The 2\textsuperscript{nd} Taipai Corporate Governance Forum

Contemporary Developments in Restoring Public Trust in the Accounting Profession – Information Disclosure, Transparency and Related International Standards

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1. Introduction

Restoration of the public’s confidence in the accounting profession is of paramount importance, and rightly so. This profession has suffered significant undermining in the level of confidence and trust the public holds in its work, by virtue of a number of major corporate collapses both in Australia and internationally.

The former SEC Chairman, Arthur Levitt Jr, recently explained just how essential the public’s trust and confidence is to the accounting profession, as follows:

*The accounting profession is a profession like no other, and, in my mind, one of the most noble in our marketplace. ...With that precious franchise come some unique pressures and challenges. In most businesses the watchword is “The customer is always right.” Accountants, however, are charged with telling the customer when he’s wrong. What other profession has that responsibility? What other profession is enshrined in our nation’s securities laws to serve no interest but the public’s? What other profession so directly holds the keys to public confidence – the lifeblood of our markets.*

*I can think of none other but the accounting profession*.\(^1\)

The issue of public trust in the accounting profession, or reduction thereof, arose due to a number of corporate collapses. I am sure you remember, all too well, the extensive publicity given in recent years to the economic impact of the collapse of large organisations across a number of countries, upon both the profession and the broader community.

In this session, I will be giving a short overview of:

- the fall-out from corporate collapses, in particular the erosion of public trust in the accounting profession;
- what is being done to re-build public trust, particularly through more open, clearer and more succinct, as well as more timely information in financial reports;
- how implementation of a single set of globally accepted standards – mainly principles-based – will assist with re-building of public trust; and
- identified issues relating to the goal of achieving a single set of global standards.

Not surprisingly, I will be commenting from both an International Federation of Accountants’ (IFAC) and Australian perspective as I am not sufficiently informed on the situation in Taipei. The invitation to speak was offered in my capacity as an IFAC Board Member. IFAC represents the accounting profession internationally. It consists of 157 member organisations spanning 118 countries, representing 2.5 million accountants employed in public practice, government, academic...
institutions, industry and commerce. IFAC also has close links with overseas regional organisations such as the Confederation of Asian and Pacific Accountants (CAPA).

A visit to IFAC’s website provides an indication of the breadth and depth of its activities. Between January and September this year, nearly 400,000 visitors from 161 countries viewed the web pages. The main area of interest for visitors is IFAC’s publications. Close to 150,000 publications were ordered and downloaded in the 9 month period. The greatest interest is in our standards activities.

2. International response to corporate collapses

Recent high-profile corporate collapses have led to increased scrutiny of deficiencies in the financial reporting process and corporate disclosure requirements. This has had a negative and cumulative impact on the perceived credibility of financial reporting. This issue is now at the forefront of public debate about the accounting profession and its effectiveness. The decline in reporting credibility is prevalent across capital markets worldwide, with the scale of the problem partly attributable to the ‘unprecedented level of share prices in many markets’.

It has been suggested that “…implementation of risk management strategies (including ethical principles) may have alleviated, if not avoided, some of the corporate collapses.” Some argue, in particular, for the inclusion of good ethical practices as an important element of risk management as part of good organisational governance. Research shows that such an approach also provides positive outcomes for the organisation, for example, “…contributing to profits, reducing fraud, avoidance of litigation, mitigating legal penalties for lapses in legal compliance and ensuring a safe and healthy environment.” However, it is clear that sound corporate governance practices are a necessary but not sufficient condition to prevent corporate collapses.

IFAC response

In October 2002, IFAC commissioned a Task Force on Rebuilding Public Confidence in Financial Reporting to “…provide an international perspective on the causes of the loss of credibility in financial reporting and corporate disclosure and to recommend courses of action to restore credibility.” In the report issued in July 2003, the task force made a number of recommendations with the aim of working towards a resolution of this issue.

Identified causes

Research has shown that corporate financial distress is the result of the combined effects of failures in business, governance and reporting. It is acknowledged that business failure is an inherent market feature. Mistakes and other failures of judgement will occur in any open economy. This does not necessarily mean that they occur deliberately, or fraudulently, particularly by, or with, the assistance of, accountants. However, action can and should be taken to minimise governance and reporting deficiencies. Accountants can assist boards and management in these respects.
In addressing what action needs to be taken, the IFAC Task Force identified the structural weaknesses of the market system that may give rise to such failings. Arising as a result of the continuous environmental pressures faced by all participants in the financial reporting process, these weaknesses are summarised in the Table 1:

**Table 1 – Weaknesses identified by IFAC Task Force**

- management incentives tied to share prices can produce unacceptable self-satisfying behaviour;
- internal discipline and controls neglected due to entities concentrating solely on the ‘bottom line’;
- the failure by boards to engender a strong governance culture;
- auditor independence is continually called into question, particularly in relation to the provision of non-audit services.
- differences in accounting standards among countries can cause confusion and impedes international comparability;
- convergence with international standards is the intent of most countries but few have in place an adequate implementation plan;
- regulation of both companies and professions may vary in effectiveness, particularly where independent monitoring is weak; and
- an alarming trend has emerged where some participants in the financial reporting process have failed to act ethically.

