Audit Oversight to Enhance Trust and Transparency in Corporate Financial Statements: Challenges in Developing Countries
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### GLOSSARY

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>ASEAN</td>
<td>Association of Southeast Asian Nations</td>
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<tr>
<td>CAOA</td>
<td>Council for Advancement and Oversight of Auditing of North Macedonia</td>
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<td>CFRR</td>
<td>Centre for Financial Reporting Reform</td>
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<td>EU</td>
<td>European Union</td>
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<td>IAS</td>
<td>International Accounting Standards</td>
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<td>IDI</td>
<td>INTOSAI Development Initiative</td>
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<td>IFAC</td>
<td>International Federation of Accountants</td>
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<td>IFIAR</td>
<td>International Forum of Independent Audit Regulators</td>
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<td>IFRS</td>
<td>International Financial Reporting Standards</td>
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<tr>
<td>INTOSAI</td>
<td>The International Organization of Supreme Audit Institutions</td>
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<tr>
<td>ISA</td>
<td>International Standards on Auditing</td>
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<td>PAO</td>
<td>Professional Accountancy Organization</td>
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<td>PCAOB</td>
<td>US Public Company Accounting Oversight Board</td>
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<tr>
<td>PIE</td>
<td>Public Interest Entity</td>
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<tr>
<td>ROSC</td>
<td>Report on the Observance of Standards and Codes</td>
</tr>
<tr>
<td>SEC</td>
<td>US Securities and Exchange Commission</td>
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<tr>
<td>SECP</td>
<td>Securities and Exchange Commission Pakistan</td>
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<tr>
<td>US</td>
<td>United States of America</td>
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EXECUTIVE SUMMARY

Introduction

Information from corporate financial statements is critical to investors and lenders. Without a credible system of financial reporting, countries can struggle to spur the investment and lending needed for broad economic growth and development.

However, the corporate financial reporting process suffers from agency problems, conflicts of interest, and skewed incentives that can diminish trust. Independent auditors are relied on to provide credible assurance of the reliability of financial statements but they are hired and paid by the companies they audit. Trust in the ability of the profession to self-regulate collapsed under a wave of accounting scandals worldwide.

Origins and Goals of the International Audit Oversight Movement

There has been a global movement towards oversight to foster both the perception and the reality of rigorous auditing. An independent body monitors audit firms through regular inspections of their systems of quality assurance and execution of select audits. It is a tool to help offer assurance that auditors have both the capacity and the incentive to insist on reliable accounting and reporting by the companies they audit so that audited financial statements will inspire confidence and promote investment and lending.

Oversight inspection findings can help spur improvements; or trigger enforcement action against auditors who cannot or will not meet professional standards. The nature of auditing, however, presents challenges for effective public oversight. Auditing complex companies does not involve following a standard set of procedures and tick boxes. To be effective an auditor must use knowledge, experience, and professional judgment, as must the oversight body in inspecting whether auditors are performing consistent with governing professional standards of ethics, quality control, and auditing.

There is no “one size fits all” model for audit oversight. Alternative structures of oversight have emerged in different jurisdictions, including oversight by Professional Accountancy Organizations (PAOs), the most common model in use around the world, or by an independent audit oversight body or government institution. The optimal model for a public oversight body depends on specific national circumstances, but key requirements include adequate funding and staffing, competent governance that is independent from the audit profession, and insulation from political influence.
The potential public benefits of audit oversight are enhancement of the perceived and actual quality and reliability of reported financial information from business enterprises, with additional possible improvements in corporate governance, including internal controls, and management. Studies have pointed to some evidence for the contribution of an oversight body towards enhancing audit quality.

In response to the global movement for audit oversight, the International Forum of Independent Audit Regulators (IFIAR) was established in 2006. IFIAR brings together independent audit regulators from around the world in an effort to serve the public interest through global enhancements in audit oversight. There is an “associate membership” category for newer bodies that are not yet fully aligned with IFIAR core principles (these include standards for clear legal authorization to act independently and in the public interest; power to enforce auditing standards; and the ability to perform recurring risk-based inspections of auditors).

Challenges in Developing Countries

Developing countries face particular challenges introducing audit oversight including the presence of weak institutions, exacerbated funding and capacity issues, presence of compromised boards, limitations in primary law, and lack of demand for audit quality.

The establishment and functioning of new audit oversight bodies are influenced by domestic political and economic constraints and do not by default lead to improvements in financial reporting. Countries with weak institutions have major difficulties in importing reform measures and oversight authorities cannot be insulated from overall weaknesses in governance, corruption, or capacity issues.

Secure and stable funding is a key challenge. Oversight bodies in developing countries must often rely on unstable funding from general state revenues. Where companies must pay for oversight it is often the same large companies that pay the bulk of fees which can lead to criticism related to the cost of regulation. In some jurisdictions there is significant resistance to the payment of oversight levies by public interest companies.

There is a risk of “compromised” oversight boards, that are not truly independent or lack the power to effect change. Smaller or more recently-established bodies appear typically to include few independent members but are instead largely made up of representatives of other regulators, government departments, academics, and representatives from the central bank. Establishing a new oversight function can also face resistance from strong PAOs who have the structure, funding, and political connections to influence government choices related to the oversight board’s members and operations.
Because it is often difficult and time consuming to make legal amendments, a weakness in the primary law, such as an abridged or limited right to inspect records of an audit firm, could affect the regulator for many years.

It is also worth noting that regulatory measures alone cannot create demand for audit quality where none exists. In a market where most companies seeking audit services do so only because of a legal mandate and generally do not care about audit quality, imposition of audit oversight will likely prove insufficient to create an audit market that adequately identifies, favors, and rewards high-quality auditing.

Conclusions

Audit oversight is an exceptionally difficult reform to implement successfully, even in countries with high capacity and substantial resources. The unique characteristics of each country should underpin analysis of whether it is ready for an independent audit oversight body. An incompetent, misdirected, or under-resourced oversight body can be ineffective and even counterproductive.

Countries with inadequate resources to fund an audit oversight body should consider focusing their resources initially on improving accounting and auditing education, developing professional accountancy bodies, and other priorities before attempting public oversight of auditing.

Situating a new oversight body within an extant regulator could be an effective interim solution, or for some developing and transitional countries it may be the best long-term solution.

Given the interest and growing demand for audit oversight guidance, there exists room and opportunity for the international community to support capacity development of audit oversight bodies in developing countries.
1. INTRODUCTION

Reliable financial reporting provides market and economic participants with the information they need to operate, create jobs, provide goods and services, and attract investments efficiently and effectively, thereby contributing to the World Banks’ mission of ending extreme poverty and boosting shared prosperity. Publicly available and accurate financial information also enhances access of information to other stakeholders, including creditors, employees, and regulators, without incurring unduly high costs. A robust accounting and auditing framework, supported by effective compliance and supervisory mechanisms, lays the foundation for such timely and accurate financial information. Supervision, as a governance mechanism, enhances user confidence, reduces the risk of crisis, and increases stability.

The World Bank champions strong accounting, auditing, and reporting frameworks as part of a broader sustainable development strategy. This is of importance to developing economies, whose underprivileged need greater access to finance, and where the business climate needs to be more transparent to promote private sector-led growth and pull people out of poverty. This is underpinned by effective financial reporting systems.

However, the corporate financial reporting process suffers from inherent “agency” problems or conflicts of interest. Unless these are properly managed, investors and lenders may never develop adequate trust in financial statements. The same managers who seek investment and lending oversee preparation of financial statements, so their incentive to skew the reporting is obvious. Independent auditors, who should provide credible assurance of the reliability of financial statements, are hired and paid by the companies they audit, so may have to bite the hand that feeds them to challenge deficient accounting and reporting. And until quite recently, the corporate auditing profession itself was largely self-regulated. Given all of these issues it is no wonder that financial reporting has experienced periodic crises in confidence, on national and global levels.

Independent oversight of auditors has emerged as a tool to manage the agency problems and conflicts of interest inherent in financial reporting. It helps offer assurance that auditors have both the capacity and the incentive to insist on reliable accounting and reporting by the companies they audit. The concept is to create a body independent of the auditing profession to monitor audit firms through regular inspections of their systems of quality assurance and execution of select audits. Inspections assess whether auditors are performing consistent with governing professional standards of ethics, quality control, and auditing. Inspection findings can help spur improvements; or trigger enforcement action against auditors who cannot or will not meet professional standards. The goal is to foster both the perception and the reality of rigorous auditing, so that audited financial statements will inspire confidence and promote investment and lending.
This paper seeks to inform World Bank clients, and capture experiences for World Bank staff learning, that reflect the unique challenges pertaining to the establishment and effectiveness of audit oversight bodies in emerging and transitional economies and aims to improve understanding of the importance of a high-quality system for corporate financial reporting and auditing. The paper explores possible approaches, tools and solutions to resolve impediments, including through leveraging innovative approaches in the global developmental infrastructure. The paper also takes into consideration extant literature, bank experience with client countries, and findings published by the IFIAR and its member bodies. This report specifically deals with financial reporting and auditing in the private sector and does not address (i) government companies / parastatals, (ii) role of agencies like supreme audit institutions and (iii) role of audit committees in the appointment of audit firms and review of audit reports.
2. ORIGINS AND GOALS OF THE INTERNATIONAL AUDIT OVERSIGHT MOVEMENT

This section outlines the main factors underpinning the drive towards independent audit oversight around the world including a discussion of the fundamental issues: a lack of confidence in financial reporting, the issues underlying self-regulation, the different models for independent audit oversight, and the role played by IFIAR.

