

HIGHER CREDIBILITY THROUGH BETTER STANDARDS: A NEW
HORIZON FOR THE ACCOUNTING PROFESSION

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Introduction

Some developing economies are home to vibrant business sectors and emerging capital markets. Others have the development of business sectors and markets on their agenda. Together with market managers in highly developed economies, these rapidly growing players on the world stage realize that firms and markets can fulfill their role in local development *only* if their perceived worth is based on credible and stable valuations. These valuations have one central ingredient: the production of credible, clear and comprehensive company accounts. This ingredient is essential for both companies in the private sector and the public sector. It is equally essential for financial and non-financial firms, regulated and unregulated activities, and domestic and international ventures. In other words, credible, clear and comprehensive accounts are a universal requirement.

This universal requirement has been propelled by the development of global markets. It has become even more pressing since corporate scandals shocked some of the world's most advanced market economies at the turn of the century. As a consequence, national jurisdictions no longer have a choice of whether to adopt or ignore the mechanisms that will assure the requirement is met. Whoever delays may fall behind in an intensifying competition for development funding and investment attraction. Whoever stays ahead may benefit from the acquired comparative advantage of transparency and reporting quality.

The requirement for credible, clear and comprehensive accounts leads immediately to the question of standards. How are accounts put together? How are they reviewed and by whom? How are they audited? And are these

auditors credible? The functioning of companies and markets depends greatly on the answers to these questions.

Financial reporting is much more than a historical representation of economic events over a specified period: it is a critical input to key financial decisions and will influence how these decisions are implemented. Therefore, standards governing the production and validation of credible, clear and comprehensive accounts have become *and will remain* a critical element in the development of firms, markets and economies.

The Traditional Model of Setting Standards

Traditionally, the standards for both financial reporting and auditing have been set by the accounting profession. In fact, standard setting activity represented one of the basic reasons for the emergence of organizations of accountants and auditors and became a focus for strong collective action. The fact that standards would be set by the professionals who were also charged with employing them, and who were most familiar with technical aspects of their duties, was a natural development and promoted cohesiveness within the profession. Furthermore, the standards themselves remained relevant and operational because members of the accounting profession knew when and how to adapt, adjust or strengthen them according to emerging needs. This self-sustaining and iterative process produced the basic body of present day standards and must be credited with considerable achievement. However, the ongoing process of development of firms and markets in an increasingly complex and global world has exposed serious limitations to this traditional model.

What are these limitations?

The first is directly related to market growth and globalization. Traditionally, standard setting by the accounting profession has been conducted on a national or, at best, a regional basis. However, while countries with strong traditions in accounting practice have benefited from their national standards, often these same standards have also been exported to less developed countries and become a catalyst for further market growth. This phenomenon demonstrates that markets create the need for comparability across time and across national boundaries.

Comparability between accounts is a central quest of both market investors and other stakeholders who depend on public reporting for their decisions. This comparability has two dimensions: internal consistency over time, and external consistency in comparison to competing enterprises in the same or other countries

Consistency over time implies not only that standards used to construct the accounts of a particular firm should be used consistently but also that the body of standards itself retains fundamental stability and integrity over time. The growing demand for external consistency results from the need for comparisons across national jurisdictions, legal and regulatory systems and is the result of globalization. These two dimensions of consistency are now inseparable and can be realized only through the use of a rigorous, credible and broadly accepted body of standards.

A second limitation of the traditional model of standard setting relates to the occurrence of failures and frauds and public reactions to these events. These are an undesirable aspect of business and market operation because they can never be completely suppressed and can often cause damage far beyond the confines of the affected enterprise. Failures and frauds will also create a challenge for those responsible for financial reporting because these events often involve delays and/or distortions in the presentation of underlying fundamental problems. When this happens, the competence and honesty of accountants, the independence and alertness of auditors and even the adequacy of the standards themselves become suspect.

A third limitation of the traditional standard setting model relates to the needs of large and diversified shareholder groups. As markets continue to develop, companies become widely held by large numbers of shareholders and of interest to many other potential investors. The role of financial reporting changes in the process. Investors as actual or potential shareholders are not necessarily sophisticated market operators, nor are they holders of private information. They depend on financial reports as a primary source of guidance for the evaluation of their positions, their investment preferences and their strategies. For this reason, financial reporting takes on the character of an information device directed to the broader 'investing public' rather than a narrow group of well-informed capitalists. In such an environment, the standards that regulate financial reporting must be clearly defined as those that serve the needs and the interests of this 'investing public' rather than major shareholders or top managers, and audits of these financial reports using robust and credible standards become the essential safeguard for the 'investing public' against inaccuracy and lack of fairness in financial reporting.

These limitations of the traditional model of standard setting have led to two types of institutional response and the development of policies to effect the necessary improvements. First, the element of public interest has been explicitly recognized through introducing some form of public control over the standard setting process. Second, the international coordination of standards has become a much higher global priority.

The Road to Better Standards: New Models

The development of International Financial Reporting Standards provides one early example of a new approach to standard setting. The core of this model is an international committee of experts operating as an independent standard setting body. This body follows an internationally agreed process of consultation and produces international standards under its own responsibility. It cannot legally impose these standards on any jurisdiction but can offer them for adoption as a comprehensive set of norms.

The remarkable spread of International Financial Reporting Standards in the past few years has been fuelled by a global demand for international comparability. One very concrete example of this has been the adoption of IFRS by the European Union to promote its goal of improving comparability of accounts within a large regional economic grouping. The ongoing discussions on convergence between US accounting standards and IFRS also attest to this pressing need. Even if, as some argue, complete convergence is will not be achievable over the near term, the need for comparability will

continue to feed the process and ensure that differing standards can continue to be reconciled while efforts continue to reduce remaining differences.