**Key recommendations**

The principal recommendations of the aforementioned IFAC Task Force report are based on three basic assumptions:

- credibility of financial reporting is both a national and international issue, with action required at both levels;
- to improve credibility, action is necessary at all points along the financial reporting information supply chain; and
- individual and institutional integrity is paramount to the successful implementation of IFAC’s recommendations.

The recommendations are set out as principles. The Task Force considers that “it is complying with a set of high quality principles that is most likely to raise the credibility of financial reporting”. This principles-based approach to restoring public faith in financial reporting allows for changes to be implemented across countries, while allowing for some flexibility to accommodate the differences in legal frameworks, business backgrounds and the country environments.

The recommendations were broadly as follows:

1. Corporate ethics codes to be implemented and widely distributed to all stakeholders, supported by effective monitoring and training.
2. Greater emphasis on effective financial management and controls by corporate management. Chief Financial Officers (CFOs) to possess adequate knowledge of reporting and internal controls assessed by the Chief Executive Officer (CEO) and audit committee.

3. Incentives to misstate financial information should be minimised. IFAC supports the introduction of a new standard requiring the expensing of costs associated with, and clear disclosure of the terms surrounding, the granting of share options. In addition, an independent body separate from management, should determine the employment and associated remuneration conditions of those in senior management positions.

4. Company boards to adopt a greater oversight role over management. The board should also evaluate their own performance. In addition, audit committees should consist of members that are financially literate and appropriately trained for the role. The committee should also be in a position to hold private meetings so that matters regarding management can be discussed openly and without fear of recrimination.

5. Threats to auditor independence need to be minimised. The auditor’s primary relationship should be with a governance body (i.e. board, audit committee) and not with management. Audit firms should reassess their profit distribution policies and other internal processes. Mechanisms should also be established to provide greater control over the provision of non-audit services by audit firms.

6. Greater focus on maintaining the quality of the audit process, including acceptance and retention policies and independent partner and post-audit reviews.

7. Codes of conduct to be developed for other participants in the financial reporting process such as financial analysis, legal advisors, credit-rating agencies and investment banks.

8. Support the strengthening of auditing standards and encourages the International Auditing and Assurance Standards Board (IAASB) to finalise the updating of its standards in a timely manner, particularly in relation to the assessment of risk and fraud. The adequacy of IAASB resources should also be evaluated.

9. Support International Financial Reporting Standards (IFRSs) becoming the worldwide accounting standards and agrees with the principles-based approach of the International Accounting Standards Board (IASB), as ‘a rules-based approach encourages a legalistic approach and the finding of loopholes, rather than attention being given to the objectives and principles of the standard.’ The convergence process should be given top priority and the IASB and national standards setters are encouraged to cooperate in order to achieve the convergence objective.

10. Note the need for improved regulation of share issuers. This can be achieved through the performance of regular and timely post-issue financial statement reviews and the speedy ‘implementation of national regulations consistent with International Organization of Securities Commissions (IOSCO) Principles of Securities Regulation’.
**IFAC reform measures**

In response to the decline in confidence in the accounting profession, IFAC also commenced a series of consultations with international regulatory agencies and other regional and international organisations. The ultimate result was a number of reform proposals which the Council of IFAC unanimously approved at its meeting in November 2003. These reforms have been, and will continue to be, implemented during 2004. The objective of the proposals was “…to increase confidence that the public interest activities of IFAC (including the setting of standards by IFAC boards and committees) are properly responsive to the public interest and will lead to the establishment of high quality standards and practices.”

The importance of these reforms was reinforced in comments made by Jaime Caruana, Chairman of the Basel Committee on Banking Supervision and the Governor of the Bank of Spain, who stated:

*Over time, IFAC’s reforms should result in improvements in international audit standards and practices that will help restore confidence of capital markets in the quality of audit services.*

Of these reforms, the key element is the establishment of the Public Interest Oversight Board (PIOB). This Board will oversee IFAC’s standard setting activities with respect to auditing, assurance, ethics, independence and compliance activities. The Board will also oversee the activities of the IAASB, and approve the IAASB’s terms of reference and those of its Consultative Advisory Group, as well as nomination of members to the IAASB. The Board is intended to be comprised of ten members from regulatory and public interest groups involved in the development of the reform proposals.