2.1. Agency problems, conflicts of interest, and skewed incentives in financial reporting

Investment and lending are critical to help entrepreneurs bring good ideas to life, enable successful small businesses to scale up, and spur growth in economies to provide broad opportunities and shared prosperity. But investment and lending almost always involve a leap of trust: investors or lenders must provide cash or other valuable resources today in exchange for a promise of repayment with interest or a chance to share in the profits tomorrow.

They will be unwilling to take this leap of trust, at least on a broad and recurring basis, unless they can obtain useful and reliable information to know whether the promise of repayment or a share in profits is meaningful. Financial statements are one of the key sources of information for making their investment decisions. Among other things, they will typically want to know how the business makes its money. They will want to know how much revenue the business has earned in recent years, and what its expenses were. They will want to know about the buildings, equipment, and other assets the business owns; to find out if it has what it needs to keep making profits in the future, or at least has something to sell to pay its debts if the business fails. They will want to know if the equipment needed to generate revenues is new and in top condition, or old and near the end of its useful life. They will want to know how much debt the business has incurred. And they will want to know how much cash has flowed in and out of the business over recent years, and for what.

All of this information is useful to help assess whether the business is likely to be profitable in the future, how much free cash it will likely generate, or whether it will even survive. And all of this is exactly the kind of information that modern accounting and financial reporting is designed to provide.

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3 See for example, International Accounting Standards Board Conceptual Framework for Financial Reporting
But there remains the problem of trust: the information in financial statements will not spur investment and lending unless investors and lenders believe it is credible. And they know that preparation of the financial statements is overseen by the very same company managers who are asking them to invest or lend, and whose performance evaluations and compensation may also hinge on reported financial results. Why should they believe any of it?

For about the last hundred years, the primary assurance that financial statements are reliable has come from the independent audit. At least at present, there is no feasible alternative to substantial reliance on private sector independent auditing to assure the reliability of corporate financial statements. Given the large numbers of reporting companies and vast numbers of financial statements filed each year, it is unrealistic to think that a regulator in any country could meaningfully test the reliability of any substantial portion of these financial statements. Indeed, even in the US, which has devoted the most resources and has traditionally had arguably the most sophisticated regulatory structure, then Securities and Exchange Commission (SEC) Commissioner Isaac Hunt explained in 2001 why regulators have no choice but to rely heavily on the work of independent auditors:

*The federal securities laws, to a significant extent, make accountants the "gatekeepers" to the public securities markets. The Commission and its staff have always understood and supported this proposition. These laws require, or permit the Commission to require, that independent public accountants certify financial information filed with the SEC.... In the fiscal year ending September 30, 2001, over 14,000 registrants filed annual reports with the Commission. While the Commission staff reviews filings, the staff is not able to review in detail all financial statements filed with the Commission. Therefore, the Commission must rely heavily on the accounting profession to be primarily responsible for the large volume of financial information that undergirds the Commission's full disclosure system.*

Thus, independent auditors are the primary gatekeepers of the financial reporting process. They are supposed to act as watchdogs, making sure companies report their financial information fairly. But they are hired and paid by the companies they audit, and there may be the temptation to please the client rather than protect the public. Managing that tension—referred to in the literature as an “agency problem” or an inherent conflict of interest—and assuring that auditors perform competently and earn the trust of investors has proved an

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enduring challenge. Preservation and enhancement of this investor confidence is also a key aim of regulators around the world.

A recent study by the Dutch Authority for the Financial Markets related to “vulnerabilities in the structure of the audit sector” notes that the quality of statutory audits is affected negatively by the current structure of the audit market, which incorporates several sources of market failure. These include:

- Market failure arising from information asymmetries and high costs for obtaining and verifying financial information resulting in users being unable to adequately evaluate the quality of auditors and exercise discipline in cases of poor audit quality.
- Market failure arising from the fact that auditing firms are engaged and paid by the audited entity.
- Market failure arising due to the conflicts of interest inherent in the audit partner model where they simultaneously exercise the roles of professional practitioner, owner and entrepreneur.
- Market failure in the business model of audit firms which impair independence and objectivity such as through the provision of non-audit services and long association of the audit firms and partners.
- Market failure arising from a lack of competition in the audit market.

2.2. The model of self-regulation

Until about 15 years ago, the auditing profession was mostly “self-regulated.” Under that model, professional bodies—whose membership, funding, and governance was typically provided by auditors themselves—often established the professional standards that govern auditors’ work, determined the qualifications for those permitted to perform company audits, and (at least in theory) imposed discipline on auditors who failed to meet professional standards of quality, independence, and ethics. In the US and other jurisdictions, securities and bank regulators had some legal authority over choice of auditors by their regulated

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7 As illustrated in IFIAR’s Mission: “to serve the public interest, including investors, by enhancing audit quality globally”
9 blogs.lse.ac.uk/businessreview/2016/08/16/should-auditors-be-reviewed-by-peers-or-should-the-statedo-it/
entities and occasionally intervened to address problems of deficient or unethical auditing,\textsuperscript{10} and national and subnational licensing bodies performed some monitoring and enforcement,\textsuperscript{11} but for the most part the profession was left to police itself.

Self-regulation was, however, a subject of regular controversy, as critics suggested it left the fox to guard the henhouse. One aspect of self-regulation especially subject to criticism was the system of “peer review,” under which audit firms enlisted other audit firms to review and assess their quality control and performance of auditing. Of particular concern, auditors were often allowed to select their own peer reviewers. As summarized by one expert reviewing empirical evidence of the effectiveness of peer review; “these results are consistent with the situation of ‘you scratch my back, I scratch yours’ that can arise when the reviewee has the freedom to choose and negotiate with its reviewer.”\textsuperscript{12} In addition, critics charged that professional bodies failed to take meaningful enforcement action even when faced with egregious audit deficiencies in cases of substantial corporate fraud.\textsuperscript{13}

2.3. The global movement towards independent oversight

Ultimately, the credibility of self-regulation collapsed under a wave of corporate accounting scandals worldwide in the early and mid-2000s including Enron and WorldCom in the US, Parmalat in Italy, Ahold in the Netherlands, and Kanebo in Japan. Following Enron’s demise, Paul Volcker, former Chair of the US Federal Reserve, said that “accounting and auditing in this country is in a state of crisis.”\textsuperscript{14} Arthur Levitt, former Chair of the SEC, said that “the system of checks and balances has let investors down”.\textsuperscript{15} In response to other scandals in corporate accounting, a similar crisis of confidence arose in Europe\textsuperscript{16} and Japan.\textsuperscript{17}

\textsuperscript{10} See for example, Marie L. Coppolino (1995) “Checkosky, Rule 2(E) and the Auditor: How Should the Securities and Exchange Commission Define its Standard of Improper Professional Conduct?”. 63 Fordham L. Rev. 2227. Available at: http://ir.lawnet.fordham.edu/flr/vol63/iss6/8


\textsuperscript{12} Anantharaman, Divya (December 4, 2007) “ How Objective is Peer Review? Evidence from Self-Regulation of the Accounting Profession”. Available at SSRN: https://ssrn.com/abstract=1015810 or http://dx.doi.org/10.2139/ssrn.1015810

\textsuperscript{13} Robert H. Colson, “In the Interest of the Investor: An Interview with Lynn Turner.” The CPA Journal, 2001 (“the fact that the PEEC [Professional Ethics Executive Committee of the Association of International Certified Professional Accountants] has failed to investigate or take action when serious financial fraud occurred and investors suffered large losses; and the inherent conflicts of interest possessed by the professional members of the PEEC leave a significant void that requires action”) Available at http://archives.cpajournal.com/2001/1100/features/f112001.htm


\textsuperscript{15} Ibid.


\textsuperscript{17} Taiga Uranaka, “TSE to delist Kanebo over accounting scandal, Cosmetics maker booted to regain trust.” The Japan Times, May 13, 2005.
Emerging countries were not immune to this crisis of confidence. For example, Satyam Computer Services in India went bankrupt in 2009\textsuperscript{18} with its Chairman confessing to manipulating its financial statements and the affiliates of its auditor PwC, sanctioned by the SEC for US $ 6 million. The SEC found that that audit failures were not restrictive to Satyam but “rather indicative of a much larger quality control failure throughout PwC India”\textsuperscript{19}.

