

# International experience in setting up audit oversight and quality assurance: institutional arrangements and activities

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IMPROVING AUDIT QUALITY THROUGH AUDIT OVERSIGHT AND QUALITY ASSURANCE SYSTEMS


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**Centre for Financial  
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# Objectives

The objective of the session is to present and discuss

- » the origins, functions, and current challenges of public oversight of the auditing profession
- » the different institutional arrangements for public oversight and quality assurance, their strengths and weaknesses
- » the main activities - using examples of audit oversight and quality assurance systems from various countries around the World



# Self-Regulation in the Auditing Profession

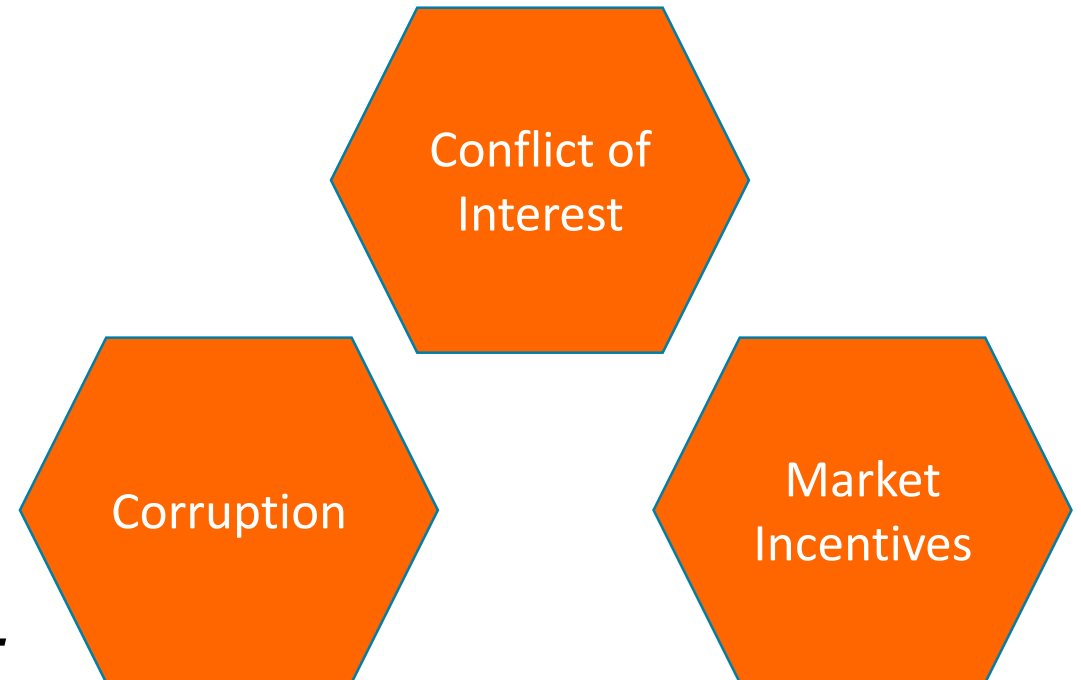
- » Until 2002 – audit profession was self-regulated: professional bodies developed auditing standards, disciplined their members, and advertised the quality and benefits of their members' audits to the public
- » Regulators in the U.S. and elsewhere occasionally intervened to discipline auditors in particularly egregious cases and sometimes to induce the profession to strengthen auditing standards

# Why Public Oversight?

» The modern movement towards public oversight of the auditing profession began with the wave of corporate financial reporting scandals starting about 17 years ago in the U.S., Europe, and Japan.

» Sarbanes-Oxley Act of 2002  
followed by the 2006 EU statutory  
audit directive –

*a worldwide consensus - auditors  
cannot adequately regulate  
themselves, mainly because they do  
not have sufficient incentive to do so:*





## Self regulation by the profession and by internal quality procedures – not sufficient any longer

- » Audit firms themselves attempt to assure consistent quality by developing internal systems of quality control addressing:
  - (a) Leadership responsibilities for quality within the firm.
  - (b) Relevant ethical requirements.
  - (c) Acceptance and continuance of clients and specific engagements.
  - (d) Human resources.
  - (e) Engagement performance.
  - (f) Monitoring.

**See ISQC 1**

- » PAOs – in the past mostly focused on areas of access to the profession and less on QA

# Role of Audit Oversight in Development of CFR

Creating mechanisms to monitor and improve auditing practices – adequate incentives to push for improvements in the quality and reliability of corporate reporting

Government authorities may lack capacity and resources to monitor the quality of corporate financial reporting directly

Private monitors of corporate reporting may be absent, underdeveloped or have no appropriate instruments (analysts, bond rating agencies, financial journalists, institutional investors)

In many emerging and middle market countries, most accounting expertise resides in the local auditing profession, including local affiliates of international network firms



# Audit Oversight to Improve Financial Reporting

An effective system of public oversight may:

- > Improve the overall system of financial reporting by sharpening the quality and rigor of audits and removing the worst performers from the market;
- > Enhance public trust in financial reporting and auditing through its work and public profile; and
- > Help promote public understanding of auditing and financial reporting through public outreach

Effective independent oversight of auditors adds **credibility** and **value** to financial information. In a competitive environment, market use and demand for financial information should then grow.