The IFAC organisational diagram, following the establishment of the PIOB is as shown below in Figure 1.

**Figure 1 – IFAC Organisational Diagram**
The establishment of the PIOB has been broadly welcomed and is expected to have a broad reaching impact upon the auditing profession. Scott Taub, Chairman of Standing Committee No 1 of the International Organisation of Securities Commissions, explained “…because IFAC’s standards are used by so many jurisdictions as the basis for local auditing standards, new oversight and regulatory mechanisms embraced by IFAC hold out the opportunity to improve audit quality in many parts of the world at once”.13

Another recent initiative, which is highly relevant to our credibility, is the IFAC Ethics Committee’s exposure draft on a revised code of ethics for professional accountants.14 This is a re-issue of the exposure draft of July 2003 which did not extend to the independence requirements for professional accountants in public practice when performing assurance engagements. The Code should contribute significantly to the development and better perception of the accounting profession and its contribution to financial reporting. IFAC’s own credibility will be enhanced by the requirements of its members to meet the obligations of IFAC’s compliance program. This will also be transparent on its website.

The public sector has not been ignored in the reform process. The IFAC Board commissioned an external review of its Public Sector Committee, which was established in 1986 with a broad mandate to develop programs for the improvement of public sector financial management and accountability. Following the launch of a Standards Program in 1996, the Committee has increasingly focused on fulfilling a role as a global financial reporting standard setter for the public sector. The first phase of the Program was completed early in 2002. In early 2003, the Committee published an omnibus standard on financial reporting under the cash basis of accounting. This was the first publication to outline requirements and indicate relevant disclosures for various governments (departments and agencies) reporting on a cash basis.

In 2002, the Committee initiated the second phase of the Standards Program which addresses:

- issues of particular significance to the public sector, such as accounting for non-exchange revenue including taxes, and the social policies of government which are not addressed in IASs/IFRSs;

- convergence with the IASs/IFRSs issued since 1997, where appropriate for the public sector; and

- convergence of the International Public Sector Accounting Standards (IPSASs) with statistical bases of financial reporting where appropriate.

In October 2003, the IFAC Board agreed to an externally chaired review of its Public Sector Committee (PSC). This decision was part of the broader reform process, which IFAC had initiated earlier in 2003, to create a more transparent and participatory standard-setting process.

The panel was chaired by Sir Andrew Likierman, then Head of the United Kingdom Government Accountancy Service of HM Treasury. The purpose of the review was to make recommendations on the strategies to achieve PSC objectives in the long term.
and to note any specific strategic initiatives/developments that should be implemented in the short, medium and long terms.

The Board considered the review at its July 2004 meeting and directed that an Action Plan to implement the Board’s decisions be prepared and submitted for consideration at its November meeting. One issue to be addressed is the establishment of the Committee as the “International Public Sector Accounting Standards Board” and any relationship it may have with the PIOB.

**Other reform initiatives**

Australia has been embarking upon a Corporate Law Economic Reform Program (CLERP) since 1997. The following extract provides an overview of this program\(^{15}\).

*The Corporate Law Economic Reform Program (CLERP) is a comprehensive initiative to improve Australia’s business and company regulation as part of the Coalition Government’s drive to promote business, economic development and employment. CLERP was announced by the Treasurer in March 1997 and is aimed at reforming key areas of corporate and business regulation.*

After a long, arduous and well debated process, the ninth instalment, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (colloquially referred to as CLERP 9) has not long been completed. The Australian Parliament recently passed this Act, for application from 1 July 2004.

CLERP 9 is designed to enhance audit regulation and general corporate disclosure framework, and introduces a number of policy changes, designed to enhance audit regulation and the general corporate disclosure framework. In particular, there is an emphasis on audit independence, integrity, objectivity, professional competence and due care, confidentiality, professional behaviour, and technical standards. As a result of CLERP 9, it is now compulsory for listed companies to include a Review of Operations in their annual reports:\(^{16}\)

*In the IFRS environment, the Review of Operations in an annual report will be of greater importance than ever in communicating with major investors.*

In Australia, the professional bodies play a significant role in the co-regulation of the accounting profession. This is via the enforcement of the jointly issued *Code of Professional Conduct* for members, where sanctions have been applied for proven breaches to this code. While still retaining this predominantly self-regulated approach to corporate governance, CLERP 9 does represent a step towards greater prescription (or regulation) for the Australian accounting profession which has been described as a ‘mixed’ regulatory approach.

