increasingly interlocking nature of international regulatory relationships.

The multi-layered nature of such regulatory arrangements is well illustrated by the fact that the European Union itself had previously established a European Group of Audit Oversight Bodies (EGAOB) in December 2005, with the specific remit of ensuring effective coordination of new public oversight systems of statutory auditors and audit firms within the European Union.[11] The press release announcing the EGAOB development cited the view of Commissioner McCreevy that this "group will help to make public supervision systems a reality in all 25 member states, promoting practical day-to-day cooperation as it goes along. It is a key initiative in our drive to bring EU audit rules into the 21st century and restore faith in the profession". The European Commission recently reiterated its views on the importance of public oversight, with a recommendation (May 13, 2008) on external quality assurance for the statutory audit of public interest entities. This expands the responsibilities of public oversight boards and emphasizes that they should play an active role in the inspections of audit firms.

The Global Regulatory Involvement of Audit Firms

A recent interesting development with respect to public oversight was the presentation by the CEOs of the six largest global auditing firms at IFIAR meetings in Norway (April 2008) and South Africa (September 2008) to consider global quality monitoring arrangements. This section considers the growing involvement of the large audit firms in international audit regulation.

During the last two decades, there has been a continued increasing concentration in the international auditing profession, with the large firms getting a greater share of the audit market. The "big eight" firms of the past are now reduced to today's "big four" of PwC, KPMG, E&Y and Deloitte—with the next two largest firms, BDO International and Grant Thornton International, being quite a lot smaller. Gradually, through a variety of pressures, often driven by major corporate collapses and financial crises, such firms have sought to ensure greater global consistency in auditing practice, such that an audit, for example, in China by PwC is equivalent to one conducted by the same firm in, say, Sweden. Through internal processes of regulation, they place pressure on parts of their network where audit quality and associated quality control procedures are apparently insufficient, and thus act as an "internal" or "self" regulatory pressure towards harmonizing standards.

The audits undertaken by the "big five" in Asia at the time of the crisis (1997–98) were sharply criticized by the World Bank, and it was this that stimulated the big five to set up a global steering committee. One of the aims was to provide a body to deal, on a collective, global basis, with the common professional and regulatory issues they were facing. Another aim was to strengthen IFAC as the global audit standard-setter. Under this initiative, the large firms supported IFAC financially, and were allocated seats on each of IFAC's standard-setting boards. In the case of the newly established IAASB (previously the International Auditing Practices Committee), they had five seats out of a total of 18. This greater engagement of the big firms with IFAC continued to grow, especially in the wake of the Enron scandal and its aftermath, with the establishment of a new organization, the Global Public Policy Committee (GPPC).

The GPPC comprises the six largest international accounting networks, and focuses on "public policy" issues for the profession. The GPPC has a Regulatory Working Group and a Standards Working Group, and, while much of its work is undertaken in private, it does issue policy papers where it expresses its commitment to working in the public interest, and facilitating the functioning of global capital markets (see GPPS, 2006). The global firms' involvement in international regulatory affairs has also seen them expand the scale of financial support that they provide to IFAC, which now receives approximately one-third of its funding from the large firms. The firms can also be seen to be making substantial efforts to further strengthen their own global organization, with a number announcing restructuring plans to align member firms more tightly within global structures/networks and introduce "enhanced" audit practice standards (see *The Financial Times*, August 20, 2008).[12] The current financial crisis has witnessed a continuing major involvement with global regulatory matters, driven by the direct consequences that auditing work could have for global financial stability through decisions relating to the valuation of "toxic" assets and the auditor's determination as to whether audited enterprises are "going concerns".

Maintaining Public Interest in Global Regulation

While the global audit regulatory arena is complex, it is possible to draw out a number of important characteristics. While contemporary audit regulation engages directly with audit practice at the national level, it is being driven primarily by events and strategic action at the global level. The development in this global regulation of audit has been rapid during the current decade, and, associated with the identification of reliable financial reporting, is becoming an essential part of a wider international financial architecture. Significant strategic actions have been made by international organizations such as the EU, IOSCO, FSF/FSB, and the World Bank to aid, support, and increasingly mandate the usage of international standards on auditing. While these organizations are primarily governmental in character, the main international audit standard-setter, the IAASB under the auspices of IFAC, is classified as private in nature, as are the large audit firms who are also closely involved, albeit in a less public way. This has placed particular emphasis and significance on the development of public oversight regimes as a way of ensuring that international audit standard-setting processes are seen to be globally credible and sufficiently responsive to public interest demands (see IFAC, 2008; PIOB, 2008). The policy recommendations emerging from the November 2008 meeting of the G20 likewise highlighted the importance of regulators serving the public interest, and the global importance of making sure that financial markets operate in the most transparent of fashions. The current financial crisis is testing global regulatory structures to their limit, and it is pretty certain that auditing will remain a fascinating field—both to observe and to debate in an open and constructive fashion. It could be argued that serving the public interest deserves no less.

