

THE QUALITY OF INTERNATIONAL AUDITS

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It has been a short time only that I have become involved with the issues of audits, the accounting profession, and standard-setting for auditors. The Public Interest Oversight Board (PIOB) which I chair was formed last March 1st, and we are still at the beginning of our task of developing oversight of standard-setting by IFAC committees. The views that I express below are views that are based on what I have gathered in this short period. They are strictly personal, and do not represent official PIOB positions.

- 1. An outside observer who looks at matters from a global perspective would think of the need for uniform quality of audits as a necessary condition for a world economy and highly interconnected international markets.**

I consider this so self-evident that no further comment should be added here. Perhaps only the point can become more specific by underlining a distinction. When we speak of international audit quality, we really include two different matters. The first concerns the audit of large international firms with operations, subsidiary companies and branches in many countries. The quality of transnational audits when they involve one or more different auditors is an important matter that should and does create responsibility for the lead auditor. Ensuring uniform quality and credibility of audits in this case can be an important barrier to ever-present incentives for distortion or misrepresentation that can be tucked away in jurisdictions where audit practice is lax. The second matter concerns the audits of similar firms across national boundaries and the need to have comparability. In this case a difference in audit quality can distort markets and lead to erroneous decision-making for investors, financiers or regulators. What are then the best conditions and proper mechanisms for ensuring high and uniform quality of international audits?

- 2. Standards, enforcement, and self-regulation are all factors that determine the desired qualitative outcome. Policy and goal setting must be exercised on each of these fronts simultaneously, since synergies are present and must be exploited, if a global result is to be achieved.**

It is clear that work must still develop on many fronts. First is the production of high quality international standards of audit and the adoption of uniform standards around the world. Second is the quality and intensity of enforcement practice that are similar or different in various national jurisdictions. Third is the quality and intensity of self-enforcement practice undertaken by the world accounting profession. Fourth is the quality and intensity of internal quality control, as undertaken by network firms that conduct audits in many jurisdictions. All these aspects of the process of audit must work together. In some progress has been made. In others the way to progress lies ahead. A multiple dialogue is underway today; it must continue and intensify precisely in order to ensure that all the aspects of the problem of international audit quality will come together. I would like to offer some comment on each of these aspects.

- 3. The creation of high quality international audit standards must serve two fundamental goals: They must be applicable to a broad range of conditions and they must respond to current public concerns for transparency, integrity, and early detection of fraud.**

Standards are not abstract entities. They must correspond to experience and must respond to public needs. They must be broad-based and not draw narrowly from limited experience. Geographic, sector, and size diversity must underlie the basis of experience on which standards are based. Standards must be applicable to varied situations, ranging from simple to complex. They must be easy to learn, easy to apply, easy to check, easy to enforce. They must be adaptable to variation in legal nuance. In short, high quality of standards must be accompanied by high usability. One test of the successful creation of international standards is their success in being adopted by various jurisdictions, and enforced. Current public concerns for the ability of audits to capture the incidence of risk, failure, and fraud are high. Standards must respond to these concerns. Quality assurance and risk assessment are important elements

that, as far as I have been able to ascertain, are now centrally placed on the agenda of international standard-setting. The public interest function of standard-setting must be widely recognized and upheld.

4. The adoption of high quality and uniform standards around the world – what we may legitimately call ‘convergence’ – is a basic building block for the assurance of high quality audits.

The variation of standards on the contrary may create opportunities of laxity through gaps of non-comparability. Convergence is not an easy goal but it can be furthered as international standards attain higher quality, as the forces of globalization become stronger, and as investing becomes more and more internationalized, and needs more and more comparable information. The adoption of the IFRS by many important jurisdictions, notably the EU, has been an important step. The pending adoption also by the EU of international standards of audit will be another major step towards convergence. It has been said that ‘convergence’ is a strong factor in the definition of international public interest. I am in agreement with this.

5. The quality and intensity of enforcement practice in various national jurisdictions must also converge as much as possible, in order to assure a high and consistent quality of international audits.

It is well known that variation in enforcement can have negative effects and may lead to high risks and high costs. It may give rise to regulatory arbitrage, among jurisdictions and it may also undermine the credibility of transnational audits. A clear requirement arises for regulatory cooperation among enforcement authorities. Many positive steps are now taken in that direction. The work towards creation of a forum of national audit regulators represents major progress. The provisions in the revised EU 8th company law directive, that mandate regulatory coordination among the relevant authorities, also represent major progress. In any case, regulatory cooperation must be crafted in a way that reduces risks while burdening the markets as little as possible. I have said in other contexts before, that regulatory coordination should positively reduce the cost of regulation by opening the door to the harmonization of regulatory practice across national borders.

6. The quality and intensity of self-enforcement practice undertaken by the world accounting profession is another major contributing factor to the consistent quality of the international audit.

The world accounting profession has come a long way towards the realization that the reestablishment of credibility requires strict efforts at self-discipline and self-enforcement. These efforts take mostly the form of member compliance programs at the level of IFAC. The conduct of the compliance exercise has been placed under the oversight of the PIOB and it is a goal of the PIOB to assess the progress of self-imposed compliance rules. Self-compliance is not a substitute for statutory enforcement. It can complement statutory enforcement and act as a smoothing influence between practices in various jurisdictions.

7. The quality and intensity of self-assessment and internal quality control, as undertaken by network firms that conduct audits in many jurisdictions, is the final and most relevant item from the viewpoint of this symposium.

Network firms are natural agents for the furtherance of convergence and consistent application of standards. They are the actual producers of audits and the parties that constantly have to face the complications of international divergences. They are the parties that stand to gain much from the rise in the international credibility of the auditing profession and stand to lose much from a possible new blow to that credibility. I realize of course that risks of litigation and liability create limitations. These risks are not everywhere the same. In any case, to ensure a consistent practice within network firms, investment is required in education and training, in quality control programs, in internal audits. To ensure a consistent practice among network firms, all the previous elements – education, training, quality control, internal post audits, peer reviews – must take the form of an explicit and well defined code of behavior, as well as an explicit inspection program. These forms of coordination are of course always in danger of surpassing the limit of legitimate competitive behavior, and cross over into anti-competitive practice. This requires good care, clear definition, and above all else, external review and certification.

Public expectations in our day are not in favor of self-regulatory solutions. That is the reason why independent oversight is sought in

many cases. A code of behavior, a standard of internal quality controls, and an international inspection program could only become operative with external certification and oversight. A debate has already taken place in this area, and it must continue forthwith. The international architecture of oversight, as it is now emerging can offer appropriate solutions.