CLERP 9 gives the Australian auditing standards the force of law. This may have the effect of increasing the risk associated with performing the external audit function, as there is a risk of litigation should breaches of Australian auditing standards be found to have occurred. Interestingly, it has also raised the question as to what is an audit, which bears directly on the issue of the audit expectation gap. The challenge for the profession is just how far we can realistically close that gap. For example, at the 103rd
American Assembly in November last year looking at the future of the accounting profession, the participants observed that:

...auditors cannot reasonably be required to provide a certainty into the quality of the financial reporting prepared by management, into management’s ability to run the business of the issuers and into the issuer’s business model.17

In Australia, there is on-going debate about the legal implications of auditing standards. While accounting standards have the legal backing of the Corporations Act 2001, previously the auditing standards did not. CLERP 9 redressed this issue, but in doing so has engendered concerns about the practicality of requiring legislative adherence in an area where there is often an exercise of professional judgement. We would agree with the American Assembly that “auditors’ best professional judgement must play a greater role” in audits of financial statements.

Australia currently prides itself on its sound conceptual frameworks for accounting and auditing. However, as a result of auditing standards becoming law, they may potentially be subject to interpretation by the courts. In doing so, precedents could be made resulting in a quasi-rules based environment which may actually limit the exercise of professional judgement and/or create possible inconsistencies and contradictions which would simply add to the uncertainty rather than alleviating it. The success of this measure will therefore very much depend on the approach taken, and understanding of the overall audit framework and standards environment, by the courts.

The United States reacted to a number of corporate collapses and subsequent public and political concern by introducing the Sarbanes-Oxley Act of 2002. This legislation is of a highly prescriptive nature which, it is said, mandates regulatory bodies seeking compliance from the profession by ‘wielding a big stick’. To some extent, the United States has been seen to have ‘gone its own way’ with respect to standard setting for both accounting and auditing. Perhaps this is not surprising given its size in relation to capital markets (holding about 51 per cent of the world’s capital) and its relatively long history in standard setting. However, recent events have encouraged greater international collaboration with support both from within and outside that country. Nevertheless, the rules based, highly prescriptive approach taken by the United States contrasts to that used in Australia, as shown in Figure 2.

The Australian Financial Reporting Council (FRC) is the peak body in Australia that is responsible for the broad oversight of the accounting and auditing standard setting process for both the private and public sectors. The Council considered a revised version of the Australian Assurance and Auditing Standards Board strategic directions at its last meeting in September. A key theme of those directions is that the objective of having the highest quality auditing standards should take precedence over the objective of having minimal divergence from international standards due to the role of auditing standards in the broader governance framework and the need to take account of the public interest. The directions are currently on the FRC website for public comment and will be discussed at the next FRC meeting in December. This is a central issue to standard setting in Australia and has received some spirited comment in relation to accounting standards in the financial media in recent weeks.19
This is not to say that Australia’s approach to regulation is purely based upon principles. There are aspects of the Australian regulatory regime that are prescriptive, which are reflected in the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2003. However, in comparison to the United States, Australia is placed more towards the principles-based ‘end’ of the continuum. This was a deliberate action taken by the Australian Parliament when debating this piece of legislation. During these debates the then Parliamentary Secretary to the Treasurer, the Honourable Ross Cameron MP, stated:

The government is taking what we would regard as a principles based approach. The alternative, which has been adopted in some other parts of the world – most particularly the United States – is a much more prescriptive black-letter law approach which seeks to micromanage the decisions being made across the private sector. Our approach has been more to adopt broad principles and seek to have them upheld.

The prescriptive approach taken in the United States is leading to concerns amongst the accounting profession about the high costs of compliance. Public Company Accounting Oversight Board (PCAOB) Chair William McDonough claims “…these costs are justified because “the goal is to obtain the best possible assurance that a company’s financial statements are reliable”23. However, others question whether the approach taken reasonably balances the cost of compliance and ultimate benefit to the shareholders and public24 or, more broadly, if the entire profession has been “…unfairly tainted by the actions of a few bad auditors”25. Participants at the 103rd American Assembly, referred to earlier, agreed ‘they favoured accounting standards that contained fewer rules and permit more judgement’.26
Questions are particularly asked in relation to smaller listed companies, which are essentially measured against the same rules as for larger ones. And more specifically, whether it is economically feasible for smaller companies to come into compliance, by putting in place an audit committee, code of ethics and meeting internal control documentation requirements. One practitioner\textsuperscript{27} has suggested that the only alternative for some smaller companies would be to delist from US stock exchanges, which, of course, also has its own costs.

On the issue of internal control, there has been considerable interest in section 404 of the Sarbanes-Oxley Act and the possibility of its extension to other countries through similar legislation. Section 404 requires:

- the management of public companies listed on US stock exchanges to assess the effectiveness of internal control over financial reporting, and include in the company's annual report to shareholders management's conclusion, as a result of that assessment, about whether the company's internal control is effective; and
- the company's auditor to attest to and report on the assessment made by the company's management.