# Audit Oversight to Improve Functioning of Audit Market

Public oversight  
can bolster the  
functioning of  
the audit market  
by:

- Enhancing knowledge in the market about the audit function and determinants of audit quality
- Providing more information to the market about the audit quality of particular firms and auditors
- Strengthening incentives, through reporting and enforcement, for firms to improve audit quality
- Removing the worst performers from the market
- Pushing for continuous improvements in practice



# Basic Functions of Public Oversight

Public oversight bodies (POBs) can monitor and improve the quality of auditing by:

- Regularly inspecting the quality control systems that firms have adopted to see if they are effectively designed and implemented
- Regularly inspecting some of the individual audits performed by firms to assess their adequacy
- Developing measures to induce firms to address any deficiencies found in their quality control system
- Conducting investigations and imposing discipline to address the most serious deficiencies, deter 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



# When is a country ready for public oversight?

Creating an audit oversight body can do more harm than good if not done properly

Countries that do not have the resources to provide an 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

Audit oversight is a challenging area of regulation to implement properly, and requires significant resources

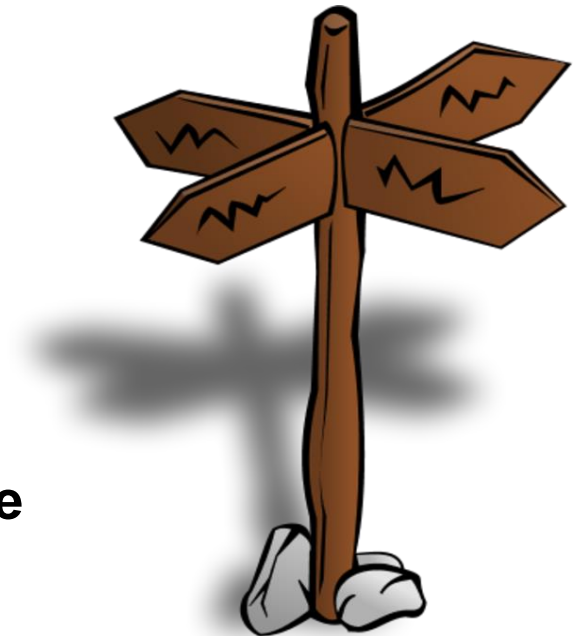
# The Peculiar Nature of Audit Regulation

- » Auditing complex companies does not involve just following some standard set of procedures and ticking boxes on a checklist
- » To be effective, an auditor must use knowledge and experience 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
  - Use professional judgement to design and perform tests for the particular company to obtain reasonable assurance that the financial reporting is reliable
  - And the auditor must do all of this efficiently, within a reasonable time and at a reasonable cost
- » Thus, **audit regulators must understand that they are not regulating a routinized activity**, in which they could expect to see the same steps and procedures performed every time. This is an enormous challenge for effective regulation.

# The danger of misdirection

- » Auditors must perform their complex function in a limited time and with limited resources
- » If regulators force auditors to spend time and resources on activities that do not involve identifying and addressing the real risks of inaccurate financial reporting for the companies they audit, they will have less time and fewer resources to fulfill their real and important function
- » A regulator that does not adequately understand modern auditing might force auditors to spend too much time on unproductive “compliance” activities such as:
  - » Satisfying excessive documentation requirements
  - » Performing formalistic or rote audit procedures
  - » Creating formalistic quality assurance processes

**A misdirected profession will not develop and improve**





# Critical Need for Audit Experience in Public Oversight

Auditing is one of the most difficult industries to regulate properly. To determine whether the auditor acted with professional competence and reasonable diligence & judgement, the regulator must

- become familiar with the large set of facts about the audited company that the auditor considered (or should have considered)
- identify and understand 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
- assess whether those procedures and programs appear reasonable in light of the risks of unreliable reporting that the auditor faced

**Only someone highly trained and experienced in auditing can adequately perform this regulatory function. For review of some audits (e.g., financial services, airline, extractives) industry-specialized experience is also needed**

# Resource/Capacity Needs for Effective Audit Oversight

## Must have adequate funding to:

- hire and retain experienced auditors, who have attained at least manager-level in international network firms or equivalent, to do audit quality inspections (**which is often challenging due to civil service pay scales**)
- retain experts to conduct or assist in review of specialized audits (e.g., financial services)
- conduct complex investigations and disciplinary actions