A global consensus has emerged that, left to their own devices, external auditors are too often insufficiently independent and rigorous in challenging their clients’ accounting, and that self-regulation of the auditing profession is inadequate to assure high quality auditing and inspire confidence in audited financial statements. In the US, the wave of scandals including Enron and WorldCom was commonly linked to the business model of the major audit firms, with increasing pressure on audit partners to cross-sell consulting services to their clients, which compromised their incentive to challenge their clients’ accounting.\textsuperscript{20} European policymakers have also focused on threats to professional objectivity and skepticism that may arise when auditors enjoy very long tenure with their corporate clients, serving them in some cases for decades without interruption. Some critics contend that such long-term relationships breed overfamiliarity, coziness, and a lack of professional distance between audit staff and representatives from the audited company.\textsuperscript{21} For example, Proctor and Gamble were represented by Deloitte and Touche for 126 years, General Electric by KPMG for 107 years, and Lloyds Banking Group by PricewaterhouseCoopers for 127 years.\textsuperscript{22}

The US was the first country to respond to the crisis in confidence arising in the early 2000s with the Sarbanes-Oxley Act of 2002\textsuperscript{23}. This created, among other things, the Public Company Accounting Oversight Board (PCAOB) to provide independent oversight, including quality inspections and a disciplinary mechanism for auditors of US traded companies.\textsuperscript{24} Notably, under the Sarbanes-Oxley Act, public accounting firms, including non-US firms that audit or

\textsuperscript{18} https://www.thehindu.com/specials/timelines/satyam-scandal-who-what-and-when/article10818226.ece
\textsuperscript{20} See for example, Chu, B., Hsu, Y., “Non-audit services and audit quality --- the effect of Sarbanes-Oxley Act,” Asia Pacific Management Review Vol. 23, Issue 3, Sept. 2018, pp. 201-208 (“The empirical results suggest that, while accounting conservatism is present in the sampled firms, the pre-SOX group with a high ratio of non-audit service fees report poorer audit quality....”)
\textsuperscript{21} However, auditors with long tenure may also better understand the business, risks, and systems of their clients, which could arguably enable them to provide more rigorous auditing at a lower cost (assuming adequate incentive to perform rigorous auditing). This paper does not take a position on whether mandatory rotation of audit firms would overall improve or harm audit quality, a major area of study and debate. See for example Soo Young Kwon, Youngdeok Lim, and Roger Simnett (2014) “The Effect of Mandatory Audit Firm Rotation on Audit Quality and Audit Fees: Empirical Evidence from the Korean Audit Market”. AUDITING: A Journal of Practice & Theory: November 2014, Vol. 33, No. 4, pp. 167-196.
\textsuperscript{22} Please refer to Audit Analytics: “A Century of Opinions: Companies with auditor tenure over 100 years” https://blog.auditanalytics.com/a-century-of-opinions-companies-with-auditor-tenure-over-100-years/
\textsuperscript{23} Pub.L. 107–204, 116 Stat. 745, enacted July 30, 2002. Following the “Bernie Madoff” scandal, the PCAOB’s jurisdiction was expanded through the Dodd-Frank Act to include auditors of securities brokers and dealers that are registered with the SEC.
play a substantial role in the audit of clients listed on US stock exchanges, were subject to oversight by the PCAOB. However, the Sarbanes-Oxley Act had no provision allowing the PCAOB to share information from inspections and enforcement with foreign regulatory authorities. Thus, in its early days, the PCAOB was charged with performing inspections and enforcement in foreign countries without even being able to share the information it collected with domestic regulatory authorities in these jurisdictions, a situation that at times caused tension. That gap would not be filled until the Dodd-Frank Act of 2010, which authorized the sharing of information with appropriate foreign authorities.

In 2006, the European Parliament and Council passed an Audit Directive which included a requirement for all EU Member States to implement independent oversight of corporate auditing. IFIAR was created in the same year as a member organization among national audit oversight authorities with the mission "to serve the public interest, including investors, by enhancing audit quality globally". Today, in part due to the 2006 Directive, EU Member States make up about half of the IFIAR membership. Other examples of independent auditor oversight boards include the UK Financial Reporting Council, Canadian Public Accountability Board, Sri Lanka Accounting and Auditing Standards Monitoring Board, South African Independent Regulatory Board for Auditors, Botswana Accountancy Oversight Authority, and the Mauritius Financial Reporting Council.

The establishment of effective systems of public oversight include components related to ethics and independence, registration of auditors and audit firms, adoption of professional auditing standards, continuing professional development, and quality assurance and investigations. These systems are geared towards:

- Improving the overall system of financial reporting by sharpening the quality and rigor of audits and removing the worst performers from the market;
- Enhancing public trust in financial reporting and auditing through their work and public profile; and
- Helping promote public understanding of auditing and financial reporting through public outreach.

It should be noted that audit quality assurance is one key component of an overarching public oversight system.

28 https://www.ifiar.org/
2.4. The nature of auditing and challenges of effective public oversight

While perceived deficiencies in self-regulation sparked the movement for public oversight, effective oversight of auditors presents substantial challenges. The very nature of modern auditing makes it one of the most difficult industries to regulate properly. Auditing complex companies does not involve following some standard set of procedures and ticking boxes on a checklist. To be effective and comply with professional standards, an auditor must use knowledge, experience, and professional judgment to:

- Understand the company’s business and the way it estimates, records, accumulates, and reports information about its transactions, obligations, and assets.
- Identify the specific risks that might cause some of these items to be reported inaccurately for that company, based on how it operates.
- Design and perform tests for the company to obtain reasonable assurance that the financial reporting is reliable.
- Evaluate the evidence obtained to determine whether there is reasonable assurance regarding the fairness of the financial statements.
- Undertake all of this efficiently, within a reasonable time, and at a reasonable cost.

Thus, audit regulators must understand that they are not overseeing a routinized activity, in which they could expect to see the same steps and procedures performed every time. Instead, they must review the auditor’s work to assess whether the auditor acted with professional competence and reasonable diligence. This is an enormous challenge for effective regulation and requires the regulator to, among other things:

- become familiar with the large set of facts about the audited company that the auditor considered (or should have considered),
- identify and understand the work performed by the auditor to identify risks of material misstatement in the financial statements based on the features of the company being audited,
- assess the procedures the auditor performed to test the company’s financial reporting, as well as the audit firm’s quality assurance programs that impacted the audit,
- determine whether those procedures and programs appear reasonable in light of the risks of unreliable reporting that the auditor faced, and
- decide whether the auditor drew reasonable conclusions based on appropriate and adequate evidence.
As should be obvious, only someone highly trained and experienced in auditing can adequately perform this regulatory function. For review of some audits (e.g., audits of banks or insurers), industry-specialized experience may also be needed. Overall, an audit oversight body must have expertise commensurate with the highly sophisticated professionals it regulates in order to perform its functions properly. The challenge of creating, funding, and staffing such an expert body is one of the reasons self-regulation persisted for so long, despite criticism.

2.5. Alternative structures of oversight and regulation

The International Federation of Accountants (IFAC) position paper on “Regulation of the Accountancy Profession”29 recognizes that there is no one size model to meet the requirements of all jurisdictions and stresses that ongoing dialogue between key stakeholders is required to ensure that the right regulatory choice is made between (1) self-regulation; (ii) self-regulation with public oversight and accountability; and (iii) external regulation. The key decision criteria in choosing between these options relates to the desired level of independence in the system and the available capacity.

Table 1. Audit function regulatory choices

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<th>Self-Regulation</th>
<th>Shared Regulation</th>
<th>External Regulation</th>
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<td>Inhouse: internal quality assurance carried out by audit firms on their own activities</td>
<td>Independent oversight by an audit oversight body of PAO processes. This is the most common model in use around the world.</td>
<td>All oversight performed by an independent audit oversight body or government institution.</td>
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<tr>
<td>Peer Review: quality assurance activities carried out by audit firms on each other’s work.</td>
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<td>Oversight of peer review process by PAO.</td>
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IFAC highlights that both governments and PAOs have responsibilities towards the regulation of the accountancy profession which is primarily conducted at the national level. IFAC also notes that the current regulatory environment is characterized by the global adoption of international professional standards, external regulation for public interest entities (PIE)

audits\textsuperscript{30}, and the issuance of IFAC Statements of Membership Obligations to support PAO performance. The paper also recommends that there is a need to conduct periodic evaluations to measure the effectiveness of the model chosen.

Box 1. Factors to Consider in Determining the Mix of Self-Regulation and External Regulation – from the IFAC Position Paper “Regulation of the Accountancy Profession”

- History of financial reporting failures
- Performance of the self-regulatory organization
- Government regulatory performance
- Membership of international bodies and adoption of international standards
- Development path of the economy
- Nature of market failures to be addressed by regulation
- Government political orientation to the use of regulation as an instrument of economic management

Implementing audit oversight requires political will and sustained commitment to building an institution that can function effectively in a particular country. As scholars have noted, “the formation and operation of the newly established system of oversight is conditioned by local political and economic constraints and, thus, does not automatically translate into concrete benefits for the quality of financial reporting”.\textsuperscript{31} The optimal model for a public oversight body depends on specific national circumstances. Different structures have their own strengths and weaknesses. The Netherlands and Australia situated their oversight body in their securities regulator.\textsuperscript{32} Other countries have self-standing oversight bodies. But the key requirements for any effective structure include (1) adequate and stable funding, (2) adequate staffing, including experienced and well-trained auditors to perform quality assurance functions, (3) governance that is competent and independent from the audit profession, (4) insulation from partisan political influence, and (5) some mechanism of accountability for the oversight officials, to ensure they are properly executing their duties. An effective oversight body is somewhat expensive, because significant funds have to be available to hire competent people to staff it. An underfunded or incompetent oversight body will likely not improve financial reporting and could actually inhibit development and improvement of the local auditing profession by misdirecting its focus.