The report from the auditor is in addition to the ‘traditional’ audit report on the company’s financial statements. While there may appear to be some duplication of efforts, the PCAOB claims\textsuperscript{28}:

\textit{The information the auditor learns as a result of auditing the company's financial statements has a direct and important bearing on the auditor's conclusion about the effectiveness of the company's internal control over financial reporting.}

From the company’s perspective, section 404 requires them to analyse and document their internal control processes. The documentation has to be kept up to date to reflect any changes to the company’s processes. The company will then issue its assessment of the controls, based on its evaluation of their design and operating effectiveness. These statements are then audited.

From the auditor’s perspective, they are required to perform ‘walk-throughs’ of important processes and test the design and operating effectiveness of controls in place. There are limits upon how much the external auditor may rely upon the work of others, even internal auditors. These requirements may lead to a significant amount of work to be performed in addition to those required for the ‘traditional’ external audit function due to a broadening of the scope of the audit. This could lead to some duplication of efforts, which is said to potentially increase external audit fees “from 25% to more than 100% of current audit fees”\textsuperscript{29}. These fee increases could be lessened to the extent to which external auditors are able to rely upon the work of competent and objective internal auditors. Putting in place a competent and objective internal audit function, or enhancing the current internal audit arrangements, may be a further cost incurred by the company in order to comply with the Act.

Debate about this section relates not only to the costs of compliance but also questions of what the impact upon the market will be if a publicly listed company is reported to have ineffective controls. Questions have also been raised about the mixed message that would be sent to the market should a publicly listed company have a ‘clean’ audit
opinion for its financial statements and a report stating its controls are ineffective, or vice versa.

The answers to these questions won’t be known for certain for some time yet. The application date for the auditing standard, entitled ‘An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of the Financial Statements’\(^{30}\), has been postponed to commence for companies with fiscal years ending on or after 15 November 2004.

In Australia, entities may request auditors to undertake a specific review of their internal controls. The Australian Auditing and Assurance Standards Board (AuASB) has issued guidance for auditors when completing and reporting upon such a review in the Australian standard AUS 810 *Special Purpose Reports on the Effectiveness of Control Procedures*. The reporting of these audits is only to those who requested the work to be completed. The standard states either the entity's management (at the governing body or operational level) or a specified third party (such as a regulator or another auditor) can engage an auditor to complete this work.\(^ {31}\) These reports therefore are not available for review by other users of the entity’s financial statements.

### 3. Moving towards global reporting standards

A suggested means of improving public trust in the accounting profession is for the implementation of a single set of globally accepted accounting standards. The IFAC Board commissioned a study by a former Board Member, Peter Wong, to examine issues relating to the implementation of standards by small and medium-sized entities (SMEs) and those in developing countries. In his recent report, “Challenges and Successes in Implementing International Standards: Achieving Convergence to IFRSs and ISAs”\(^ {32}\) Peter observed that:

> high quality standards of financial reporting, auditing, and ethics underpin the trust investors place in financial and nonfinancial information and, thus, play an integral role in contributing to a country’s economic growth and financial stability\(^ {33}\).

In this section, I will be discussing both the benefits and challenges that lie ahead as we move closer towards a single accepted set of global accounting standards.

**Benefits of implementing global reporting standards**

There are numerous benefits of a single, accepted global set of accounting standards. They include:

- greater comparability of financial information for investors;
- greater willingness on the part of investors to invest across borders;
- lower cost of capital;
• more efficient allocation of resources; and
• higher economic growth\textsuperscript{34}.

From the perspective of building public trust in the accounting profession, it is the aspects relating to investors that are paramount, such as consistent, comparable, credible and understandable, accounting information and related explanations. Investor confidence can be improved with an international set of auditing standards which bear on both the reporting and the relevant accounting standards on which an audit is based.

\textbf{Challenges in implementing global reporting standards}

Peter Wong identified the following challenges to the successful implementation of international accounting standards:

• understanding the meaning of international convergence;
• translation of international standards;
• complexity and structure of international standards;
• frequency, volume and complexity of changes to the international standards;
• challenges for small and medium-sized entities and accounting firms;
• potential knowledge shortfall; and
• implication of endorsements of IFRSs.

I will now briefly outline each of these challenges.

\textbf{Understanding the meaning of international convergence}

Among other issues, there is a degree of confusion as to what the term ‘adoption’ actually means in the convergence process. The reason for this is that there is no single universally accepted definition for the term. The non-existence of an accepted definition creates problems, as it is difficult to measure the progress of international convergence.

