PUBLIC INTEREST OVERSIGHT OF GLOBAL STANDARDS-SETTING

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Introduction

My principal function today is to talk about the new Public Interest Oversight Board (PIOB) and its mandate to oversee the public interest activities of IFAC. But although this topic for some of you may be spellbinding on its own, I thought I would embellish it with some context at the beginning and the end. I propose, therefore, to start with some observations on the globalization of policy-setting. Following that, I'll talk about the profession's role in setting auditing standards under the supervision of the PIOB. In that context, I'll examine the current framework, which John Kellas will present in much greater detail and give a brief explanation about how we got to the current structure.

Finally, I'll conclude with some thoughts on the sustainability of the current structure going forward and examine some of the hurdles that must be overcome if the current structure is to survive.

Globalization of Policy-Making

Globalization has been shaping our markets and our lives for so long now that we take it for granted. It has been a dominating force in our capital markets, where capital now flows across borders almost without restriction. But it has been a market-led phenomenon. Policy makers, while interested observers, largely confined their responses to analysis and study. Globalization had little effect on domestic policies; local markets continued to be governed by local policies.

But these local policies were often wildly different from, and sometimes contrary to policies in other connected markets. After all, they had been formulated over the years in response to local pressures — not international concerns. Worse still, they were often founded on different legal systems and different regulatory philosophies.

For many market participants, venturing outside their home markets had become necessary for their survival. They struggled mightily to cope with local legacy regulatory systems that often were barely compatible. For their part, policy makers stayed on the barricades; jealously guarding their sovereignty. There was little appetite for deferring to policy-makers in other countries; an impasse that offered little hope of international convergence.

This impasse might have continued to fester but for the intercession of a world-changing event — the collapse of Enron on December 2, 2001. The shock of this mostly unpredicted collapse quickly rippled around the world; billions of dollars of investments were lost overnight; the jobs of hundreds of thousands of employees - vaporized.

It was perhaps magnified, coming as it did only 2 _ months after the September 11 attacks here in the U.S. But it was certainly intensified by the aftershocks of the scandals at Global Crossing, Adelphi and WorldCom.

Propelled by voter anger (2002 was a congressional election year), the U.S. congress passed the *Sarbanes Oxley Act*, a singularly domestic response to what U.S. lawmakers considered to be a U.S. domestic issue. Initially, policy-makers in many other countries didn't challenge this view as it provided easy justification for their own inaction. As a Canadian, I remember well the refrain; "...if there is fraud or corruption in corporate America, they should fix it. Fortunately we don't have the problem here." Ergo, we needn't take any action.

Many of those same policy-makers soon realized to their horror that imbedded in this U.S. domestic response was a broad extra-territorial reach. And we now know that the U.S. corporate collapses were not merely U.S. domestic problems. Their global impact became apparent even before a number of high-profile failures occurred in Europe and elsewhere.

The Enron collapse, with the corroboration of the subsequent scandals, awoke the world to some serious systemic problems in the financial markets. And this was the catalyst that began the migration of policy-making upward from the national to the international level.

I can best illustrate this evolution, perhaps even a revolution, by recounting how events unfolded amongst securities regulators. I can then draw some pretty close parallels in your world – in the setting of accounting and auditing standards.

But first some background. In 2000, I was elected the Chair of the Technical Committee of the International Organization of Securities Commissions. The Technical Committee is IOSCO's principal policy-making body, and its *de facto* directing mind. At that time, it was mostly a "talk shop" or a "meet and greet". Its principal activity was to survey its members to determine how they were dealing with a particular problem and then publish the results.

Members were then left to their own devices to determine what, if anything, they could learn from other members' experiences.

The agenda was controlled by a couple of the major countries and there were some subjects that were untouchable.

The September 11 attacks, and the Enron and subsequent scandals, precipitated a major change in IOSCO's role. As Chair of the Technical Committee during these world-changing events, I found the organization faced with challenges beyond my wildest imagination.

Following September 11, the most pressing issue for securities regulators was to prevent securities markets from being used to finance terrorist activities.

We immediately convened a meeting in Rome and devised a plan to combine the enforcement capabilities of the world's securities regulators; a plan that would create a formidable force to combat financial crime and securities fraud.

We began by drafting a multilateral memorandum of understanding that countries would need to apply to join. To be accepted, they would need to demonstrate that their laws permitted them to co-operate in international enforcement cases; that there were no impediments to the use of their domestic laws to investigate suspected abuses and to share the information with other regulators; to prosecute participants in cross-border schemes. Once admitted to the MOU, a country's participation would be monitored to determine that they were walking the talk.

There are now about 30 countries participating in the MOU with several others working to change their domestic laws so that they too can participate.

The agreement on enforcement co-operation began IOSCO's transformation. But the real transformation took shape after the Enron and WorldCom scandals. Enron collapsed on December 2, 2001. We had previously scheduled a Technical Committee meeting in Hong Kong for late January. By that time, Enron was big news in virtually every media market. Although the SEC was reluctant at first to discuss the Enron problem with its peers, it quickly recognized the benefits of having their support.