## Also must have:

- leadership with the credibility to command the respect and attention of the profession, reporting companies, other regulators, and stakeholders
- Incentives and accountability for the leadership to devote sufficient time to developing, guiding, and publicizing the oversight body, and communicating to the general public
- mechanisms to obtain regular input and feedback from stakeholders

# Need for Risk Targeting in Inspections

Review of individual audits by an oversight body requires substantial time, resources, and expertise

Oversight bodies can therefore review only a tiny portion of the audits performed within their jurisdiction

To be effective, oversight bodies must develop sufficient expertise to identify the audits that are most likely to pose substantial risk, based on

- > the likelihood of audit deficiencies and
- > the potential impact on stakeholders

Oversight bodies must also be able to identify whether an audit firm's internal quality control program is adequate to help assure competent auditing

# The Challenges of Structuring an Oversight Body

As should be apparent, countries face substantial challenges in structuring, funding, staffing, and operating effective audit oversight bodies. The body needs to be:

- Independent of the auditing profession, but informed by the knowledge and expertise of the profession
- Stringent in imposing accountability on auditors, yet sensitive to the role of auditor judgment and the limitations of routine business audits
- Specialized and focused, yet informed and responsive to the evolving needs of a broad community of users of financial information and other stakeholders, including investors, lenders, regulators, corporate board members, financial analysts, and others



# The Fundamental Dilemma of Public Oversight:

## EXPERTISE

- Auditing is a highly technical field, and most knowledge and experience resides within the profession

## INDEPENDENCE

- An outside and independent body is needed to supervise the profession, but if that body lacks expertise, it may misdirect the profession

# How should oversight board be structured?

The audit oversight body could be:

- A self-standing, separately funded, independent agency
- An office , division, or component of a body with a broader regulatory function, such as a securities regulator
- An office or department within the country's public administration (e.g. Ministry of Finance)

For instance, out of 24 EU member states that reported information about their oversight bodies to IFIAR in 2014:

- 19 had created their oversight bodies as separate, independent bodies
- The other 5 housed (some within integrated financial sector regulator, some as part of public administration)

## Examples of Structures (1)

- » In **Malaysia** the six members of the [Audit Oversight Board](#) are appointed by the Securities Commission Malaysia
- » The [Certified Public Accountants and Auditing Oversight Board](#) (CPAAOB) in **Japan** is an independent regulatory body (council) established within the Financial Services Agency (FSA), consisting of one chairperson and one full-time and eight part-time commissioners. The board members are appointed by the Prime Minister with the consent of the Diet. The Board exercises its statutory authority independently from the FSA

## Examples of Structures (2)

- » The public oversight function in the **United Kingdom's Financial Reporting Council** has always been independent
- » The public oversight function in the **Netherlands** has always been part of that country's securities regulator, the Authority for Financial Markets.
- » The **French** audit oversight body, the H3C, was created in 2003 as a high-level independent public authority with direct links to the Minister of Justice and has a working relationship with the combined banking and insurance regulator
- » The **U.S. PCAOB** is established as an independent body, but its budget and significant decisions are subject to review by the securities regulator, the SEC

# Advantages of a Separate, Dedicated Body

## Advantages of a separate, independent body:

- More specialization and focus in its mission and operations may result in better accumulation of knowledge and more informed decision-making. The Board members of a body with a much broader mission may never develop sufficient expertise to adequately guide the audit oversight function
- A single body can ensure that audit oversight remains consistently a top regulatory priority
- A single, dedicated body may be more accountable for results
- In some countries, a separate oversight body may be structured to avoid governmental compensation limits, allowing more flexibility to attract former auditors with the needed skills and experience



# Advantages of Embedding in a Larger Regulator

In countries where there is comparatively little appreciation of the value of a POB, and where there is greater appreciation & public recognition of other regulators, it might make sense at least in the short-term to establish the POB as part of another regulator.

Countries with a relatively small pool of accountants with significant experience of IFRS and derivative financial reporting standards might benefit from combining the POB with other regulators who need and would benefit from such experience as they review their regulated entities' financial statements.

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.

# Need to Insulate from Excessive Political Influence

Housing the public oversight body as an office within the Ministry of Finance or an equivalent may leave it more vulnerable to political influences, instability, and neglect, particularly in an environment where government ministers are frequently reshuffled

The selection of board members for the oversight body should be structured to favor relevant experience and competence over political connections

Terms of board members should be long enough to allow them to take a more-long term view and to give some continuity to the board and its activities

Ideally, funding should be insulated from big swings in state budgetary priorities & free from undue influence from the profession



## Composition of the Board

Board members should be selected to achieve both **competence** and **independence**. Must find board members with

- adequate **financial sophistication**
- willingness to devote **time and attention**
- **credibility** with the profession and the public

**Someone on the Board should have in-depth understanding and experience of the auditing process and/or have a perspective of user of financial information, or the Board must have a way of seeking advice with persons with that experience, without compromising its independence. This may be particularly challenging in emerging markets with a younger audit profession.**



# Examples of Board Composition

Public Oversight Boards at large IFIAR members typically include:

- Retired professionals such as lawyers
- Former audit professionals
- Former bankers
- Directors or former directors of leading companies
- Representatives of business community
- Former civil servants

In addition, members often include

- representatives of other regulators, departments, or central bank, *ex officio*
- Academics (university professors, etc.)



