

REGULATION OF THE ACCOUNTANCY PROFESSION

Regulation of individual professional accountants is primarily conducted at a national level, with professional accountancy organizations playing an important role in working with governments to ensure that such regulation is effective, efficient and in the public interest. Ongoing dialogue and cooperation is essential to ensure an appropriate balance between self-regulation by the profession, self-regulation with public oversight and accountability, and external regulation

Introduction

High-quality performance by professional accountants benefits the economy and society by contributing to the efficient allocation and management of resources in both the private and public sectors and to the operation of financial and capital markets, and through both of these to the production of goods and services.

The Accountancy Profession

Members of the accountancy profession contribute to their communities in a wide variety of different roles, and within a range of different organizations. Professional accountants work in, and contribute across, virtually all sectors of the economy, fulfilling diverse roles.

Professional accountants:

- contribute to the growth of individual companies, support and sustain non-profit organizations, and assist governments in achieving their economic and social objectives; and
- promote financial market performance, through the reporting of, and providing assurance on, financial information on which investors and other stakeholders rely in making resource-allocation decisions.¹

In these ways and others, professional accountants contribute to the growth of economies and ultimately to the well being of society.

The Need for Regulation

Every profession is defined by the knowledge, skills, attitude, and ethics of those in the profession. Regulation of a profession is a specific response to the need for certain standards to be met by the members of that profession. The need for and nature of such regulation is dependent on the specific profession and the market conditions in which it operates. Where a profession such as the accounting profession provides an important public service, it is imperative it serves and acts in the public interest.

¹ This paper addresses only the regulation of the accountancy profession, and does not address the regulation of other components of the financial reporting supply chain.

Like other professions, the sustainability of the accountancy profession depends upon the quality of the services provided by its members and on the profession's capacity to respond effectively and efficiently to the demands of the economy and society. Regulation seeks to ensure the right quality and, where appropriate, consistency in the quality of accountancy services.²

There are a number of reasons why regulation might be necessary to ensure that appropriate quality is provided in the market for accountancy services.³ These include ensuring compliance with ethics, technical, and professional standards and the need to represent non-contracting users of accounting services, such as investors and creditors.

While specific triggers for regulatory change will differ over time, there are two generally accepted explanations why regulation may be an effective means of ensuring quality and addressing inefficiencies inherent in the operation of the market for accountancy services.

Firstly, regulation may assist in situations where there is a *knowledge imbalance* between the client, who is acquiring accountancy services, and the provider of those services, who has professional expertise (refer to Box 1).⁴

Box 1: Benefit of Regulation – Addressing Knowledge Imbalance

Regulation can address the knowledge imbalance between the provider and purchaser of professional services by providing a level of comfort to the purchaser that the provider has the necessary qualifications and is obliged to meet the appropriate professional standards in his or her work. In this way, the purchaser is given comfort that they are receiving services of the right quality.

Secondly, regulation may assist where there are significant benefits or costs from the provision of accountancy services that *accrue to third parties*, other than those acquiring and producing the services (refer to Box 2).⁵

Box 2: Benefit of Regulation – Impact on Third Parties

Regulation can address situations where parties outside of the contracting parties (the purchaser and provider of services) either receive benefits or incur costs as a result of the transaction. Regulation can ensure that those benefits and costs to third parties are taken into account in determining what service is to be produced, and at what quality. For example, because financial statements have a much wider use beyond the company acquiring an audit, regulation of financial reporting and audit ensures that investors or potential investors (being the third parties) receive the information they require. Regulation acts to ensure that the benefits to these third parties are “built in,” when a company contracts for an audit.

² The generic term in economics for situations where regulation is deemed necessary to ensure market efficiency is “market failure.” Market failure can arise for a number of reasons, and does not necessarily mean there is either a lack of competition within the market or failure (including anti-competitive behavior) on the part of market participants. Generally, professional services are subject to some form of regulation given the nature of the services, which for the accountancy profession involves operating in the public interest.

³ Competition in a market is, generally, a powerful force in driving improvements in product or service quality and value. The market for accountancy services, which appears to be quite active, is clearly one mechanism to ensure overall quality and consistency as professional accountants compete to offer the best value services. For this reason, most economies have in place laws or regulations to protect competition. This area of regulation is not the subject of this policy position paper.

⁴ The technical term for this type of market failure is ‘information asymmetry’.

⁵ The technical term for this type of market failure is ‘externalities’.

