



## “Audit regulation: the quest for international harmonisation”. FEE Conference on Audit Policy

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The aim of my intervention is to convey a single clear message: the relevant role of audit in financial markets and the importance of achieving a harmonised regulatory framework based on common high quality standards.

I think we all here share the view that one of the main challenges for public authorities and private players in the current crisis situation is to restore public confidence in the functioning of world capital markets.

One essential ingredient of any sensible strategy to pursue that goal is to enhance transparency of the current economic and financial situations of all issuers of securities in financial markets.

That, in turn, requires a sensible accounting code and an effective preparation of financial statements by the reporting companies. But the availability of true and fair information on issuers depends very much on the quality of audit work.

Indeed it should not come as a surprise to hear the request made by several stakeholders to enlarge the scope of audit work in order to provide more assurance to investors. I appreciate the recent work by the International Auditing and Assurance Standard Board on this matter.

Likewise, I obviously welcome, as well, the green paper on audit issued by the European Commission.

I believe that this paper is an honest effort and a timely invitation to reflect on some key aspects related to the auditing activity.

The scope of the paper is quite broad but I would like just to focus on a few relevant points: the structure of the market, conflicts of interest and the adoption of ISAs.

As a general remark, I share the concerns on the current degree of concentration in the audit market. This concentration raises risks for the good functioning of the market and makes the allocation of audit services worldwide vulnerable to a possible crisis of one of the large firms.

At the same time, on the basis of the available historical experience, it should be acknowledged that the scenario of a possible disruption in the audit market –while potentially adverse for capital markets- cannot be deemed as having large systemic implications as for instance the crisis of a big financial institution could have.

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In that vein, any measure aiming at reducing the degree of concentration should be carefully calibrated so as not to generate distortions that could dampen quality of the services provided.

As a concrete example, some stakeholders are proposing to use regulation to stimulate the performance of joint audits by teams of different firms.

However, there is not much experience available and some of it –although not all- points to possible adverse effects on audit quality. Taking this into account, I think it would be sensible to perform an impact assessment on the proposal, as suggested by the European Parliament, before adopting a definitive legislative action on this matter.

Something similar could be said on ways to mitigate conflicts of interest.

I do agree that some restrictions should definitively be introduced to limit the provision of non-audit services to audit clients. More aggressive measures –such as an across the board ban on non-audit services by audit companies- should be subject to a thorough cost-benefit analysis as they may entail relevant risks for the audit sector.

A related issue is mandatory rotation of audit firms. After many years of debate about this matter we have not achieved consensus. It is clear that both sensible pros and cons of regulating rotation can be identified. An idea that we –in ESMA- have supported is to consider introducing a recommendation on this matter subject to a comply or explain mechanism.

That should be accompanied by a more intense involvement of the Audit Committees in the selection procedures for the external auditor.

As with the previous proposals, the introduction of formal regulatory obligations on this field should be preceded by a rigorous assessment of the relative size of potential benefits and drawbacks.

Let me now turn to the issue of regulatory convergence in the field of audit and the role of ISAs in this regard.

As you know, between 2006 and 2009 the IAASB performed an intensive revision and clarification of the ISAs in an exercise called “Clarity Project”.

I agree with the EC, IOSCO and other organisations that the “clarified ISAs” are more robust than previous versions. In particular, they deal with issues that the crisis has revealed as highly relevant such as changes in the nature of audit evidence regarding fair value accounting or the reporting based on estimations and sensitivities.

Yet, the EC is considering whether it would be convenient to introduce the ISAs in the EU through binding or not binding legal instruments. That is of course a politically sensitive matter.

We, in ESMA have expressed an opinion in favour of formally adopting ISAS in the EU through an endorsement system akin to the one in place for IFRS.

This system incorporates a good balance between ultimate regulatory sovereignty and a sort of delegation on an independent international technical board.

I think that we can all agree that the availability of common high quality global standards for both auditing and accounting would significantly contribute to more integrated world capital markets and to foster confidence of all market participants: Something that we badly need at present to overcome the most adverse effects of the financial crisis.

Having said that, it is clear that, despite some relevant progress, the international standard setting framework in the field of audit is less developed than in the field of accounting.

Indeed, in the financial reporting area a well respected, independent and highly competent international body, the IASB, issues international standards that are widely applied throughout the world.

Of course, there are still some relevant problems and uncertainties: for instance about the future SEC's approach on financial reporting for domestic issuers in the United States. Still, the overall picture is quite positive with respect to the prospects for harmonising accounting principles around the globe.

Moreover, as you all know, in the last years some measures have been taken to assure the protection of public interest in the accounting standard setting activity. Indeed the financial crisis has shown that there is a need to enhance the channels through which the IASB is sufficiently accountable to public authorities.

That was mainly the reason for establishing a Monitoring Board composed of capital market authorities and in which IOSCO plays a relevant role. In addition, the IFRS Foundation is revising its own governance structure, precisely to ensure a proper distribution of responsibilities between the technical board, the Foundation itself and the public authorities represented in the Monitoring Board.

In the field of auditing there exists as well a structure for the development of international standards and for the monitoring of their compatibility with the public interest. Indeed, as you all know, several Boards –under the IFAC umbrella- do conduct intensive work for the development of professional standards relating to audit, ethics and education.