\textsuperscript{30} Typically, part of a shared regulatory system with audits of PIEs being overseen by independent audit regulators.


\textsuperscript{32} Japan’s oversight body is within the Financial Services Agency
Further, the capacity and resources available in PAOs and other regulatory agencies also needs to be taken into account for an assessment of whether to delegate parts of the framework to PAOs. In jurisdictions with more robust PAOs, the inspections of non-PIE audits may be carried out by PAOs and/or the audit oversight board may delegate certain tasks to the PAO.

In general, the new frameworks adopted in leading jurisdictions around the world remove some powers from professional organizations and transfer them to the public oversight body, to strengthen independence. They often no longer allow quality assurance and enforcement of auditors of PIEs to be delegated to professional organizations (while there is some variation, including within the EU, PIEs are generally defined as banks, insurers, and listed companies). However, professional organizations can still perform these functions for auditors who do not audit PIEs, where risks to the public from misstated financial statements are generally lower. In some jurisdictions the professional bodies are still responsible for investigating misconduct and imposing professional discipline, with the audit oversight body taking a supervisory role to ensure that the professional body investigates complaints and imposes disciplinary penalties properly. Similarly, audit oversight bodies may oversee the educational curricula and qualification systems set by the professional bodies rather than setting them themselves. As a result, the effectiveness of the public oversight system may still hinge in part on the quality of the professional bodies and on the strength of the relationship between the professional bodies and the oversight body.

Table 2. Delegation of oversight functions to professional accountancy organization in the EU

<table>
<thead>
<tr>
<th>Oversight</th>
<th>Non PIEs</th>
<th>PIEs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Approval and registration of auditors</td>
<td>May be delegated</td>
<td>May be delegated</td>
</tr>
<tr>
<td>Adoption of standards</td>
<td>May be delegated</td>
<td>May be delegated</td>
</tr>
<tr>
<td>Continuing Education</td>
<td>May be delegated</td>
<td>May be delegated</td>
</tr>
<tr>
<td>Quality Assurance</td>
<td>May be delegated</td>
<td>May not be delegated</td>
</tr>
<tr>
<td>Investigations and discipline</td>
<td>May be delegated</td>
<td>Option to delegate sanctions and measures only to a body independent from the profession</td>
</tr>
</tbody>
</table>

33 Accountancy Europe Briefing Paper June 2014: Public Oversight of the Audit Profession: Enhancing credibility and supporting cooperation
2.6. The potential public benefits of audit oversight

As with any possible regulatory reform, policymakers should weigh the likely costs and achievable benefits of audit oversight in their own country before undertaking the reform. The chief benefit to be sought from audit oversight is enhancement of the perceived and actual quality and reliability of reported financial information from business enterprises, with additional possible improvements in corporate governance, including internal controls, and management.

High quality reliable financial information is pivotal in generating trust between investors and corporates and thereby for improving transparency, fostering investor confidence, and promoting capital formation. The availability of robust internationally comparable financial information enables cross border investments and facilitates trade, while enhancing transparency and competitiveness. It is thus crucial for developing countries seeking to attract foreign investment.

Leuz highlights how harmonized financial reporting allows users to analyze and compare financial information across firms. This produces economy-wide savings by removing the need for individual parties of transactions to negotiate the cost of disclosures. Tarca reinforces that even if financial statements are not ‘fully’ comparable, high-quality accounting standards will still achieve some degree of standardization, which reduces the time and cost to analyze financial statements resulting in an overall lower cost of capital for all market participants.

Gordon et al (2012) cited in Tarca (2012) studied 124 firms and found a positive correlation between International Financial Reporting Standards (IFRS) adoption and foreign direct investment. Tarca cites various research (Li, 2010; Daske et al, 2008) to show that the adoption of IAS-39 (now replaced by IFRS 9) led to reduced processing costs and reporting lags, more analysts following companies adopting global standards, enhanced quality of analysis by foreign analysts, and specifically for financial institutions, less space for loan loss reserves manipulation. These benefits were less noticeable in environments more prone to corruption or with poorer enforcement (De Fond et al, 2011, cited in Tarca, 2012). Benefits were more noticeable where the gap between previous and proposed standards was larger. For instance, Gjerde et al (2008) cited in Tarca (2012) did not find any increase in the ‘value relevance’ of financial information for Norwegian firms. Adoption is also not always regulation driven. Some countries adopted IFRS voluntarily not due to external pressures but because of a considered assessment of benefits, such as the Malaysian Accounting Standards Board 2008 (Saito 2008 cited in Tarca 2012).

Further, “the globalization of trade and business has increased the number of companies operating across national borders and helped create an international market for capital and

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credit flows. As a result, investors and other private stakeholders have an increasing interest in promoting consistent, international good practices for transparency and integrity in capital and credit markets. For their part, individual countries have a strong interest in following international good practices in order to compete effectively for investment capital in the global marketplace and improve the efficiency and reach of their domestic capital and credit markets. Finally, national oversight bodies that regulate audits of companies with multinational reach must determine whether and to what extent they can rely on the oversight bodies of other countries to assess the effectiveness of auditing practices within their respective jurisdictions”.

Audit oversight bodies play a critical role in monitoring and improving the quality of auditing and financial reporting by (i) regularly inspecting the quality control systems that firms have adopted to see if they are effectively designed and implemented, (ii) regularly inspecting individual audits performed by firms to assess their adequacy, (iii) developing measures to induce firms to address any deficiencies found in their quality control system, (iv) conducting investigations and imposing discipline to address the most serious deficiencies, deterring other firms from allowing similar deficiencies to occur, and removing from the market those audit firms that cannot or will not conform to professional standards, and (v) enhancing public trust in financial reporting and auditing through its work and public profile. Adopting professional standards is also an important area (either through full and timely adoption of International Standards on Auditing, including updates, or developing strong national audit standards etc.)

In this regard, studies in the US demonstrated that the PCAOB inspection process resulted in an improvement in the quality of audits executed by the Big 4 audit firms. This was established by a measurement of auditee abnormal accruals following the first two PCAOB inspection visits for auditees of Big 4 firms. Abnormal accruals were used as a proxy for earnings management for a variety of reasons including that higher quality auditors reduce abnormal accruals by focusing on critical management estimates and judgments and accounting policy choices. The study noted significant reductions in abnormal accruals (and hence earnings management) in the years following PCAOB visits. Similarly, in Malaysia, Ismail et all reviewed the financial statements of fifty companies prior to and subsequent to the formation of the Audit Oversight Board and found levels of discretionary accruals to be lower after the oversight board was formed. The authors noted that although the result was not

36 CFRR (June 2017) “Public Oversight Systems for Statutory Audit in the EU”.
37 Please refer to IFIAR Core Principles at Annex I
39 Hashanah Ismail, Ung Chui Theng (2015) “Auditing the Auditors: Has the Establishment of the Audit Oversight Board Affected Audit Quality”
statistically significant it provided evidence for the contribution of an oversight body towards enhancing audit quality.

Further, findings exist suggesting that PCAOB inspections successfully help to address auditors’ deficiencies in detecting and reporting upon material internal control weaknesses and thereby leading to improved quality in the audits of internal controls, albeit at a higher cost to audit clients.40 This study found that PCAOB inspection reports that indicated higher rates of internal control audit deficiencies contributed to an increased issuance of adverse opinions on internal control by auditors with respect to companies with these weaknesses.

Similarly, studies41 using a sample of non-financial companies located in 51 countries, covering the period 2003-2012, found that the level of abnormal accruals, working capital accruals, and discretionary revenues significantly decreased for companies domiciled in countries with oversight bodies conducting independent inspections compared to companies whose auditors are domiciled in countries that do not conduct inspections. They also found more timely loss recognition in corporates in jurisdictions where auditors were subject to inspections by public oversight bodies and noted that the effects of the introduction of inspections on audit quality was more pronounced for Big 4 audit clients.

Inspection is a crucial part of the oversight process, and its reporting requires considerable finesse in striking the right balance between transparency and confidentiality of results. Details of the inspection selection process, the number of inspections conducted, and the areas of focus are uncontroversial, however information and trend analysis of inspection findings in audit oversight board reports can be a cause of concern for reportees.

• IFIAR’s 2018 survey highlighted the following five inspection areas with the highest frequency of inspection findings for listed PIE audits as reported by its members:
  • Accounting Estimates, including Fair Value Measurements
  • Internal Control Testing
  • Adequacy of financial statement preparation and disclosure
  • Revenue Recognition
  • Audit Sampling

IFIAR acknowledges that the use of a survey is an imprecise tool, however the percentage of listed PIE audits inspected with at least one finding has reduced to 37% in 2018 compared to 47% in 2014.

40 Mark L. DeFond and Clive S. Lennox (September 21, 2015) “Do PCAOB Inspections Improve the Quality of Internal Control Audits?” University of Southern California
2.7. IFIAR and the global movement for audit oversight

The potential benefits of audit oversight have become widely recognized and have sparked a global movement to promote and improve implementation of audit oversight. IFIAR was established through initial meetings in Paris in 2006 and brings together independent audit regulators from around the world, including those from the most significant capital markets such as the US, Japan, and many EU Member States. IFIAR seeks to serve the public interest through global enhancements in audit oversight. The overall objective of IFIAR is to: “(i) share knowledge of the evolving audit environment and the practical experience of independent audit regulatory activity; (ii) promote collaboration and consistency in regulatory activity; and (iii) provide a platform for dialogue with other international organizations interested in audit quality.”