Regulation

There have been many changes to the regulatory environment for the accountancy profession in recent years as professional accountants, their clients, professional accountancy organizations, and governments seek to ensure that the profession continues to deliver high-quality services and contributes to economic growth and development. Some of these changes have been driven by perceived shortcomings in regulatory arrangements, and debate continues about the optimal model for such regulation.

Characteristics of Good Regulation

In designing and implementing regulation, care needs to be taken that the nature and characteristics of the operation of the market are well understood; otherwise, the regulation may not achieve its purpose. To meet the public interest, regulation must be proportionate, transparent, non-discriminatory, targeted, implemented consistently and fairly, and subject to regular review. In addition, effective regulation must not be anti-competitive, and the benefits of regulation to the economy and society should outweigh the costs of that regulation.⁶ Regulation that meets these criteria is more likely to achieve the required outcomes and to be acceptable and credible to the public at large.

Furthermore, regulation needs to be transparent. Regulatory bodies should have robust governance arrangements and publicly disclose details of their activities. Transparency is particularly important as it enables the public to know and understand how the profession is being regulated and what the regulator is doing. This information adds to the credibility of regulation and makes it more effective by providing the public with the means to judge the value of regulation and its impact on the market.

Areas that Regulation of the Accountancy Profession Typically Cover

It is important to have high-quality standards as these provide a foundation for members of the profession, users of accountancy services and regulators to assess compliance with best practices by members of the profession. Compliance with regulation is facilitated by high-quality standards. International consistency of regulation is promoted where there is global regulatory convergence of practice and standards (refer section below titled “Current Regulatory Environment”).

Regulation of the accountancy profession usually covers the following: entry and licensing requirements, including education and ongoing professional development requirements; monitoring of the behavior and performance of professional accountants; the standards, including ethical standards, that professional accountants must meet; and disciplinary systems and procedures for those who fail to meet the requirements. It involves a range of different regulatory practices, including: quality assurance reviews of individual professional accountants; enforcement of professional and ethical standards by professional accountancy organizations and/or regulatory bodies; fulfillment of obligations of IFAC membership by professional accountancy organizations; and public oversight by external regulatory bodies.

⁶ Within economics it is also recognized that “government failure” (regulatory failure) can occur. The existence of actual or potential market failure does not necessarily mean that regulation improves the position. Regulation can, for a number of reasons, make a situation worse. This might occur where compliance costs are markedly higher than estimated, or there are serious unintended consequences. The objective of public policy is to design regulatory systems that address market failure without causing government, or regulatory, failure and thereby increase the well-being of the economy and society.

The Value of Ethical Behavior

While regulation is important, it is not on its own enough to achieve the objective of ensuring quality and consistency of quality in the provision of professional accountancy services. No regulation can be truly effective unless it is accompanied by ethical behavior; and so regulatory systems should be designed to promote and achieve this behavior. It is the ethical behavior of the professional accountant that is the ultimate guarantee of good service and quality.

IFAC recognizes that values also are critical in driving behavior. Education and practical training in values, especially through example and the appropriate use of experience and professional judgment, based on a solid educational foundation and reinforced through continuing professional education, are essential in promoting ethical behavior.

Ultimately, high-quality service from the profession is a function of professional standards, including ethics, personal competencies and values, and regulatory systems, all of which must be consistent with and supportive of one another.

A Shared Approach to Regulation – Roles for Government and Professional Accountancy Organizations

IFAC recognizes that professional accountancy organizations play an important role in working with governments to ensure that regulation is effective, efficient and in the public interest. Ongoing dialogue and cooperation is essential to ensure an appropriate balance between self-regulation by the profession, self-regulation with public oversight and accountability, and external regulation.

A strength of *self-regulation* is that professional accountancy organizations:

- are close to the markets in which their members operate and, thus, have a good sense of how regulations might affect behavior; and
- can more easily access this information and draw upon the skills and experience of their members to regulate the profession. In particular, they have an ability to respond and act quickly in light of changing circumstances.

Self-regulation with public oversight and accountability would typically involve some form of oversight being carried out by an independent agency. Reporting by the professional accountancy organizations to an independent agency in the discharge of its accountability, and oversight activities exercised by that agency, complement and add strength to self-regulation.

Being independent of the accounting profession, and therefore of professional accountancy organizations, is seen as an important aspect of *external regulation*. Under external regulation, the profession is regulated by the government⁷, either through a government agency or through an independent agency that has been created and delegated regulatory powers by the government.

