



International Federation of Accountants

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Mr. Greg Tanzer
Secretary General
IOSCO General Secretariat
Calle Oquendo 12
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Spain
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Re: Public Comment on the Transparency of Firms that Audit Public Companies: Consultation Report

Dear Mr. Tanzer,

The International Federation of Accountants (IFAC) values the opportunity to provide comment on the IOSCO paper, *Transparency of Firms that Audit Public Companies: Consultation Report*.

Attached is a submission that outlines the views of IFAC with respect to the central ideas discussed in the IOSCO paper. In developing our response, IFAC conducted some limited consultation with a number of our member bodies and members of the Forum of Firms.

In general, while we consider that transparency of audit firms is an important issue, and therefore support IOSCO's initiative in this area, we do not consider that further mandatory transparency requirements will impact significantly on either audit quality or the availability and delivery of audit services to public companies. We do identify the need for research, drawing on the use currently made of transparency information emerging from the reporting of oversight bodies and other empirical data, to assess whether stakeholders use this information in circumstances where audit quality is an important element in decision-making.

However, notwithstanding the general conclusion referred to in the paragraph above, IFAC considers that transparency is desirable for a number of reasons, including as evidence of sound corporate governance processes in organizations in which there is a significant public interest, and for these reasons we strongly support the codification and international alignment of transparency requirements.

Given the position taken in this submission we have felt it more helpful to organize our submission by reference to certain key issues, rather than by addressing the specific questions raised in consultation report. We hope that the views expressed in this submission assist IOSCO in the further development of its position on this matter.

If IOSCO seeks additional clarification or further consultation regarding the enclosed submission, please do not hesitate to contact me.

Sincerely,

A handwritten signature in black ink, appearing to read 'Ian Ball'. The signature is fluid and cursive.

Ian Ball,
Chief Executive Officer

The following document reflects the views of the International Federation of Accountants (IFAC). IFAC is the global organization for the accountancy profession. It works with its 159 members and associates in 124 countries and jurisdictions to protect the public interest by encouraging high quality practices by the world's accountants.

Introduction:

In its consultation report IOSCO has raised the issue of audit firm transparency as a mechanism to improve audit quality, and therefore the reliability of public company financial statements, and also to improve the availability and delivery of audit services to public companies.

IFAC considers audit quality to be critical to the functioning of capital markets. In examining the role of transparency of audit firms, it is necessary to consider the potential impact of additional transparency requirements in the context of the range of measures which are directed at the goal of achieving audit quality. The central question we will address is whether additional transparency will contribute significantly to further enhancing audit quality.

Similarly, in relation to the availability and delivery of audit services to public companies, the issue is whether additional audit firm transparency would likely have a significant impact on competition and choice in the market for audit services, given other characteristics of that market.

The submission below addresses these central questions, and concludes that additional transparency is unlikely to contribute materially to either of the stated goals.

The submission then addresses the reasons why a certain level of audit firm transparency is desirable, and proposes that the focus of international regulatory efforts be on identifying appropriate transparency around audit firm corporate governance and on achieving great international consistency in transparency requirements.

1. IFAC believes that increased audit firm transparency requirements will not be instrumental in achieving materially improved audit quality because existing regulatory, self-regulatory and market mechanisms create sufficient incentives for audit providers to conduct high-quality audits.

- a. Three categories of mechanism currently create a collectively significant range of incentives for audit service providers to ensure the quality of audits: *regulatory, self-regulatory and market mechanisms:*

Regulatory Mechanisms – Historically there has been a range of regulatory mechanisms employed to promote high-quality audits. In many jurisdictions, regulatory authorities have prescribed educational requirements, have registered audit practitioners and have prescribed restrictions on the ownership arrangements for audit firms, for example. Over the past decade this range of mechanisms has been substantially strengthened in numerous jurisdictions. These changes include, most significantly, the Sarbanes-Oxley Act in the United States and the subsequent establishment of independent audit oversight bodies in many other jurisdictions. Taken together, this range of regulatory mechanisms is designed to provide assurance to capital market participants that they can have confidence in the quality of audits. The recent developments in audit oversight have been very directly designed to address concerns over audit quality by giving the audit oversight bodies in most major capital market jurisdictions considerable and detailed access to the full range of information needed to form views not only on the firm level policies and structures but also on the actual conduct of specific audits.

Self-regulatory Mechanisms- The self-regulatory mechanisms administered by professional accountancy institutes prior to the regulatory changes referred to above still exist today, though in a modified form in many countries. These include such mechanisms as educational requirements and certifications mandated by professional accountancy institutes; requirements for continuing professional development; ethical codes which place requirements on auditors on matters such as auditor independence; auditing standards; and the organizational structures of firms and their ownership arrangements. It should be noted, however, that internationally there has been a trend for self-regulatory mechanisms to become externally regulated.