According to IFIAR’s membership criteria, public oversight systems should be:

- Independent of the audit profession, which means that a majority of the relevant governing body should be non-practitioners and funding should be free from undue influence by the profession; and

- Engaged in audit regulatory functions in the public interest and responsible for the system of recurring inspection of audit firms that undertake audits of public interest entities, exercising that responsibility either directly or through oversight of inspections undertaken by professional bodies.

55 countries on 5 continents are currently IFIAR members. About half the membership is from the European Union. Most G20 countries are members, although China and India are notably absent. Only a few developing countries are currently members, and representation of Africa and Latin America is so far sparse.

Table 3. IFIAR members

<table>
<thead>
<tr>
<th>Sample G20 Countries</th>
<th>IFIAR Member</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>×</td>
</tr>
<tr>
<td>Australia</td>
<td>✓</td>
</tr>
<tr>
<td>Brazil</td>
<td>✓</td>
</tr>
<tr>
<td>Canada</td>
<td>✓</td>
</tr>
<tr>
<td>China</td>
<td>×</td>
</tr>
<tr>
<td>France</td>
<td>✓</td>
</tr>
<tr>
<td>Germany</td>
<td>✓</td>
</tr>
</tbody>
</table>

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42 https://www.ifiar.org/about/
IFIAR generally admits new members only if they are aligned with most of the IFIAR core principles. These include standards for clear legal authorization to act independently and in the public interest; power to enforce auditing standards; and ability to perform recurring risk-based inspections of auditors amongst other criteria.

The IFIAR Board has also introduced an “associate membership” category for newer bodies that are not yet fully aligned. In keeping with available capacities and member needs. IFIAR’s governance structure and activities tend to be led by the audit oversight boards from developed market economies.
3. **CHALLENGES IN DEVELOPING COUNTRIES**

This section discusses the key challenges faced in the establishment of independent oversight boards in developing countries.

3.1. **Weak institutions**

Developing countries need robust financial reporting and effective and independent oversight of the auditing profession as much as the most developed market economies. There is fairly persuasive evidence showing the positive impact of adopting IFRS, in particular, on the ability to trade, transact, and list securities in foreign markets. It has also been highlighted that these positive benefits are more likely or pronounced in environments where there is less corruption, a higher level of enforcement, an infrastructure which provides adequate incentive for adoption, and other factors rendering the adoption ‘serious’ and ‘credible’ (De Fond et al, 2011 cited in Tarca 2012).43

However, in the case of some developing countries, the application of the rule of law is so unreliable or absent that the threat of these measures is negligible. Indeed, the non-transparent business culture that prevails in many developing countries can create particularly strong risks to auditor independence and performance and to the reliability of financial reporting.

Where business is commonly done through opaque networks of connections and associations, auditors may have unofficial affinities or affiliations with their clients or other stakeholders that compromise their incentive to challenge their clients’ accounting. Further, the audit market in developing companies typically does not adequately recognize or reward quality in auditing. Auditors can face strong temptation to compromise quality to undercut their competitors with cut rate services or accommodate their clients’ interests, in particular accounting outcomes.44

In addition, the capacity of the auditing profession is typically limited, especially in domestic firms unaffiliated with international networks but sometimes also within international affiliates. This, coupled with the lack of an established accounting and/or auditing tradition, weak professional accounting bodies, and a non-transparent business culture, creates added challenges for effective auditing.

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43 Ibid.
44 See for example the World Bank Serbia ROSC A&A June 2015 update
As noted by a World Bank report\textsuperscript{45}, countries that have undergone accounting and auditing assessments (Reports on Observance of Standards and Codes Accounting & Auditing – ROSC A&A) were found to be struggling “to put in place the basics of effective regulation with existing regulatory institutions, including banking and securities regulators, frequently lacking the mandate, resources, and methodologies required to monitor and enforce accounting and auditing requirements”. The report also notes that “the robustness of self-regulatory bodies is questionable, especially in those jurisdictions where the record of dealing with conflicts of interest is not encouraging. Even where formally independent regulatory bodies do exist, regulatory capture is frequent, and the judicial system is not considered an effective mechanism for seeking redress in matters relating to accounting and auditing”.

In many advanced economies, it is suggested, the audit profession is subject to discipline through additional mechanisms separate to audit oversight bodies such as civil litigation, with the threat of these sanctions acting as a deterrent to unethical practices.\textsuperscript{46} However, in developing countries with weak rule of law such alternative avenues of redress may not be realistically available.\textsuperscript{47}

On the other hand, when oversight bodies are manned by state nominees with unchecked powers, there is a potential for unduly harsh consequences and corruption. In some developing countries, government auditors have the power to hold employees in state owned enterprises personally liable for accounting fraud or error, including hefty fines and imprisonment, which has been seen to be counterproductive or even corruption inducing.

Although the creation of independent audit oversight bodies has been promoted as an integral component of an effective financial reporting architecture, these oversight bodies cannot be insulated from the overall weaknesses in governance, corruption, and capacity issues that afflict many developing economies. The establishment and functioning of new audit oversight bodies are influenced by domestic political and economic constraints and, thus, do not by default lead to improvements in financial reporting. Countries with weak institutions have major difficulties in importing reform measures developed in countries with a history of strong institutional effectiveness; the introduction of audit oversight bodies in the recent past has rested on the fundamental premise that every country can establish these bodies modeled on the Anglo American Model\textsuperscript{48}; and that the efficacy of local audit oversight

\textsuperscript{45} The World Bank. (September 2004) “Implementation of International Accounting and Auditing Standards - Lessons Learned from the World Bank’s Accounting and Auditing ROSC Program”


\textsuperscript{47} Please also see Matar, Soud “The impact of legal responsibility of external auditors on auditing quality and investment level” http://bura.brunel.ac.uk/handle/2438/11988

\textsuperscript{48} the efficacy of Anglo American model of corporate governance is largely dependent on a number of institutional factors, such as, ownership patterns, shareholder activism, efficiency of the capital market; the
boards should not be taken for granted. Countries differ significantly in their historical, social, cultural, and economic traditions and these differences in turn affect their ability to introduce systems of effective oversight and related reforms. Clientelist political systems, weakness of state apparatus, and limited country capacity are significant factors affecting the operation of recently established oversight bodies and noted that these factors exist in many countries.\textsuperscript{49}

IFIAR recognizes that oversight systems should be suited to the unique circumstances of each country but advocates a long-term vision for the “establishment of an authority which reflects widely recognized international practices for independent oversight of auditors”\textsuperscript{50}. Over time, international organizations like IFIAR may help create impetus for addressing problems in governance and performance of national oversight bodies by increasing the profile and visibility of audit oversight as a policy priority and highlighting good practices, thus creating a kind of international peer pressure for improvement.

International bodies may also help address capacity gaps in national oversight systems. Important initiatives have been launched to realize this vision. In December 2015, IFIAR established the Small Regulators Task Force (recently renamed as the Emerging Regulators Group), as a knowledge sharing platform among the new and emerging oversight bodies that already belong to IFIAR. In 2017 it set up a “new member only” section on its website, which enables enhanced information sharing of content and tools amongst participants.\textsuperscript{51} This is in addition to various working groups\textsuperscript{52} which aim to reduce capacity gaps. For example, IFIAR has an Inspection Workshop Working Group whose core responsibility is to organize annual training events for inspection staff from IFIAR member countries.

However, IFIAR and its members may not currently have an adequate budget or staff to meet demand for tools and resources to help developing countries design oversight systems; draft enabling legislation establishing initial operations in inspections, enforcement, and other critical functions; and provide other needed help to bring this vision to fruition. Although a number of IFIAR members have assisted non-IFIAR countries to develop audit oversight regimes, and may continue to do so in the future, these important efforts are unlikely to fully meet the growing need for assistance by the many developing countries currently building or likely to implement oversight systems.

\begin{flushright}
\textsuperscript{49} Constantinos Caramanis, Emmanouil Dedoulis, Stergios Leventis “Transplanting Anglo-American accounting oversight boards to a diverse institutional context”\textsuperscript{51}
\textsuperscript{50} IFIAR Reference Guide 2016
\textsuperscript{51} IFIAR Annual Report 2017
\textsuperscript{52} IFIAR Working Groups (WGs) are Enforcement WG, Global Audit Quality WG, Investor and Other Stakeholders WG (https://www.ifiar.org/members/investor-and-other-stakeholders-working-group/), International Cooperation WG (https://www.ifiar.org/members/international-cooperation-working-group/), Inspection Workshop WG (https://www.ifiar.org/members/inspection-workshops-working-group/), Standards Coordination WG (https://www.ifiar.org/members/standards-coordination-working-group/)
\end{flushright}
3.2. Exacerbated funding and capacity issues

Audit oversight boards must have adequate funding to hire and retain experienced auditors (who have attained at least manager level in international network firms), retain experts to conduct or assist in the review of specialized audits (e.g., financial services), and conduct complex investigations and disciplinary action. In addition, audit oversight boards require credible leadership to command the respect and attention of the profession and other key stakeholders, and provide incentives and accountability for the leadership to devote sufficient time to develop and guide the body.