Shared Regulatory Responsibilities

There are a number of ways that self-regulation and external regulation may be combined to create an efficient and effective regulatory mix. In striking a balance between the various methods of regulation, it is possible that professional accountancy organizations will have responsibility for some aspects of

⁷ In this paper "government" refers, as appropriate in the context, to all the branches of government, including the actions of the legislature (in establishing legislation) and the executive (in monitoring and enforcing compliance with legislation and regulations).

regulation and a government or independent agency for other aspects. For example, a professional accountancy organization may have responsibility for aspects of regulation where it has significant expertise, such as setting education requirements for professional accountants.

The mix of self-regulation and external regulation will vary by jurisdiction and will depend on a number of factors, including:

- The historical experience in the jurisdiction; for example, financial reporting failures have often led to more external regulation;
- The self-regulatory performance of the professional accountancy organization;
- The regulatory performance of government;
- Membership of international bodies, and the use of standards and practices developed and endorsed by these bodies;
- The general political orientation to regulation as an instrument of economic management;
- The development path of the economy; and
- The nature and characteristics of the market failures to be addressed by regulation.

Trends in the balance between self-regulation and external regulation may also differ. In recent years many countries have seen an increased role for external regulation, while in other countries, especially those in transition, the trend has been to strengthen the self-regulatory role of the profession.⁸

Whatever method, or combination of methods, is employed, there needs to be periodic evaluation to assess effectiveness.

Shared Regulation in Practice

In practice, a professional accountancy organization would rarely regulate without some form of government mandate or oversight. Similarly, the government would rarely regulate without any form of interaction with, or explicit or implicit delegation of authority to, the professional accountancy organization.

Commonly, professional accountancy organizations act under a delegation from their respective governments. The government has given legal recognition to the professional accountancy organization and has assigned to it a set of roles and responsibilities and some form of reporting (accountability) requirement. These responsibilities can include:

- setting admission criteria;
- setting education requirements, including continuing education requirements;
- establishing disciplinary procedures; and
- adopting and implementing ethics, technical, and professional standards.

Reporting requirements vary, but can take the form of annual reports by the professional accountancy organization to the government, which has the primary, over-arching public interest oversight responsibility under these arrangements. However, reporting by the professional accountancy organization of its activities assists in fulfilling its public interest and public accountability responsibilities.

⁸ IFAC considers that whatever the balance in a particular jurisdiction, the outcome is more likely to be positive where there is a collaborative and mutually respectful relationship between the parties.

Even in environments where the auditing of public interest entities (PIEs) is highly regulated by the government, there is still an obligation on the professional accountancy organization to conduct some significant elements of self-regulation over a broad range of activities. For example, professional accountancy organizations monitor and enforce the quality of professional accountancy services offered by its members in a manner consistent with IFAC's Statement of Member Obligations (SMOs). Also, through the enforcement of continuing education and professional development and ethical requirements, professional accountancy organizations regulate their members who operate as professional accountants in business, as well as preparers and auditors of public sector entities' financial statements.⁹

Typically, shared regulation of auditing at the national level includes:

- Audits for PIEs being regulated by independent audit regulators. Independent audit regulation exists in countries representing approximately 80% of global stock market capitalization.
- Professional accountancy organizations regulating audits for some PIEs (typically smaller PIEs) with oversight from an independent audit regulator.
- Professional accountancy organizations regulating audits for non-PIEs and for PIEs where there is no independent audit regulator. SMO 1 *Quality Assurance*¹⁰ provides guidance to professional accountancy organizations in this area.

The Role of Government

The role of government in the regulation of the accountancy profession is to ensure that regulation is achieving its public interest objective of – at the lowest possible cost – quality, and consistency of quality, in the supply of accountancy services. To do this effectively, governments need to:

- Understand the nature and characteristics of the issues that regulation is seeking to address;
- Have in place a system for monitoring the performance of the body(ies) charged with regulating the accountancy profession;¹¹
- Be focused on outcomes, in this case the overall quality and consistency of accountancy services; and
- Have an ability to amend legislation and regulation quickly where circumstances require.

The Role of Professional Accountancy Organizations

Professional accountancy organizations, whose own reputation will reflect the quality of services provided by its membership, must play a role in the regulation of the profession to ensure the quality of the services provided by their membership. In fulfilling this role, they have an important responsibility to the community in which they live: to the public interest, not just to their current clients or employers or to themselves. While individual members of a profession have an obligation to serve the public interest, professional organizations have a more specific responsibility and role in this regard.