The work conducted by those boards is widely respected. However, the formal adoption of the standards issued by these bodies –in particular, the ISAs- is not as wide as the acceptance of IFRS. Although local auditing rules are often based on international standards, we are still far away from a sufficiently harmonised regulatory framework.

As any effort towards harmonisation, progress can only be made if sufficient political will exists so as to delegate a certain portion of national regulatory sovereignty.

We know that, as a matter of fact, the intensity of that political willingness is not homogeneous across jurisdictions and varies over time.

Yet, adoption of international standards would be greatly facilitated if all relevant stakeholders feel confident in the technical quality of the standards and, in particular, that national authorities do trust the existing mechanism to ensure the satisfaction of the public interest.

In this regard, it is worth recalling that, unlike other standard setters –such as the IASB-, the IAASB –and the other IFAC boards- are mostly composed of individuals who do not work full time for that organisation.

Indeed, most board members have been nominated by audit firms pertaining to IFAC professional structure.

This may generate some potential conflicts of interest that need to be controlled through an appropriate governance structure and effective mechanism to preserve the public interest.

In fact, much progress has been made to date to establish procedures to strengthen the technical independence of standard setters and to monitor the public utility of the work they conduct.

You all recall that in 2003, after a series of corporate financial reporting failures with great public impact that undermined confidence in financial reporting and auditing, a set of reforms was adopted to ensure that the standards reflected the public interest.

This reform was a consequence of the dialogue maintained, between IFAC and six regulatory and international financial public institutions, on the importance of having high quality audits of public companies financial statements.

As a consequence of that, a more varied composition of the IAASB and of the rest of the IFAC Boards was achieved. At present half of the members nominated by IFAC membership are non practitioners. Moreover, there are a minimum of three members per board representing the public interest.

The IFAC reform also entailed the creation of the PIOB and the Monitoring Group.

The PIOB is in charge of overseeing that due process is followed in the process of establishing international auditing standards and that the public interest has been properly taken into account. The Monitoring Group monitors the entire process and the PIOB activity and can give guidance to the different bodies. This group is currently composed of representatives of the Basel Committee on Banking Supervision, the European Commission, the International Association of Insurance Supervisors, the World Bank, the Financial Stability Board and the International Organisation of Securities Commissions. IOSCO holds the chair of the Monitoring Group.

IFAC reform was definitively an important step-forward to strengthen the professional standard setting procedures. The relevant activity performed since then by the IAASB, the ethics and the educational boards has benefited from those improvements.

Still, although I only became chairman of the Monitoring Group a couple months ago, it has not been difficult to identify some deficiencies in the organisation that should be solved as soon as possible.

Those deficiencies affect primarily the composition of the professional boards, the role and structure on oversight bodies and the financing of the organisation.

In what respects composition of the standard-setting boards, although the IFAC reform implied an increase in the number of non-practitioners in the boards, further steps are required to ensure that those non-practitioners do not keep direct or indirect links with audit firms.

Moreover, as suggested in the recommendations issued by the Monitoring Group last year, establishing an independent chair for some of the boards should be considered, at least for the ethics committee.

Finally, selection procedures should be revisited in order to capture nominations from a wider variety of stakeholders.

In relation to the oversight function, it is important to clarify the respective roles of the PIOB and the Monitoring Group. The former should focus its activities on monitoring due process. The latter should instead oversee the functioning and the overall strategy of the PIOB and the professional boards.

In addition, the composition of both bodies should be reviewed. For example, membership of the Monitoring Group does not include at present a representative of audit regulators.

Fortunately IFIAR –the international organisation of audit regulators- attends meetings as an observer. It is important that the current resistance within IFIAR membership to increase its

involvement in the Monitoring Group could soon be overcome in order for this organisation to become a full member.

Moreover, it is important to increase the visibility of the important work that both the PIOB and the Monitoring Group conduct.

If the public does not know of the existence of these oversight bodies it is going to be hard for them to contribute to enhance public confidence on the standard setting process.

The third area to be reviewed is that of funding. At present, IFAC finances all the activities of the different standard-setters. Moreover, the PIOB is also financed mostly by IFAC. The European Commission also makes a cash contribution, although its continuation in the future is conditional on the PIOB being able to achieve a more diversified funding.

Some international organisations represented in the PIOB do provide a sort of in kind contribution by covering the expenses of their representatives. In addition, the Spanish CNMV contributes to the finances of the PIOB by providing the office space in Madrid where the headquarters of the organisation are located.

In any case, the current situation is not optimal from a governance point of view.

Although IFAC contributions are obviously welcome, it is probably not appropriate that most of the funding comes from the organisation which is currently overseen by the PIOB.

It is therefore important to explore ways to achieve a more diversified funding structure in line with what the European Commission and other observers request. The moderate size and budget of the PIOB should help us to achieve that goal.

Therefore, to be sure, while much has been done already, we have to take additional steps to strengthen further the standard setting process and to achieve a fully effective and reliable oversight structure. To that end, I have the intention to propose that the Monitoring Group launches a public consultation to gather views from stakeholders on possible improvements in the governance of public interest oversight activities in the audit field.

This exercise will mirror the public consultations launched by the IFRS Foundation that I mentioned before. I truly believe that this governance review should contribute to foster confidence in international audit standards and therefore to facilitate its adoption in the different national jurisdictions.

Let me finish by strongly encouraging you all to contribute your views to this consultation that I hope will be out in the fall.

Thank you very much for your attention.