The most common ways to fund public oversight bodies are through (i) general state revenues; (ii) fees or other levies on auditors or professional bodies; or (iii) fees or other levies on companies or listing authorities (see also Annex III).

Box 2. IFIAR’s Principle 2

IFIAR’s Principle 2 clearly outlines that “the audit regulator should have a stable source of funding which is secure and free from influence by auditors and audit firms and sufficient to execute its powers and responsibilities.”

The 2018 Accountancy Europe survey report on “Organization of the Public Oversight of the Audit Profession in Europe” highlighted that fees levied on audit firms constituted most of the funding for oversight bodies in most European countries. It noted that of the 24 IFIAR members in the EU: 6 are funded by the state, 7 entirely by audit firms, and 11 receive a mix of funding.53

Generally, the larger IFIAR members, including the US, UK, and Germany, receive little or no state funding. In contrast, smaller and more recently established oversight bodies tend to be reliant for a large proportion or even all of their funding from the state. In Europe, oversight bodies in Bulgaria, Croatia, the Czech Republic, Latvia, Lithuania, and Romania, for example, are fully or predominantly funded through the state budget.54 An overview of the funding arrangements in oversight bodies from developing or transitional countries which are IFIAR members – such as Georgia, Sri Lanka, Philippines, and Indonesia – also highlights that these bodies are all funded through state budgetary allocations (Table 4). In a sample of ASEAN Audit Regulatory Groups’ prospective member countries55 it is noted that oversight bodies in Cambodia, Vietnam, and Philippines56 are all financed through government budgetary

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53 CFRR (June 2017) “Public Oversight Systems for Statutory Audit in the EU”
54 Accountancy Europe study
55 Philippines, Brunei, Cambodia, Laos, Myanmar, and Vietnam
56 No longer a prospective member and joined IFIAR in 2019
allocations, with the exception of Laos where the body is financed through levies on audit firms (Table 5 below). Similarly, in Latin America national governments will likely continue to play a role in establishing and fostering independent audit oversight boards - in the absence of sizeable stock exchanges through which sufficient fees could be generated through listed companies for this purpose.  


### Table 4. Oversight bodies funding arrangements in some developing and transitional countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Funding Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Georgia</td>
<td>Fully funded by the state. The draft budget document is approved as part of the annual budget legislation by the Parliament of Georgia.</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Fully funded by the state. Funding comes from the state budget, approved by the House of Representatives, ensuring adequate funding and removing the possibility of undue influence from statutory auditors and audit firms.</td>
</tr>
<tr>
<td>Philippines</td>
<td>Fully funded by the state.</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>Fully funded by the state. The Board is presently funded entirely from the Government’s budgetary allocation to the Ministry of Finance appropriated by the Parliament of Sri Lanka. However, Act No. 15 of 1995 provides for the imposition of a compulsory charge on specified business enterprises, although this not been implemented yet.</td>
</tr>
</tbody>
</table>

### Table 5. Overview of the funding arrangements in ASEAN Audit Regulatory Groups’ prospective member countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Funding Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cambodia</td>
<td>Fully funded by the state. The National Accounting Council has its own budget which is a part of the budget of the Ministry of Economy and Finance.</td>
</tr>
<tr>
<td>Vietnam</td>
<td>Fully funded by the state. The Accounting and Auditing Policy Department is financed by the state budget.</td>
</tr>
<tr>
<td>Laos</td>
<td>Not funded by the state. Fixed annual fee paid by audit clients through audit firms for each audit engagement performed during the year</td>
</tr>
</tbody>
</table>

Government funding gives an audit oversight body independence from the profession. However, it renders oversight funding vulnerable to the vicissitudes of annual state budgeting
priorities, as well as dependent on political interests shaping the budget that may not always favor initiatives for greater transparency. Further, in jurisdictions, where audit oversight is part of MOF, capacity is limited by government rules in hiring staff as well as by the government salary structure which proves to be an impediment in recruiting staff at market-based salaries.

While lack of secure and stable funding is a key challenge faced by audit oversight bodies around the world, the problem is compounded in developing countries as most oversight bodies in these jurisdictions (i) appear initially to rely on funding from general state revenues, which tends to be unstable, especially if fiscal positions are constrained; (ii) statutory regulators may rely on the same set of large companies for the bulk of their fees, which can lead to criticism related to the cost of regulation; and (iii) for some audit oversight bodies, there is significant resistance to the levies on public interest companies where oversight bodies have unclear legal remits to charge these fees.

**Box 3. Extracts from Republic of North Macedonia ROSC A&A Update and Knowledge Paper findings**

**ROSC update**[^58]: “Identified need for the audit oversight board to augment staffing and technical capacity to be able to properly oversee the audit profession.”

**Knowledge Paper**[^59]: “Even now the Council for Advancement and Oversight of Auditing (CAOA) is struggling to secure sufficient funds to finance its operations and gain technical expertise to effectively fulfill its legal responsibilities. Approximately 80 percent of the CAOA budget is financed from the state budget and the remaining 20 percent comes from the Institute of Certified Auditors (ICARM), licensing fees, and other income arising from operations. The CAOA Council members do not contribute financially to the budget. These members include representatives from industry and other regulatory bodies.”

**Box 4. Extract from South Africa ROSC A&A findings**[^60]

“The audit oversight board’s resources and capacity should be increased and its funding model should be stabilized. IFIAR’s core principles provide that the audit regulator should have a stable source. While the Independent Regulatory Board for Auditors is charged with a wide range of responsibilities under the Auditing Profession Act that are both labor and cost-intensive, it does not have adequate financial and human capacity to carry out this mandate.”

[^58]: Republic of North Macedonia ROSC Accounting and Auditing update September 2014
[^59]: Knowledge Paper: Key Accounting and Auditing Reforms, December 2017
[^60]: South Africa ROSC Accounting and Auditing June 2013
“The Standards and Regulator Board should, in the short term, continue to enhance its independence by strengthening its processes, capacity, and funding. It should explore alternative sources of funding by referring to practices in other countries.”

In some cases, as the oversight bodies do not directly regulate public interest companies, it proves difficult for them to collect fees from PIEs, if that is part of the funding structure. In addition, in some countries, although governments commit to providing initial voluntary grants to help establish the audit oversight body, obtaining and replenishing these on an annual basis to sustain the oversight body proves problematic. Similarly, tax regimes in some jurisdictions do not provide for tax exemptions on the levies received by the oversight body, leading to inefficient fiscal outcomes and impacting the financial sustainability of the oversight body.

In Pakistan, for example, the Audit Oversight Board established in 2016 was initially financed through discretionary contributions by the Securities and Exchange Commission of Pakistan (SECP), the securities regulator, and the State Bank of Pakistan, the central bank and banking sector regulator. The law gives the audit regulator powers to levy an annual fee on public interest companies but this has been challenging. There have been a series of disputes and lawsuits by companies arguing either that they are not a public interest company and not within the scope of the audit oversight board act or that the fee is not justified. These companies also take the position that their regulator is the SECP and they have already paid it a regulatory fee. There are approximately 100 registered audit firms with about 300 audit partners. Since most firms are small, the potential revenue from auditors’ regulatory fees is relatively low. An additional issue faced in Pakistan is that the audit regulator does not have an explicit exemption from income tax. That means a substantial part of its gross income could potentially be taxed because of competing interpretations of the technicalities of the tax law. Taxation of statutory regulatory bodies is the norm in Pakistan, with a few exceptions such as the State Bank of Pakistan. Pakistan’s audit regulator is seeking funding through an annual budgetary allocation and explicit tax exemption to strengthen financial sustainability.

The situation in Pakistan illustrates the broader challenge in many developing countries in which the legal features, powers, and funding mechanisms for audit oversight may not have been clearly established through legislation. For instance, the 2016 Annual Report of the Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) observes the following: “a cess can be levied from specified business enterprises computed as a

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61 Zambia ROSC Accounting and Auditing October 2017
62 https://fp.brecorder.com/2018/05/20180511370657/
64 Tax or levy
percentage of shareholders’ equity or profit after tax whichever is higher as may be
determined by the Hon. Minister of Finance under the Act to finance the expenditure of the
Board. However, this option was not preferred by the Ministry of Finance and the cess which
was proposed to be in operation for periods commencing on or after 1 January 2008 was
withdrawn by the Hon. Minister on 7 October 2008.” The Sri Lanka ROSC A&A notes this
funding issue as a key challenge relating to improving corporate financial reporting as the
statutory framework does not allow SLAASMB to access additional sources of funds to
supplement existing government funds65.

Developing countries also frequently lack the essential building blocks of a strong accounting
education curriculum and a robust PAO which underpin the development of competent
accounting professionals. Thus, there may be a fundamental dearth of accounting
professionals available to these countries and, consequently, to staff any oversight body with
competent inspectors.