The World Bank encountered diverse categorisation regarding the adoption of IFRSs when preparing a recent report. Categories included:

• full adoption;
• full adoption with time lag;
• selective adoption; and
• national standards based on IFRSs.
Peter Wong also notes that there are other barriers to international convergence, such as national accounting regimes that are primarily designed for tax purposes and limited accessibility of international standards attributable to the IASB fee paying structure.

**Translation of international standards**

Translation of the standards is perhaps the most significant challenge facing both national and international standard setting bodies. Translation issues arise because of the difficulties in conveying the intended meaning of the original English text. As a result there is a call for international standards to be written in plain English where possible.

In addition, due to the frequency and volume of changes to the international standards, there is an apparent shortfall in the level of donor funding facilitating the translation process. As a result, organisations will have insufficient resources to allocate to the task. This could severely affect the quality of the translated standards, thereby compromising the integrity and credibility of the international convergence process.

Concern has also been raised that there is insufficient time to respond to international exposure drafts given the time it takes to translate them. In response to this issue, Peter recommended that a 30-day period be added to the exposure draft process. The participation of professional accountants in any translation related process is vital in ensuring that the quality of the translation is not compromised.

**Complexity and structure of international standards**

Generally speaking, international accounting standards are becoming more complex and rules-based in their approach, which is having a negative impact on the convergence process. Standards relating to financial instruments (accounting) and audit risk, fraud and quality control (auditing) were identified as being amongst the most complex.

There is some debate as to what approach should be taken in setting international standards. Standard setters are in favour of longer and more detailed standards to address complex issues and allow for consistent application and tighter regulation. While a number of participants are in favour of a rules-based system for the financial reporting process, many support a more principles-based approach. The latter argue that a rules-based approach may encourage a legalistic approach and the finding of loopholes (avoidance). Some users would support simple, relatively short, principles-based standards that are easy to apply. Similarly, other users consider that a more rules-based approach provides greater certainty. Practically speaking, the answer is probably somewhere in between, to at least satisfy all stakeholders.

There are also concerns expressed over the perceived illogical structuring of some standards and the added complexity of standards as a result of the IASB’s move towards a fair value accounting model. In his report, Peter Wong recommends that international standard setters become “…more attuned to the challenges national standards setters and preparers, auditors and users face in implementing the international standards”. While this proposition would be generally accepted, the timetables for implementation are not often, or solely, at the discretion of the standard

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setters. Rather, it is mainly Governments and/or their regulatory bodies that decide on adoption and timetable issues.

**Frequency, volume and complexity of changes to the international standards**

The regularity and intricacy of changes to international standards in recent years could be seen as overwhelming. Many changes are the result of new requirements imposed by parties external to the standard setting process. The speed at which these changes are occurring may cause some national standard setters to hesitate in adopting IFRSs that are likely to be further amended, on the basis of a cost/benefit type analysis. This has been the case in Britain, which has been sometimes wrongly portrayed as a reluctance to adopt the international standards.

Another problem with numerous changes to the standards is the apparent lack of real life practical examples of what is considered to be ‘best practice’. In addressing this issue, Peter noted it is “…important for the international standard setters to strike a balance between the need to improve the international standards on a priority basis and the need to address the practical issue of providing countries with the time they need to adopt and implement these standards.” Indeed, this point has been recognised by the IASB with no new standards expected to be operative for at least twelve months.

The IAASB also remains mindful of this issue and is contemplating the use of a ‘quiet period’ in the adoption and implementation of International Standards on Auditing. This would allow a certain period of time to adjust to the standards prior to any new or revised ISAs becoming effective. The imperative for both the IAASB and IASB is to have a credible and accepted set of international standards in place by 2007 and 2005, respectively, for adoption in Europe and other countries such as Australia.

**Challenges for small and medium-sized entities (SMEs) and accounting firms**

There is concern over the relevance and suitability of international standards to SMEs with anxiety expressed in the following areas:

- lack of representation by SMEs on the IASB;
- length, complexity and inconsistent application of international standards;
- unfavourable compliance burden; and
- perceived bias towards large-entity issues.

A further challenge is that of the burden of compliance, particularly on smaller entities. The IASB has a task force in place to develop simplified global accounting standards for SMEs. The goal of this project is “…to reduce the burden of disclosure for companies, while preserving the recognition and measurement principles of international standards” The IASB has also issued a discussion paper on this topic, *Preliminary Views on Accounting Standards for Small and Medium Sized Entities*. My Office has contributed to the response by CPA Australia to this Paper. That response
supports a separate set of international financial reporting standards for SMEs but recommends that SMEs should measure and recognise assets, liabilities, revenues and expenses in the same way (my underlining) as entities applying full IFRSs. 38

As a matter of interest, IFAC has established a permanent Task Force to examine issues relevant to small and medium-sized accounting practices (SMPs) (See Figure 1). The constituents of this Task Force are SMPs that provide accounting and assurance services principally, but not exclusively, to clients who are SMEs. Insofar as they provide services to SMEs, other professional accountants are also included as constituents. A member of the IAASB acts as a liaison person with the SMP Permanent Task Force.