The Hong Kong meeting began a process that within a few months saw the creation of international standards for such issues as auditor independence, public oversight of the audit function, analyst standards and the role of audit committees. In doing so, we had to overcome seemingly impossible barriers, because each standard had to work under all of the different legal systems around the world.

Several other standards have followed.

IOSCO is now expected to be <u>the</u> international standards setter for securities regulation. Bodies such as the World Bank, the IMF and the Financial Stability Forum now just expect that IOSCO will deal with securities regulation matters as they occur.

The same transformation is happening in your universe. It has the same roots and is propelled by the same drivers — fix systemic problems exposed by the corporate scandals and use the opportunity to make differing local systems converge.

The International Accounting Standards Board and FASB signed the so-called Norwalk accord and IFRS goes a long way towards achieving both of these objectives. And, as I will describe in a few minutes, IFAC and its auditing and assurances standards setting activities have been given new life and legitimacy with the establishment of the Public Interest Oversight Board. All of these initiatives are taking place at the international level, drawing on the expertise of domestic standards setters from countries in every corner of the world.

Implications for Policy Setters

But these activities have profound implications for domestic policy-setters. Emerging problems are now discussed at the international level before domestic solutions are implemented. Domestic policy-setters realize that they must be at the table for two important reasons: First, they want to be able to influence the ultimate standard — to try to ensure that elements important in their markets are reflected. Second, they want to be plugged in to the discussion and the emerging consensus so that they will know how to implement it back home; what are the important elements? What flexibility will international markets tolerate?

One of the huge benefits of this transformation is that we are seeing for the first time a global harmonization of regulatory standards. But it has also brought with it a restriction on the freedom of domestic policy-makers to craft purely domestic responses to emerging issues. Once an international standard is articulated, policy-makers will be able to depart from the standard in their local markets only for very good reasons. Indeed these effects are already being felt in many countries. Canada is a good example: on the securities side, we used the emerging international standards as checklists in drafting the Canadian auditor oversight body, our equivalent to the PCAOB.

We also use the new international standards as the basis for new rules relating to audit committees, new requirements for auditor independence and new and tougher standards for analysts. And Canadian accounting and auditing standards-setters have recently proposed the adoption of IFRS and ISAs as Canadian Generally Accepted Accounting and Auditing Standards. The setting of unique accounting and auditing standards in Canada is largely a thing of the past.

And so the globalization phenomenon has finally overtaken domestic policy-makers; no doubt a welcome development for the thousands of market participants who operate internationally.

Role of the Accounting Profession in Setting Global Auditing Standards

As investigators sorted through the wreckage from the Enron, WorldCom and other financial disasters, it quickly became clear that most of the checks and balances upon which market participants relied, had been ineffective to prevent the collapses or even to provide an early warning. Although, stunned investors demanded answers about the roles of boards of directors, audit committees, analysts, rating agencies, lawyers and securities regulators, attention quickly was focused on the audit profession and the adequacy of accounting and auditing standards.

Inevitably, this latter enquiry led to questions about the suitably of the accounting profession continuing to set auditing standards.

This question became the principal focus of a group which came to be known as the "Monitoring Group"; comprised of representatives of five international regulatory organizations; IOSCO; the Basel Committee on Banking Supervision; the International Association of Insurance Supervisors; the World Bank and the Financial Stability Forum. The common goal of all five was to establish independent and effective supervision over the standard-setting process for accountants.

At about the same time, IFAC began to recognize the desirability of some public oversight of its standards-setting process. Following a fairly long process of planning and negotiation between IFAC and the members of the Monitoring Group, a consensus emerged for reforming IFAC's constitution and for the creation of a new, independent Public Interest Oversight Board (PIOB).

The Board's mandate is to oversee all of IFAC's public interest activities. These include the setting of auditing, ethics and educational standards and the monitoring of compliance with these standards. The Board is also expected to oversee the process for populating these committees, including approving both the process for seeking nominations and the actual selection of nominees. Thus, responsibility for ensuring that proper consideration is given to the interests of the public – those outside the profession with a stake in the outcome – is now at least shared by both IFAC and the PIOB.

The PIOB has been designed to be independent of the accounting profession. Seven of its eight members are appointed by the regulators, one of whom is designated as chair. The eighth member is appointed by IFAC and can be an accountant by profession.

On February 28 when the PIOB was born, a new period started. For the first time all the major regulatory organizations came together at a unique confluence of views, working in tandem with IFAC, to implement meaningful reform.

The challenge of fulfilment of the goals of reform has now shifted to the PIOB itself. And these challenges will be formidable; by design, all but one of our members are not trained in accountancy. Fortunately, we have available to us the substantial resources of IFAC, its member bodies and its consultative advisory groups. And we currently have on the PIOB Board an excellent balance and a variety of Board Members' skills, experience and perspectives.

Members come from a number of professions and all branches of regulation, often with broad and deep experience in several spheres. The Group has also been well-balanced geographically with three members domiciled in Europe, four in North America and one in Japan.

The working atmosphere among PIOB members is excellent and we are all optimistic about the output of its work. Recently, the European Commission appointed two observer members to the PIOB. We welcomed this development and believe it will add an important new dimension to the quality of PIOB deliberations and the balance of perspectives within the Board.