Professional accountancy organizations can perform regulatory responsibilities in a manner that increases the overall effectiveness of the regulatory system. They aim to ensure the quality of services

⁹ By definition, some public sector entities will be public interest entities, and hence auditors of such entities will be regulated by public audit oversight bodies, or professional accountancy organizations, as appropriate.

¹⁰ Refer to www.ifac.org/download/statements-of-membership-obligations.pdf

¹¹ Whether the regulation is conducted by a professional accountancy organization or by a government or independent agency, the monitoring should encompass the adequacy and quality of the resources available to the organization.

provided by their members, through their dedication to upholding and promoting high-quality professional practices. They also have a role to play in the development of regulation affecting the profession, including a responsibility to communicate and work with governments in the public interest. To achieve this, professional accountancy organizations must use their knowledge of the profession and the markets in which they operate to assist government and external regulatory agencies to design and implement high-quality professional regulation.

Current Regulatory Environment

Global regulatory convergence of the accountancy profession, including the adoption and implementation of high-quality ethical, technical, and professional standards, enhances the ability of capital markets to work globally, allows investments to move more efficiently across borders, and reduces the risks and uncertainties in capital markets. It assists in achieving a stated goal of the G-20, to strengthen transparency and accountability in the context of financial and capital markets, and creates a level playing field in the interpretation and exchange of financial information.

IFAC recognizes that regulation of the accountancy profession is primarily conducted at a national level. Therefore, to achieve international convergence, national regulation should aim to endorse and implement principles, approaches, and obligations outlined in material issued by authoritative international bodies.

Consistency in external regulation by government has been enhanced in recent years through shared knowledge and experience, and greater cooperation between regulatory bodies, often achieved via international organizations established by, and representative of, national regulators.

Over the last decade there have been many changes to the regulatory environment for the accountancy profession. New and emerging trends in regulation have highlighted the importance of ongoing dialogue between the accountancy profession and government regulators, as the appropriate balance is struck between self-regulation and government regulation. These developments include:

- Global adoption and implementations of international high-quality technical and professional standards. Successful adoption and implementation of standards across jurisdictions assumes that standards are adopted without alteration to ensure consistent, universal application. Also, it assumes that governments ensure that: (i) rigorous processes are developed to ensure that standards are translated in a consistent manner across languages; and (ii) support requirements are identified and provided to appropriate organizations to develop and deliver high-quality implementation guidance as well as high-quality education to those responsible for applying and monitoring the standards.
- External regulation of the market for audits of PIEs, often undertaken in a manner consistent with the principles outlined in the *Core Principles for Independent Audit Regulators*, issued by the International Forum of Independent Audit Regulators (IFIAR). Independent audit regulation exists in countries representing around 80% of global stock market capitalization.
- The issue of SMOs by IFAC, which provide clear benchmarks to professional accountancy organizations to assist them in ensuring high-quality performance by professional accountants. As part of IFAC's Member Body Compliance Program, member bodies are required to perform ongoing self-assessments of their compliance with each SMO. The seven SMOs cover areas such as

quality assurance, investigation and discipline arrangements, and advocating adoption and implementation of standards issued by independent standard-setting boards.¹²

Conclusion

Professional accountancy organizations and government regulators share a commonality of interests and objectives, in respect of their concerns for the quality, behavior, and standards of professional accountants, and awareness of the public interest imperative for the accountancy profession.

How the profession is regulated is an important aspect in achieving these aims. If regulation is to be internationally consistent and effective, regulatory convergence is essential. At a national level there needs to be ongoing dialogue and an alignment of actions between governments and professional accountancy organizations. This dialogue should address developments in the profession and developments in the economy and society that may affect the profession and how it performs its role. Dialogue is essential if regulation and regulatory systems are to remain current, efficient, and effective.

While regulation helps to ensure the quality of services that professional accountants provide, ultimately it is the ability of the profession to put the public interest first that will earn the profession the respect of communities and regulators around the world.

This Policy Position has been prepared by IFAC. The approved text of this Policy Position is published in the English language.

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¹² Refer to www.ifac.org/download/statements-of-membership-obligations.pdf for details and descriptions of these SMOs

IFAC MISSION

IFAC's mission is to serve the public interest by:

- Contributing to the development, adoption and implementation of high-quality international standards and guidance
- Contributing to the development of strong professional accountancy organizations and accounting firms, and to high-quality practices by professional accountants
- Promoting the value of professional accountants worldwide
- Speaking out on public interest issues where the accountancy profession's expertise is most relevant