Retaining qualified personnel and levying fees to pay inspectors at market rates may
sometimes be easier when the quality assurance function is initially delegated to a
professional body, with oversight from, and an element of risk-based inspections by, the audit
oversight body.66 However, in developing countries the level of audit fees is often low and
this would make any additional levies by the professional body on firms and auditors for
quality assurance activities burdensome; in some circumstances, there could be concern that
additional levies on audit firms could reduce the resources they have available to perform
their audits adequately. This option is also potentially detrimental to the independence of the
audit oversight system.

As reflected in Table 6 above, these issues, among others, have been highlighted as key
challenges in developing and transitional countries for the establishment and effective
functioning of oversight systems.67

<table>
<thead>
<tr>
<th>Country</th>
<th>Key Challenges identified</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vietnam</td>
<td>Lack of financial resources with funding for quality assurance only from the government and no mechanism to collect contributions from the profession or PIEs.</td>
</tr>
</tbody>
</table>

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65 ROSC Accounting and Auditing Sri Lanka, June 2015
66 In addition, other benefits may include (i) stable funding based on fee assessments made by the professional body; (ii) no civil-service restrictions on salaries which make recruitment difficult; and (iii) a professional body may better appreciate the experience and key attributes required by quality assurance staff for the new system.
67 Based on a questionnaire administered to AARG prospective member countries in 2017. feedback from the Audit Oversight Board, Pakistan and ROSC reports.
### Country | Key Challenges identified
--- | ---
Cambodia | The biggest challenge in the establishment and maintenance of a public oversight and quality assurance system in Cambodia will be finding a structural budget to hire experienced quality reviewers in continuity.
Laos | Need to build qualified auditors and reviewers (time and costs)
Pakistan | “Although steps have been taken toward independent oversight, with the establishment of the Audit Oversight Board, further development and a sustainable institutional framework is required. The institutional capacity of the Audit Oversight Board needs to be built, by ensuring adequate funding arrangements for the Audit Oversight Board and the Quality Assurance Board of the Institute of Chartered Accountants of Pakistan, affiliation with IFIAR, and support in building the capacity of the Audit Oversight Board and Quality Assurance Board” 68
South Africa | “While IRBA 69 is charged in the Auditing Profession Act with a wide range of responsibilities that are both labor- and cost-intensive, it does not have adequate financial and human resources capacity. IRBA is in need of additional funding to carry out its existing mandate.” 70

#### 3.3. Enhanced risks of “compromised” boards

In accordance with IFIAR core principles, audit oversight bodies in most jurisdictions contain a majority of non-practitioners to avoid conflicts of interest and ensure independence from the profession. In the EU, in compliance with EU Directives, all oversight boards contain only non-practitioners and mostly include lawyers, bankers, former civil servants, and audit professionals. In the US, two out of the five PCAOB board members have to be certified public accountants but they must be completely independent of the profession once they join the board. Members of oversight boards in smaller or more recently-established bodies typically include representatives of other regulators, government departments, academics, and representatives from the central bank.

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68 Pakistan ROSC A&A, January 2017  
69 South Africa Independent Regulatory Board for Auditors  
70 South Africa ROSC A&A, June 2013
“IFIAR has determined independence to mean at least having a majority of non-practitioners within the relevant governance oversight body and having funding that is free from undue influence of the profession”.

In this regard, oversight bodies in developing countries may also suffer from a significant challenge due to the fact that PAOs pre-date them by a number of years and possess the structure, funding, and political leverage and clout to influence discussions related to government policy choices related to: (i) where to situate the oversight body; (ii) the ability to influence legislation pertaining to the establishment of oversight bodies (thereby diluting or influencing its remit); and including (iii) the appointment of key management and nomination of members to its governing body. Members of PAOs may also hold positions of power in both the private and public sectors, including on other regulatory authorities. The more power the local PAO commands, the more difficult it could be for the new audit regulator to do its job as an effective regulator.

Indeed, risks related to vested interest groups exerting pressure on politicians and policy makers are amplified in developing countries and may extend to the nominations for oversight bodies’ boards. A comparison of the independence of audit oversight boards of advanced EU Member States and the US determined that while all countries claim to possess formal independent oversight bodies, there was a visible gap between countries with comparatively strong independent oversight authorities and systems in which accounting bodies still maintained far-reaching regulatory influence.71

IFIAR has identified the key factors determining independence as having a majority of non-practitioners within the relevant governing oversight body and having funding that is free from undue influence by the profession. In developing countries, however, many board members also serve on the boards of various companies in various capacities, including being represented on the audit committees of such companies. There have also been cases where the heads of regulatory agencies tasked with audit oversight have joined audit firms as independent non-executive directors while maintaining their extant responsibilities. The discharge of these roles may bring into question the independence and objectivity of these directors and by implication of the audit oversight body. PCAOB members, by contrast, are required to be full time employees.

Nominated board members may also lack the required technical capacity or understanding of the issues they are supposed to address, thereby reducing the effectiveness of the oversight system.

3.4. Weaknesses in primary law

Newly formed audit regulators may suffer from weaknesses in the primary law establishing the audit regulator. Because it is often difficult and time consuming to make legal amendments, a weakness in the primary law, such as an abridged or limited right to inspect records of an audit firm, could affect the regulator for many years. There would ideally be a set of clear principles agreed internationally that a law establishing an audit regulator should be able to meet. These principles could be similar to IFIAR’s core principles pertaining to independence, funding, and powers. Currently, IFIAR’s principles are more of a reference point for the audit regulator that wants to become a member of IFIAR, rather than a benchmark for the law establishing the regulator. Therefore, more clear guidance on minimum legal standards would help both existing regulators to amend their laws and future audit regulators to implement appropriate laws.

3.5. Regulation cannot fully address lack of demand for audit quality

Very low prevailing audit fees in some jurisdictions (such as Pakistan) directly affects audit quality, for example a firm may not invest in audit software if its revenue and potential to grow are limited. Low audit fees also indirectly affect the regulatory authority responsible for overseeing audit quality, as enforcement is extremely challenging in an environment that resists paying for quality. Audit needs to be valued and paid for accordingly before long running quality chain issues, such as how to attract high achievers to choose audit as a profession, can be addressed.

Audit oversight can play some role in improving market conditions to promote audit quality. For example, in every jurisdiction, there are a certain number of purported auditors who may be willing to sell audit reports rather than audit services. That is, for a very low fee, they may be willing to provide a company subject to statutory auditing requirements with an audit report, while performing little or no actual auditing. This is essentially fraud, because a standard audit report affirms that an actual audit was performed in accordance with professional standards and that the opinion offered is based on that audit work. Such fraudulent activities may make it difficult for diligent and honest auditors to survive in the marketplace if companies do not care about audit quality but only about paying the lowest possible fee to meet (or appear to meet) the statutory audit requirement. Sellers of fraudulent audit reports can always offer a lower fee than auditors who actually seek to fulfill their professional obligations.

An audit oversight system should prioritize identification of such fraudulent actors and remove them from the audit market, so that honest auditors may bid for audit engagements with some hope of being paid fees that will support a genuine audit. Furthermore,
information generated by the inspections system should enable those companies that actually care about audit quality to identify the auditors who are willing and able to provide it, thus also improving market conditions favoring quality auditing.

However, regulatory measures alone cannot create demand for audit quality where none exists. In a market where most companies seeking audit services do so only because of a legal mandate and generally do not care about audit quality, such measures will likely prove insufficient to create an audit market that adequately identifies, favors, and rewards high-quality auditing.
4. CONCLUSIONS

This section offers three conclusions relevant to countries considering the introduction of audit oversight. It also calls on the international community to consider establishing a capacity development body to provide guidance and technical knowledge in audit oversight.

4.1. Carefully assess whether the country is ready for public oversight

The unique characteristics of each country should underpin analysis of whether it is ready for an independent audit oversight body. Audit oversight is a challenging area of regulation that requires significant resources to be implemented properly (see also Annex II: Significant factors relevant to establishing an audit oversight function). Creating an audit oversight body can do more harm than good if not done properly. Auditing is one of the most difficult industries to regulate. Countries that do not have the resources to provide an audit oversight body with adequate funds or sufficiently experienced and knowledgeable personnel may better focus their resources initially on improving accounting and auditing education, developing professional accountancy bodies, and other priorities before attempting public oversight of auditing. In Bangladesh, for instance, the 2015 ROSC report\(^\text{72}\) concluded that a new oversight authority would be too sophisticated given the relatively smaller size of the corporate sector and the accounting/auditing profession compared to developed countries.

4.2. Consider placement of the oversight body within an extant regulator

Audit oversight bodies can be situated either within government, within wider-remit regulators, or set up as independent bodies. Each model has its advantages and disadvantages. In developing countries facing substantial capacity challenges, establishing the oversight body as part of another regulator may sometimes be the most workable solution.

In countries with comparatively little appreciation of the value of an audit oversight board but greater appreciation of other regulators it might make sense, at least in the short-term, to establish the audit oversight board as part of an existing regulator, such as a securities commission. This would also allow the audit oversight board to leverage the expertise, brand, and resources available to such established regulators\(^\text{73}\) and help address potential regulatory


\(^{73}\)A recent example is the Audit Oversight Division housed within the Capital Markets Authority in the Kingdom of Saudi Arabia
“turf” issues among regulators, while minimizing additional costs to the audit firms and PIEs. New audit regulators tend to lack brand recognition which could result in a poor response to their actions and demands as the audit market seek to understand their remit and scope of activities. A communication from an established securities regulator, insurance regulator, or banking regulator is more likely to be taken seriously with an intent to comply. A similar challenge will be faced by the audit oversight board when dealing with other government organizations and ministries that may be largely unaware of the new regulator.