Since November 2003, the Task Force has made submissions to the IAASB on a number of new and revised standards including:

- clarity of IAASB standards;
- accounting estimates (revised ISA 540);
- audit materiality (revised ISA 320);
- documentation (revised ISA 230); and
- related parties (revised ISA 550).

The SMP Permanent Task Force also made a contribution to IFAC’s response to the above-mentioned IASB discussion paper. The Task Force has a close relationship with the IASB, with two of its members represented on the IASB’s SME Standards Working Party.

Potential knowledge shortfall

Given that international standards are becoming increasingly lengthy and complex, concern has been raised at the possibility that there may be a shortage of accounting professionals who possess adequate knowledge of IFRSs. Compounding this issue is a peak in demand, expected in 2005 as the European Union (EU) and other countries (including Australia) adopt the international standards. There is also concern from an educational perspective that tertiary institutions and other training organisations are struggling to keep up with the changes to international standards, which is having a direct effect on the quality of students entering the profession. This simply exacerbates the problems, for many of us, of having sufficient new entrants to the profession, particularly in view of the aging workforce in many countries.

It is imperative that national accounting bodies take a lead role in encouraging the expansion of professional accountants knowledge of international standards. Educational institutions should also ensure that teaching staff received adequate training and that students are offered programs to develop a thorough understanding of international standards. In addition, Peter Wong suggests “…urgent attention be given to the development of implementation guidance that is widely available to all in need of such guidance”. 39 The profession in Australia has been most assiduous in this respect.
Implication of endorsements of IFRSs

The endorsement of IFRSs may give rise to a variety of different implications. For example, international standards in the EU have only limited mandatory application (i.e. listed entities that prepare consolidated financial statements). Unless EU member states decide that IFRSs will apply to all entities, two very different sets of accounting standards may apply, which has the potential to negatively affect the credibility, and comprehension by users, of the financial information being reported.

There is also concern over the lack of preparedness by some entities, in particular the smaller ones, for the adoption of international standards. In a survey conducted by Institute of Chartered Accountants in Australia in July 2004, less than half of all respondents had commenced IFRS implementation procedures. Furthermore, only 35 per cent had begun to communicate with stakeholders the likely financial effect of adopting IFRSs. It is recommended that all stakeholders resolve these outstanding issues quickly in an attempt to help smooth the adoption process. In some cases it is simply inertia but I would again stress the need for adequate time for implementation and education for all concerned, including financial analysts and the media.

It is recognised that there needs to be a ‘full and balanced combination of capacity and incentives’. The World Bank states that ‘more emphasis should be placed on the deterrent incentives of robust monitoring and enforcement regimes’. As well, countries should give closer attention to regulatory pre-conditions. In particular, the World Bank states that:

Special efforts should be made to strengthen and leverage the linkages between the various standards and codes that affect the implementation of international accounting and auditing standards (these include those related to the supervision of banking, securities markets and insurance, as well as corporate governance) and fill any gaps that remain.

Of interest, is that the Bank has developed a diagnostic tool that captures a comprehensive review of accounting and auditing standards and practices in a country.

4. Concluding Comments

While there is some way to go in resolving the challenges identified, there is a commitment to restore the public’s confidence in the accounting profession. This is a global issue requiring a global response from all participants in the profession.

IFAC has a facilitating role in this process and the recommended principles included in the report produced by the IFAC Task Force on Rebuilding Public Confidence in Financial Reporting identifies the action that needs to be taken going forward. The latter also involves Member Bodies which will be subject to newly promulgated member obligations that will enhance our public credibility and related confidence in the profession.

The establishment by IFAC of the Public Interest Oversight Board is expected to have a broad reaching impact upon the global accounting profession. Further to this,
separate initiatives and reforms undertaken by IFAC, and others, in the areas of standards, code of ethics, education, financial management and reporting, corporate governance, small and medium sized enterprises, developing nations and public accountants in business, will also contribute to the credibility of the profession. In addition, work being done by the Professional Accountants in Business Committee on both Sustainability and Narrative Reporting will enhance both comprehension and transparency of an organisation’s performance.

Closely linked and assisting improving public confidence in the accounting profession is the move towards global accounting and auditing standards. The benefits of implementing a single set of globally accepted standards relate not just to improving investor confidence. These standards will also improve general confidence in the information produced by the profession, as well as to its transparency. In this respect, IFAC has adopted the role of facilitator to translation processes. This will be in the nature of guidance for translating organisations to assist greater consistency of presentation and understanding by users.