Market Mechanisms – Market mechanisms relate to the competitive incentives that exist for the provision of high quality audits, irrespective of the incentives around compliance with regulatory or self-regulatory requirements. These incentives derive ultimately from the value of an audit in lowering the cost of capital of the reporting entity. Any reduction in the cost of capital is contingent on the audit providing assurance on the reliability of the information reported to capital markets. Such assurance is in turn derived from the quality of the audit, a function of many elements, but especially the expertise and independence of the auditor. Market pressures should therefore provide incentives for transparency if additional disclosures about firm structures and processes provided convincing evidence of audit quality. Market mechanisms also create incentives to improve audit processes, whether to enhance the level of assurance or to provide the same level more efficiently. Additionally, markets provide incentives to mitigate the risks associated with poor quality audits, given the costs of contesting and settling litigation where poor quality audits are alleged.

When considering the potential benefit to be gained from mandating additional levels of audit firm transparency, IFAC's view is that it is highly unlikely that such additional transparency would have a significant, arguably even noticeable, effect on audit quality. We consider that, taken together, the three types of mechanisms above create considerable pressure to undertake high quality audits.

- b. A secondary point relates to the relative novelty of many of the regulatory changes of the past decade. Many of the changes are still recent, and to reach conclusions regarding their limitations or to the need for additional requirements such as further transparency seems premature. Similarly, some of the other factors which contribute to audit quality have also undergone significant, recent change. An example is the clarified set of International Standards on Auditing (ISAs), which are currently being implemented. Given the extent of recent change in areas which can be seen to have a very direct and significant impact on audit quality, our view is that further change in areas which impact less directly on audit quality should not be pursued at the present time.

While recognizing the risk to investors associated with placing excessive confidence in the audit inspection activities conducted in many jurisdictions, we nevertheless consider that the incentives around this mechanism in particular are significantly more powerful and more direct than those created by additional transparency. As the primary regulatory mechanism aimed at achieving audit quality, oversight bodies have access to information concerning firm structures and processes as well as very specific and detailed information related to the conduct of individual audits. Additionally, oversight authorities employ the professional expertise necessary to interpret and analyze significant quantities of information, and to form judgments on audit quality based on that information. Because of the specialized knowledge and institutional authority they possess, audit oversight bodies are uniquely placed to ensure that audit firms comply with the professional standards, legal requirements and regulatory provisions of their respective jurisdictions. Given that shareholders, investors and the general public would not, under any conceivable transparency regime, have access to the same breadth and depth of information, and nor would they have the same access to professional expertise, our conclusion is that, from a comparative perspective, additional transparency requirements are very unlikely to generate enhanced audit quality.

The analysis in the preceding paragraph reflects our informed opinion, given current knowledge. We are conscious, however, that conclusions on the role of transparency in assessing audit quality could be informed by empirical research. Audit oversight bodies, in at least some jurisdictions, report on many of the features of audit firms that the consultation report identifies as candidates for transparency reporting. Additionally, information may be available through reporting on peer

reviews of audit firms. To the extent that such reporting is sought and utilized in, for example, engagement decision-making by audit committees, it would seem possible to obtain empirical evidence bearing on the role of such information in decision-making where audit quality is important. Such research would, we believe, contribute to a better understanding of the role of transparency and we would welcome the opportunity to participate in the design and conduct of such research.

2. IFAC considers that increased measures of transparency would not enhance in any significant way the availability and delivery of audit services to public companies.

- a. IFAC considers that increased transparency requirements will do little to facilitate greater availability and delivery of audit services to public companies. There are a number of factors which have led to the current level of concentration in the audit market and a range of actions which have been advocated as a means of mitigating that level of concentration. IFAC's view is that, while there is no single action which would address the current situation, and certainly not in a short time frame, there are a number of areas where action has the potential to be more effective than through increased transparency. Included amongst these is reform in the area of professional liability, which would not only reduce the risk of entering or expanding in the large public company audit market, but would also reduce the risk of losing one of the existing players in that market. We strongly support efforts to reduce barriers to entry to this market, where the elimination of those barriers will not compromise audit quality (see b. below). This is not to argue that the additional measures of transparency posed by IOSCO would have no bearing on marketplace dynamics and competition; however, we do not believe a strong enough case can be made to demonstrate that it would achieve an impact of any real significance, relative to other possible actions.
- b. There are a number of barriers to entry in the market for large public company audit services which restrict availability of audit services and contribute to the current state of audit firm concentration. These barriers, which are listed below, should be the subject of further research and debate. Key amongst them are the following:
 - i. International Regulatory Barriers - The complexity and diversity of regulatory regimes around the world present major barriers to entry into the global audit firm marketplace, by increasing the costs associated with this activity. Better regulatory coordination in respect to registration, licensing, inspection and other procedures that generate costs for global audit service provision could potentially reduce significantly both the level of investment and the ongoing operating costs necessary to engage in this market. The current