# Role of Advisory Committees

A POB may establish advisory committees, either for a specific and temporary purpose, or on a standing basis, to assure that its decisions are adequately informed. Use of such committees can also increase stakeholder visibility and support. Consultations should occur in a public and transparent way, to assure there is no appearance of compromise of the Board's independence. Such bodies might include:

- > Representatives from the profession
- > Large or institutional investors
- > Leading academics
- > Financial journalists



## Possible Model of Board Composition: Begin with Minority of Practitioners, and Work Towards Full Independence

In an environment where retired audit partners or other former practitioners are not available, and other sources of technical audit knowledge may not be available, it may sometimes be best to begin a Board with some sitting practitioners, who would only command a minority of the voting power, to assure that the Board is adequately informed with knowledge of the auditing profession

As the system matures and develops access to professional knowledge, the Board should become fully independent by removing current practitioners entirely from the decision-making body

# Alternative Structures of Inspections Systems

Globally, there are broadly three approaches with regards to inspecting audit firms in countries with Public Oversight Boards:

- The POB directly inspects auditors of public interest entities and auditors of other entities
- The POB directly inspects auditors of public interest entities and oversees the professional accounting organizations who in turn directly inspect auditors of other entities
- The POB oversees the professional accounting organizations that in turn directly inspect auditors of both public interest entities and other entities.

Locating quality assurance within the POB will render it more independent, but possibly less qualified, depending on how funding and structure are resolved

# One Possible Model: Begin QA with Professional Body?

Retaining qualified personnel and levying fees to pay inspectors at market rates may sometimes be easier when the QA function is initially delegated to professional body

- Funding based on fee assessments may be stable/adequate
- No civil-service restrictions on salaries
- Professional body may understand need for experience/other attributes for quality assurance staff

Profession itself may thereby be mobilized to support adequate funding and staffing for the new system.

# Working towards Independence of the QA System

If quality assurance begins with the professional body, the independence of the QA function can be enhanced through measures such as required POB involvement and approval for:

- Hiring, firing, promotion and compensation of inspectors;
- Planning of inspections and inspection reporting;
- Continuous training and development

The inspections team might later be transferred to the POB



# Investigations and Discipline

To be effective, every regulatory system must have an enforcement mechanism that can impose serious sanctions for failure to comply, and this certainly applies equally to audit regulation

In addition, a primary function of audit regulation is to remove incompetent or unethical participants from the market

The structure of enforcement systems is heavily dependent on national law and the legal environment

An effective enforcement system will need to have:

- Sufficient resources to investigate complex fact patterns
- Access to expertise about auditing and quality-control standards
- A fair and independent process for charging and adjudication

# IFIAR Principles - The Structure Of Audit Oversight

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

The structure of audit oversight:

**Principle 1:** The responsibilities and powers of audit regulators should serve the public interest and be clearly and objectively stated in legislation

**Principle 2:** Audit regulators should be operationally independent

**Principle 3:** Audit regulators should be transparent and accountable





## IFIAR Principles – The Operations Of Audit Oversight

**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

**Principle 5:** Audit regulators should ensure that their staff is independent from the profession and should have sufficient staff of appropriate competence

**Principle 6:** Audit regulators should be objective, free from conflicts of interest, and maintain appropriate confidentiality arrangements

**Principle 7:** Audit regulators should make appropriate arrangements for cooperation with other audit regulators and, where relevant, other third parties



## IFIAR Principles – Audit Inspection Principles

**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

**Principle 9:** Audit regulators should ensure that a risk-based inspections program is in place

**Principle 10:** Audit regulators should ensure that inspections include effective procedures for both firm wide and file reviews

**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

# Strategic Direction of Public Oversight

Identifying and rooting out the worst auditors, who undermine the audit market, the profession, and the public's trust

Using inspections and enforcement as capacity-building tools

Strengthening the market for audit services to focus more on audit quality and gradually realigning the incentives of the auditing profession

Serving as a “thought leader” in the development and use of auditing services



## Let's Discuss:

- » What role do you think audit oversight could play for your country in supporting economic development and integration with other markets?
- » Which stakeholders can be enlisted to support public oversight? Which might resist? What can be done to gain their support?
- » What would an ideal board look like in your country? What challenges do you see in recruiting the right people to serve on your board?
- » Should your board be part of another agency/department, or separate?