A good example of the latter is the new International Standard on Auditing, *The Auditor’s Responsibility to Consider Fraud in the Audit of Financial Statements*, which builds on the new audit risk standards issued last year and requires the auditor to focus on areas where there is a risk of material misstatement due to fraud, including management fraud. As well, we have two new standards on quality control, ISQC 1 – *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements*, and ISA 220 – *Quality Control for Audits of Historical Financial Information*. Both of these standards are effective from 15 June 2005. Another example is ISA 600 – *The Work of Related Auditors and Other Auditors in the Audit of Group Financial Statements*.

The market's increasing demands upon preparers of financial statements to issue reports in shorter time frames places pressures on auditors to complete their work faster. This same market also demands a more comprehensive audit. It is expected that auditors will detect and report fraud, despite what the professional standards and legal precedence may state about the role of financial statement auditing. It is equally expected that auditors will complete additional tasks to ensure compliance with increased professional and legislative requirements. Some also expect that the fees charged for external audit services, now a higher risk industry than ever before, will not increase dramatically. The question remains whether the profession has gone far enough to bridge the expectation gap between that which is required of it, and that which is often expected. Or, as the American Assembly at Columbia University last year suggested, is too much being demanded of the auditing profession.45

Of the interrelationships in the international framework, interesting ones to note are the relationships between:

- for audit, the United States’ Public Company Accounting Oversight Board (PCAOB) and the IAASB; and
- for financial reporting, the United States’ Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB).

With respect to accounting standards, a Memorandum of Understanding was struck between the IASB and the FASB, ‘The Norwalk Agreement’, in September 2002.
Under this agreement, the IASB and FASB are working towards the elimination of differences between the United States’ generally accepted accounting principles and the IASB’s International Financial Reporting Standards. As this work progresses, a number of amendments are expected to be made to both IASB and FASB standards.

Progress is also being made with respect to auditing standards. In May 2004, the PCAOB’s Chief of Staff, Samantha Ross, appeared before the United States House of Representatives Committee on Financial Services to discuss regulatory dialogue between the PCAOB and the European Commission. In her testimony for the Committee, Ms Ross outlined the cooperative approach being taken by the PCAOB and the European Commission, and how both of these organisations have been given observer positions with the IAASB. The PCAOB has also offered the IAASB observer status on its standard-setting advisory group. Such moves to increase discussion between these auditing organisations are expected to assist with reducing duplication of efforts, and streamline auditing practices across the United States, the European Union and internationally.

To date, more than 70 countries have adopted the International Standards on Auditing (ISAs) issued by the IAASB, either in total or by identifying that there are no significant differences between their national standards and ISAs.

IFAC has continually encouraged the international convergence to globally accepted accounting and auditing standards. I earlier quoted the six primary challenges in implementing IFRSs and ISAs, as well as the implications of the endorsement of IFRSs. In the latter respect, the following observation by PricewaterhouseCoopers (quoted earlier) is particularly apposite to the key concerns I was asked to speak to:

*The market reaction to IFRS will be dictated as much by the perception of transparency in the conversion process as by the actual effects on reported numbers.*

Arthur Levitt Jr’s view of the accounting profession and its unique position in our market place, quoted at the outset, is insightful. It highlights the distinct challenges that we face. IFAC acknowledges its obligation to continue to address the issues of public trust in the profession. By this means we will ‘ultimately demonstrate the international profession’s commitment to quality, transparency, and most importantly, integrity.’
Notes and References


2 IFAC 2004. *About IFAC*, found at http://www.ifac.org/About/


5 Ibid, p383.


7 Ibid., pp.12-15.

8 Ibid., p.4.

9 Ibid. p.42.

10 Ibid. p.4.


12 Caruana Jaime 2003. *IFAC approves reforms including new Public Interest Oversight Board*, Accountant, December, p.14

13 Ibid., p.14

14 IFAC Ethics Committee *Proposed Revised Code of Ethics for Professional Accountants*, Exposure Draft, IFAC, New York, October.


18 Ibid., p.8


20 ANAO internal assessment, June 2004.


22 Australia, House of Representatives 2004, Debates, 23 June, p 30500.


31 AUS 810 *Special Purpose Reports on the Effectiveness of Control Procedures* paragraph .01


36 Ibid, p. 15.


41 Ibid, p.3

42 Ibid, p.4

43 Ibid, p.5


The European Commission is the politically independent body that represents and upholds the interests of the European Union (EU) as a whole. The European Commission has four main roles:

1. to propose legislation to Parliament and the Council;
2. to manage and implement EU policies and the budget;
3. to enforce European law (jointly with the Court of Justice); and
4. to represent the European Union on the international stage, for example by negotiating agreements between the EU and other countries.