A newer, important example has been furnished by the collaborative model worked out among the International Federation of Accountants, world regulatory organizations and the World Bank.

For a number of years, the International Federation of Accountants (IFAC) established committees to set international standards in the areas of audit, ethics and education for the accounting profession. These bodies were made up of expert professionals who worked as volunteers to produce a substantial body of standards in response to the need for international standards that could be considered for adoption by a variety of jurisdictions. This IFAC initiative overcame some of the limitations of the traditional standard setting model but not others.

In 2003 a group of international organizations – IOSCO, the Basel Committee, IAIS, the World Bank and the European Commission – entered into an important agreement with IFAC for a substantial reform of the international standard setting activity in the areas of auditing and assurance, ethics and professional accounting education. This reform explicitly recognized the need to elevate consciousness of public interest within the standard setting process. It instituted ways in which the public interest could be recognized and explicitly inserted into standard setting activities, starting with the creation of an independent board to oversee all aspects of the standard setting process. This is the PIOB, the group which I have the honor to represent today, which started its operation in early 2005. This reform also called for a shift in the composition of standard setting bodies away from the

dominance of practitioners and the creation of consultative stakeholder groups alongside the standard setting bodies to offer advice and criticism to standard setters on an ongoing basis. Furthermore, it strengthened IFAC's commitment to compliance of international standards by its member bodies.

This new architecture, which is already at work, aims to completely overcome the limitations of the traditional model that I pointed out before. It is now in its third year of operation, and I believe that it has started to produce the desired outputs in terms of high quality standards that reflect the international public interest.

The Standards and the International Public Interest

How can it be ensured that standard setting undertaken by experts who are not public servants and do not work for a public organization will serve the international public interest? Is it necessary to maintain some influence of the accounting profession on standard setting or should the profession be totally expelled from the exercise? Can we reasonably expect that international standards, as they are now produced, will be adopted by many countries? These are valid questions that a viable model of international standard setting must be able to answer. I will give you the PIOB responses and views on these questions.

We understand that the international public interest must be securely anchored to the objective of satisfying those who use financial information and rely on auditors and the audit process. The scope and nature of international financial reporting and auditing standards must deal not only

with reporting and auditing activities but also with their prerequisites: the high standards of behavior and qualification to be expected from both the accountant and the auditor. Furthermore, comparability between local and international standards should be clear, and the extent to which local accountants and auditors have complied with the relevant standards must be easily accessible and totally transparent. This aspect of the public interest calls upon the accounting profession to demonstrate the integrity required to achieve these demanding goals.

High quality international standards are indispensable in meeting international public interest objectives. To be widely accepted and adopted such standards must include clear objectives and sound principles. They must be clearly written for ease of understanding and application. They must be operable in widely varying local environments in terms of level of development, legal system and regulatory requirements. They must also be suitable for application in a variety of client and auditor situations.

It is not enough for international standards to be of high quality and applicability. It is also necessary that the process by which these standards are set inspire confidence. It must be transparent, forward looking and flexible, provide ample opportunity for stakeholder input, and be subject to independent oversight and review. Let me also offer a comment on the individuals who serve as international standard setters, as they must also inspire confidence. They should be knowledgeable, experienced and committed to the public interest. They must act independently, be responsive to emerging needs and very open to stakeholder input. They must be drawn from diverse backgrounds in terms of professional experience, regional or sectoral affiliation. They should not be exclusively practitioners nor

exclusively non – practitioners. Rather a blend of expertise is desirable. The process of selecting the standard setters should itself be transparent and subject to oversight and review. The promotion of standards quality and credibility is a central part of the PIOB mandate and, as they are achieved, will facilitate widespread acceptance and effective implementation of international standards.

A New Horizon for the Accounting Profession

I said at the outset that standards form a critical core of norms around which the accounting profession is organized. This will continue to be the case. The standards in effect define the profession and the scope of its activities. The changes in the model of standard setting and in the character of standards themselves have far reaching implications for the accounting profession and define a new horizon.

The profession is already undergoing change from being ‘national’ and inward looking to being ‘international’ and outward looking. The profession is also shifting from making and changing local rules with ease to internationally agreed standards, to which they have established avenues for providing input, but with which they have to comply. A corollary to this is that as standards become based on principles, their application must be adjusted to the local situation but must also remain consistent with similar applications in other jurisdictions. The international harmonization of implementation cannot and should not be left only to a handful of international audit firms. It should become a task for the profession, acting as a global entity.

The scope of international standards covers the professional process, behavior and qualification of auditors and accountants at large. Thus, all the parameters that describe this “profession” are stated in a common international body of norms. Implementing them involves much more than just compliance. Implementing them means organizing and developing the accounting profession in countries and jurisdictions where it is weak, so that it can fulfill the norms. Implementing them also means that such critical matters as the competence, the independence and the integrity of individual accounting professionals are now subject to explicit and comparable norms that establish a benchmark for such professionals around the world. In a world where linguistic differences remain a challenge, the successful implementation of international standards creates a universal professional language for accountants and auditors.

This new horizon for the accounting profession is being driven by the same two forces I mentioned earlier. One is the globalization of markets, investments and valuations. The other is the internationalization of the notion of public interest. It is important for the profession to recognize and embrace these realities as it strives to reestablish public confidence in financial reporting and the audit of financial reports. The road to achieving this objective lies in the creation of high quality and comprehensive standards and in implementing these standards in ways that preserve their public interest focus. In the end, confidence in financial reporting and auditing cannot be rebuilt without renewed recognition that auditors and accountants are first and foremost professionals whose primary goal is to serve the public interest.