One of the main reasons the audit mandate is often not given to the securities regulator is that it requires more subject matter expertise and time than a securities regulator (focused on the capital markets) may be able to provide. However, for countries with relatively few accountants who possess significant experience of IFRS and derivative financial reporting standards, combining the audit oversight board with other regulators could maximize use of their financial reporting knowledge and insight in the review of regulated entities’ financial statements.

Separate institutions and regulators require comparatively greater resources in terms of time and funds to establish and maintain infrastructure. Developing economies are often too small (and with tremendous pressure to cut costs) to afford fully fledged independent audit regulators with all the duplication in costs from IT servers to support services personnel. Combining regulators may reduce overhead costs and help alleviate some of the funding issues associated with recently established oversight bodies. This set up may also allay issues faced by audit oversight boards in raising fees through additional levies on companies.

Such a structure would ensure that in the crucial initial formative years of the oversight body, sufficient funding is available for it to discharge its oversight role and also to attract competent and qualified staff as it builds capacity. Indeed, establishing the oversight body within an extant regulator may not only act as an interim solution; this may in some cases be the best long-term solution for a developing country with established regulators being the founders (and parents) of the audit regulator, with long term ownership.

4.3. Explore opportunities for a new international audit oversight capacity development organization

Developing countries are at various stages of adoption and implementation of international accounting and auditing standards, and there is clearly a significant unmet need for an enduring, centralized, competent, and adequately funded source of technical advice and assistance, available to all developing countries seeking to implement independent audit oversight. CFRR experience in various developing countries including with oversight bodies in South Asia, Eastern Europe, and East Asia demonstrates a need to develop basic legal frameworks, regulations, and institutions to oversee auditing of financial statements of PIEs,
including the financial sector, to help promote investor and lender confidence, and to facilitate integration into the regional economy. Training, advice, and capacity development are critical to the success of these bodies. A centralized source could efficiently develop, accumulate, and disseminate tools and knowledge of good practices for implementation and operation of audit oversight systems, with a focus on tackling the challenging environments seen in many developing countries.

The international community should, therefore, consider exploring opportunities for establishing a capacity development body similar to the IDI to help with building the capacity of recently established audit oversight boards in developing countries. IDI was established in its current form at the Sydney INTOSAI Congress in 1986 and supports INTOSAI members, including over 140 developing countries, enhance the independence, professionalism, and performance of supreme audit institutions. Activities of the IDI include long-term regional training programs, regional satellite and partnership programs, as well as IDI training seminars and workshops in key areas of government auditing. There has been stable financial support and funding provided to the IDI by the Office of the Auditor General of Norway, the Swedish International Development Agency, the United States Agency for International Development, the International Fund for Agricultural Development, the Norwegian Agency for Development, the Austrian Development Agency, and INTOSAI, amongst others.

Accordingly, stakeholders should explore whether a similar, enduring body with stable funding could have similar benefits in the development of audit oversight.

74 Source: http://www.idi.no/en/about-idi/introduction
76 http://www.idi.no/en/about-idi/finances
ANNEX I: IFIAR CORE PRINCIPLES

IFIAR further specifies 11 core principles of public oversight systems arranged around three themes:

**The structure of audit oversight:**

1. Principle 1: The responsibilities and powers of audit regulators should serve the public interest and be clearly and objectively stated in legislation.
2. Principle 2: Audit regulators should be operationally independent.
3. Principle 3: Audit regulators should be transparent and accountable.

**The operations of audit oversight:**

4. Principle 4: Audit regulators should have comprehensive enforcement powers which include the capability to ensure that their inspection findings or recommendations are appropriately addressed; these enforcement powers should include the ability to impose a range of sanctions including, for example, fines and the removal of an audit license and/or registration.
5. Principle 5: Audit regulators should ensure that their staff is independent from the profession and should have sufficient staff of appropriate competence.
6. Principle 6: Audit regulators should be objective, free from conflicts of interest, and maintain appropriate confidentiality arrangements.
7. Principle 7: Audit regulators should make appropriate arrangements for cooperation with other audit regulators and, where relevant, other third parties.

**Audit inspection principles:**

8. Principle 8: Audit regulators should as a minimum, conduct recurring inspections of audit firms undertaking audits of public interest entities in order to assess compliance with applicable professional standards, independence requirements, and other laws, rules, and regulations.
9. Principle 9: Audit regulators should ensure that a risk-based inspections program is in place.
10. Principle 10: Audit regulators should ensure that inspections include effective procedures for both firm wide and file reviews.
11. Principle 11: Audit regulators should have a mechanism for reporting inspections findings to the audit firm and ensuring remediation of findings with the audit firm.
ANNEX II: SIGNIFICANT FACTORS RELEVANT TO ESTABLISHING AN AUDIT OVERSIGHT FUNCTION

<table>
<thead>
<tr>
<th>Factor</th>
<th>Considerations</th>
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<tbody>
<tr>
<td>State budget</td>
<td>An audit oversight board which is dependent on a stagnant, declining, or insufficient state budget and is prohibited from raising additional revenues may not be able to properly to perform its obligations. It might be better instead to form the professional oversight board as an entity that is not dependent on financing from the state budget.</td>
</tr>
<tr>
<td>Raising revenue</td>
<td>If other regulators in the jurisdiction already levy fees on PIEs and the audit oversight board is considering raising revenue in the same way it might be easier for PIEs to pay a single charge, to be divided among different agencies as appropriate. This does not necessarily mean that regulators should merge although it would make things easier from an administrative perspective if they did.</td>
</tr>
<tr>
<td>Influence</td>
<td>If the role and value of an audit oversight board is not yet well appreciated, and there is wider understanding of other regulators, it might make sense to establish the audit oversight board as part of another regulator, at least in the short-term.</td>
</tr>
<tr>
<td>Pay scales</td>
<td>Countries where civil service pay scales would be insufficient to attract appropriately qualified and experienced staff to an audit oversight board might consider establishing their professional oversight board outside of the civil service.</td>
</tr>
<tr>
<td>Regulators’ accounting capacity</td>
<td>Countries with a relatively small pool of accountants possessing significant experience of IFRS and other financial reporting standards might consider combining the audit oversight board with other regulators to make best use of this knowledge in the review of their regulated entities’ financial statements.</td>
</tr>
<tr>
<td>Regulators’ audit capacity</td>
<td>Countries with a relatively small pool of experienced audit professionals might benefit from combining the audit oversight board with other regulators who need and would benefit from such experience in their interactions with audit firms.</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>Separate institutions and regulators require comparatively greater resources in terms of time and funds to establish and maintain infrastructure. Combining regulators may reduce overhead costs.</td>
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77 CFRR (June 2017) “Public Oversight Systems for Statutory Audit in the EU”
<table>
<thead>
<tr>
<th>Factor</th>
<th>Considerations</th>
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<tbody>
<tr>
<td>Number of PIEs</td>
<td>Countries with a relatively small number of PIEs might be better served by fewer regulators given that audit oversight boards tend to review the audits of individual PIEs on a three-year cycle and other regulators tend regularly to review PIEs’ financial statements.</td>
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<tr>
<td>Number of auditors of PIEs</td>
<td>Countries with a relatively small number of auditors of PIEs might be better served by fewer regulators, particularly as other regulators tend to meet regularly with PIEs’ auditors to discuss general industry issues as well as approaches to specific accounting and auditing concerns.</td>
</tr>
<tr>
<td>Regulation of listed entities.</td>
<td>In countries with lots of regulation aimed solely at listed companies there is likely a close relationship between the audit oversight board and securities regulator; e.g., the US PCAOB has a close relationship with the SEC.</td>
</tr>
<tr>
<td>Appetite of other regulators</td>
<td>If other regulators are not keen on the idea of a super regulator or regard an integrated audit oversight board as a distraction, burden, or irrelevance, the audit oversight board may be better kept separate. An independent body has a much clearer institutional focus on audit oversight and the governance arrangements are often clearer.</td>
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## ANNEX III: FUNDING OPTIONS

<table>
<thead>
<tr>
<th>Source</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government funding</td>
<td>Ensures maximum independence for the audit oversight body</td>
<td>Insufficient funding may be programed, commitments may not be received or not received on a timely basis, especially in developing countries with constrained fiscal positions.</td>
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<tr>
<td></td>
<td>Signals government commitment to audit reforms</td>
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<td></td>
<td>As auditing benefits society some public funding is appropriate</td>
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<tr>
<td>Funded by levies on audit firms</td>
<td>Equitable as the providers of services are charged for the necessary assurance on their activities</td>
<td>Low audit fees in most developing countries may make it difficult for firms/profession to raise sufficient funds.</td>
</tr>
<tr>
<td>Funded by levies on companies</td>
<td>Independent of the profession</td>
<td>Onerous on companies, legal wherewithal of the audit oversight body to levy fees may be challenged in court.</td>
</tr>
</tbody>
</table>