environment requires, for example, resources for staff coverage (experts who understand the local rules, laws and procedures) in different localities throughout the world. The greater the diversity of practice, the greater the investment in staff required to command, and remain current, across divergent regulatory regimes, including professional standards.

- ii. Professional Liability Risk - Professional liability presents a significant barrier to market entry. Without liability caps, proportionate liability, and/or other measures designed to protect firms from unlimited damages, the incentives to seek to expand in this area of activity (large, transnational public company audits) is reduced. As noted above, action in this area should also assist in reducing the risk of one of the existing large firms from exiting the market. IFAC's view is that, in the current state of the market, it is more important to focus on preventing any market participants from exiting the market than to look to enlarge the pool of audit firms. Although any unnecessary barrier to entry should be removed, enabling market entry and growth by the smaller of the current participants, the greatest risk to the market is the exit of a major current participant. This view is partly a reflection of the current structure of the market (referring to the gap between the Big 4 and other large global firms) and of the time needed to change that structure in any significant way.
- iii. Market Perceptions – One of the barriers to entry, or to enlargement of mid-tier audit firms, lies in market and possibly regulatory perceptions of the capacity of audit firms other than the “Big 4” to provide services of the required quality. For mid-tier audit firms to grow, it is critical that they have access to work for which they have the necessary capacity, and are not precluded from consideration for such assignments. While IFAC is of the view that perceptual barriers of this kind exist, this is a subject that requires further study and consideration, both as to the extent and seriousness of the problem and the possible avenues for addressing the issue.

A final comment in relation to the suggested disclosures in the consultation report is that, if there were a move to increased transparency requirements in the large public company audit market, it would be critical to take full account of the manner in which such changes might apply to smaller audit firms – in particular it would be important to ensure that the requirements did not flow through into the small practice sector in a manner which resulted in disproportionate costs, and therefore create or increase barriers to entry.

- 3. IFAC considers that all significant entities in which there is a public interest – which includes the auditors of public interest entities - should be subject to transparency requirements, especially in relation to their corporate governance arrangements. This issue requires more attention, but not primarily in relation to the two goals identified in the consultation report.**

IFAC's view is that there is a public interest in certain aspects of the operations of audit firms, given the importance of their role in providing assurance in a capital market context, and for this reason some level of transparency is required. Currently, such requirements vary markedly across different jurisdictions and the rationale for such requirements also varies markedly. In some cases the required transparency is associated with the legal form of the audit firm, in other cases the requirements relate more directly to the audit function and its role within the financial system. IFAC acknowledges that transparency requirements associated with the legal form of the organization are best considered within the context of the national or jurisdictional legal system. However, to the extent that transparency requirements derive from the public interest nature of the audit function, our view is that there should be greater international consistency in those requirements. While our view is that there needs to be further research in this area, we consider that the transparency requirements associated with the public interest role of audit are most likely to relate to issues of corporate governance, such as information concerning management structures, independent non-executives, compliance systems and similar aspects which provide shareholders of listed companies and other stakeholders (e.g., clients, creditors, and others in the financial community) with some indication of the quality of corporate governance.

- a. As noted in the consultation report, transparency requirements, similar in general terms to those discussed in IOSCO's paper, exist in a number of jurisdictions. The European Union's Article 40 of the 8th Company Directive is an example of one such system that has international application. Article 40 already requests comparable information to that proposed in IOSCO's paper (e.g., corporate governance structures, educational competencies, quality control systems, and the basis for remuneration). Given the relative novelty of these requirements, and the fact that they are applicable across a number of different countries with different legal systems and institutional arrangements, we would favor research into the impact of these disclosures as input to further consideration of this issue.
- b. Finally, IFAC is of the view that transparency requirements derived from the public interest role of auditing should, to the extent possible, be developed and applied in a consistent manner internationally, and presumably this is implicit in IOSCO addressing this issue rather than leaving it to be resolved in individual jurisdictions. Based on analysis and research into the set of

information which will assist investors and other external stakeholders to understand the quality of corporate governance in audit firms, our view is that the focus of the regulatory community should be on achieving consistency in transparency requirements.