Making It Happen

For international audit regulation to meet the claims laid out for it, in terms of global scope and consistency of application, requires a variety of actions and commitments on the part of the international financial regulatory community. Some of the more frequently mentioned priorities include:

- ISAs to be fully endorsed by international financial regulators;
- ISAs to be adopted globally for listed company audits;
- IFAC to continue to operate as an international organisation acting in the global public interest;
- Greater global coordination of the work of audit regulatory and oversight bodies;
- Enhanced visibility of the quality and achievements of audit work.

More Info

Websites:

- IAASB (2009): www.ifac.org/IAASB/
- IFIAR Charter (undated): www.frc.org.uk/images/uploaded/documents/IFIAR%20Charter1.pdf

References

- IFAC. *Regulation of the Accountancy Profession*. New York: IFAC, 2007.
- IFAC. *International Standard Setting in the Public Interest*. New York: IFAC, 2008. IOSCO. *Contingency Planning for Events and Conditions Affecting Availability of Audit Services: Final Report*, Technical Committee of the International Organization of Securities Commissions. Madrid: IOSCO, 2008.
- PIOB. *Third Report of the PIOB*, Madrid, Public Interest Oversight Board, 2008.

Abbreviations

ACCA	Association of Chartered Certified Accountants
AICPA	American Institute of Certified Public Accountants

BCBS	Basel Committee on Banking Supervision
CAP	Compliance Advisory Panel
EU	European Union
FSF/(FSB)	Financial Stability Forum/Board
GPPC	Global Public Policy Committee
GPPS	Global Public Policy Symposium
IAASB	International Auditing and Assurance Standards Board
IAIS	International Association of Insurance Supervisors
IFAC	International Federation of Accountants
IFIAR	International Forum of Independent Audit Regulators
IFRS	International Financial Reporting Standard
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISA	International Standard on Auditing
ISQC	International Standard on Quality Control
PIOB	Public Interest Oversight Board
PCAOB	Public Company Accounting Oversight Board
ROSC	Report on Standards and Codes (World Bank)
SEC	Securities and Exchange Commission

Notes

1 See www.web.ifac.org/download/2008_IAASB_Annual_Report.pdf

2 The FSF was re-established as the Financial Stability Board (FSB) in April 2009. See www.fsforum.org/press/pr_090402b.pdf

3 See www.fsforum.org/cos/key_standards.htm

4 See www.sec.gov/news/speech/2007/spch121007lj.htm

5 See www.web.ifac.org/clarity-center/index

6 See www.webcpa.com/news/Accountants-Uncertain-IFRS-Roadmap-50340-1.html

7 See www.ifac.org/Ethics/Resources.php

8 See www.worldbank.org/ifa/rosc_aa.html

9 See www.ifac.org/ComplianceProgram/

10 IFIAR's formal charter can be found at www.frc.org.uk/images/uploaded/documents/IFIAR%20Charter1.pdf

11 See www.europa.eu.int/rapid/pressReleasesAction.do?reference=IP/05/1596&format=HTML&aged=0&language=EN&guiLanguage=en

12 See www.ft.com/cms/s/0/198b3e42-6edd-11dd-a80a-0000779fd18c.html?nclick_check=1

See Also

Best Practice

- Best Practices in Risk-Based Internal Auditing
- Effective Financial Reporting and Auditing: Importance and Limitations
- Has Financial Reporting Impacted on Internal Auditing Negatively?
- Implementing an Effective Internal Controls System
- Incorporating Operational and Performance Auditing into Compliance and Financial Auditing
- Optimizing Internal Audit

Checklists

- International Financial Reporting Standards (IFRS): The Basics
- Sarbanes–Oxley: Its Development and Aims
- Understanding Internal Audits

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