Marshalling these resources, we will work to further the goals of quality, independence, transparency and convergence. In doing this we will strive to fully recognize the needs of all of the users of the outputs of the accounting and audit functions. Our challenge will be to assert our role of public interest overseer, but to do so without disrupting the efficient operation of the existing process.

Our learning curve has been steep and the Board has taken up the challenge with enthusiasm. We have attended virtually all meetings of public interest activity committees to date, covering the International Audit and Assurances Standards Board, the Ethics and Education committees, their related consultative advisory groups and IFAC's nominating committee.

Our intention is to attend as many of these public interest meetings as feasible during the coming year to deepen our understanding of the work and of the process of these groups.

Although this first year of operation has been dedicated primarily to learning, we have also been providing input to IFAC due process. We recently approved a critical document setting out the framework under which all standard-setting projects are to be conducted. As a result, IFAC has now adopted a common due process for all standards-setting committees and their related consultative advisory groups.

We are currently considering draft terms of reference for Consultative Advisory Groups and their Chairs, as well as the draft Terms of Reference for the standards committees themselves.

We have also monitored very closely the IFAC nomination process during the past year and have recommended some improvements in its conduct. It is our view that the nominating cycle which we observed this year was conducted in a highly professional and transparent fashion. We will be recommending further improvements in the future, as our engagement continues and deepens.

We also worked during our first year to establish an active liaison with national oversight authorities such as the PCAOB in the United States, the Canadian Public Accountability Board and the U.K. Financial Reporting Council.

This past year has seen a rapid development of similar bodies in a number of jurisdictions around the world, each of whom will have key roles to play in regulating the accounting profession.

Clearly the quality of audit standards, the level of ethical codes and the professional capacity and quality of the participants in the process of reporting on financial results are crucial foundations for the market system.

The Future

Where do we go from here? IFAC has been reorganized; the PIOB is in place. But will this baby fly?

There's no question that we're off to a good start. IFAC participants have welcomed the PIOB's involvement and I believe that encouraging progress has been made in just a few short months.

But there remain many sceptics. International accounting standards are now set by a group of full-time professionals under the supervision of a group of trustees who themselves are now accountable to a council of regulators. Audit standards-setting in many local jurisdictions has been wrestled away from the accounting profession and vested in quasi government entities. Internationally, our new structure is somewhat unique. I am not aware of any international SRO with authority for setting global standards. In each of the banking, securities and insurance industries, international standards are set by groups of national regulators, supported by strong secretariats of fulltime professionals.

Realistically, I think it is prudent to view the current structure as somewhat of an experiment, the results of which will only become apparent over time. Indeed, the sceptics seem to have adopted a wait-and-see posture.

What then are the likely ingredients for success? What are the hurdles which must be overcome?

If success is to be solely dependent upon the quality of the standards resulting from the process, then one would expect to see comprehensive, comprehensible standards that address all of the important aspects of the auditing process plus the independence of the auditor, other ethical requirements and meaningful educational and experience requirements both at the entry level and on a continuing basis.

There must be no evidence that standard setters are avoiding controversial issues. And, perhaps most importantly for such an analysis, it must be demonstrable that proper consideration has been given to the public interest throughout the process.

There are clear advantages to having the profession itself setting the rules by which professionals will conduct themselves. For example, compliance is far more likely if the conduct has been specified by the profession rather than by government. In this respect, a clearer case can perhaps be made for professional involvement in auditing standards than for accounting standards.

Speaking personally, I have been impressed with the sheer numbers of volunteers both from within the profession and external to the profession and the extremely high level of expertise being brought to bear by these people into the standards setting process. I've also been impressed with the rigour of the discussion and willingness to address tough issues. In my view, however, we need further effort to ensure that the interests of stakeholders outside the profession are understood and properly considered.

To consider only the output of the standards setting process, success will be measured by the quality and clarity of the standards, the rigour of the process by which they have been developed and the extent to which the public interest has been recognized.

Unfortunately, however, life is not that simple. These reforms were born out of the corporate scandals of the last few years and the failure of our system to disclose the true financial condition of the companies on a trajectory to failure. Critics of the profession will thus be looking to see whether the reforms have materially lessened the risk that such faulty financial information will ever again be accompanied by a favourable audit opinion. While audit standards meeting the highest of the quality tests to which I referred a minute ago are a necessary ingredient to ensuring this success, they are by no means sufficient.

If standards meeting or exceeding ISAs are not adopted by a high percentage of local bodies around the world or if adopted they aren't rigorously enforced, then there is strong likelihood that these reforms will be judged to be unsuccessful. This underscores the importance of the IFAC member compliance program. But it also demonstrates the need for IFAC members to rigorously enforce adherence to the standards by all professionals practicing accountancy in their jurisdictions. And where enforcement is not part of a member's remit, the member must work with responsible authorities to ensure that enforcement is adequate.

And so implementation of the IFAC reforms is critical to the preservation of the profession's continued role in standards setting. But real success will also depend on compliance and enforcement.

Thank you.