Hong Kong Institute of Certified Public Accountants

Hong Kong as a World Capital Market – What the Future Holds for Hong Kong's CPAs

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Keynote Address 3 - Global Developments in the Accountancy Profession

June 18, 2011

Thank you, Chris, for the introduction. Good morning ladies and gentleman. It is a pleasure being here today and I want to thank you all for coming so early on a Saturday morning. The topic for my comments today is global developments in the accountancy profession. While I will focus on global developments, the issues I will address certainly have local implications.

The global economy is still emerging from a crisis that has tested the international financial system to its limits. The most critical phase of the crisis may, and I stress may, have passed, but recovery remains fragile, and the impact of the crisis continues to be being felt around the world. As a profession we need to think about both how we can contribute to the avoidance of future crises, and how the current crisis will affect our role in the economy and society going forward.

This morning I will introduce the International Federation of Accountants (IFAC), outline the diversity of our profession, describe very briefly the nature of regulatory developments in recent years, and identify some likely developments for the future—including integrated reporting, the role of the audit, and public sector financial reporting. I will also comment briefly on developments in the structure of the accounting profession itself.

But first, while I am sure many of you are familiar with IFAC, for those of you who are not, I will briefly explain who we are and what we do. IFAC is the worldwide organization for the accountancy profession—made up of 164 professional accountancy organizations in 125 countries. We are involved in setting professional standards in a number of areas, including auditing, public sector financial reporting, accountancy education, and professional ethics. With the exception of the International Public Sector Accounting Standards Board (IPSASB), the Standard-Setting Boards (SSBs) are overseen by a Public Interest Oversight Board (PIOB), which is entirely independent of IFAC and based in Madrid.

We also have a number of activities related to Professional Accountants in Business (PAIB), to Small and Medium Practices (SMP), and to the development of the profession around the world through our

Professional Accountancy Organization Development Committee and the Member Body Compliance program. We also work with the accounting firms through the Forum of Firms and the Transnational Auditors' Committee.

Increasingly, we speak for the global profession on matters of public interest, especially in our relationship with international governmental and regulatory organizations like the G-20, the Financial Stability Board (FSB), International Organization of Securities Commissions (IOSCO), International Forum of Independent Audit Regulators (IFIAR), the International Accounting Standards Board (IASB), the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors (IAIS), the International Valuation Standards Council (IVSC), and many others.

Our members and associates represent more than 2.5 million accountants in public practice, industry and commerce, government, and academe. We are headquartered in New York, and currently have a staff complement of 72. In addition to staff resources, we receive extensive support from our members, like the Hong Kong Institute of Certified Public Accountants (HKICPA), who nominate highly qualified individuals to serve on our boards and committees.

Our diverse member body base is a reflection of our profession today. Our member body base encompasses professionals from every part of the globe. Some of our member bodies comprise individual members from all sectors of the economy, some are more specialized, and are comprised only of auditors (there are quite a few of these), some are confined to management accountants, some to accountants in the public sector. Most have a single level of membership, while others, like mine, the New Zealand Institute of Chartered Accountants (NZICA), have tiers of membership—accounting technicians, Associate Chartered Accountants, and Chartered Accountants.

Our members also vary greatly by size, geographic spread, financial resources, and regulatory role.
The American Institute of Certified Public Accountants (AICPA), our largest member body by some measures, is the national professional organization of Certified Public Accountants (CPAs) in the United States, with nearly 370,000 CPA members in 128 countries in business and industry, public practice, government, education, student affiliates and international associates. It has revenues of approximately US$215 million.

By contrast, we have some very small member bodies. For example, our member in Madagascar has 165 members and annual revenue of US$52,000.

There is diversity also in the size and scope of accounting firms, and in the size and nature of the organizations in which members operate, whether in business, academia, or government.

While most of what I address this morning relates to future developments, it is worth for a moment to consider how much the profession has changed in the past decade, especially in terms of its regulatory arrangements.

We saw how financial reporting failure in the private sector (Enron) led to dramatic action, including the passage of the Sarbanes-Oxley Act (SOX), and the creation of regulatory bodies for private sector audits in most major countries. The Sarbanes-Oxley Act, which created the Public Accounting Oversight Board (PCAOB), required that auditors of U.S. public companies register with the PCAOB and be subject to external and independent oversight for the first time in history. Previously, as I noted, the profession was self-regulated and the passage of SOX generated change, a seismic shift really, in the regulation of the profession, at least on the audit side.

The extent of Sarbanes-Oxley's extra-territoriality meant it had a global impact, both through imitation and competition, not to mention on occasions retribution. There is no doubt that the recent global financial crisis has had a significant effect on the accountancy profession and the financial services sector. Even though the crisis has not been blamed on financial reporting or auditing, questions are being asked, whether through the G-20 pressure on the IASB and Financial Accounting Standards Board (FASB) to converge more rapidly, or through the House of Lords enquiry into auditing in the UK, the European Commission Green Paper or the recent speeches of the new chairman of the Public Company Accounting Oversight Board (PCAOB).

Whatever the assessment of the role of accounting and auditing in the current crisis, there is a widespread view that they must be part of the actions needed to avoid future crises.

I will focus on the following three areas in my speech, two of which are directly related to the crisis, the third less so:

- Integrated reporting—of relevance to both preparers and assurance providers
- The role of audit and the audit report—of relevance to auditors
- Public sector financial reporting—of relevance especially to those who work in or provide consultancy services to the public sector

In each of these areas I see significant change on the horizon.

First, Integrated Reporting

I will address this only briefly – perhaps my comments can best be seen as a lead in to the later session where this is covered in more depth.

There are at least two concerns with the current reporting model:

- It omits significant variables that impact a company's value and long-term sustainability, in which category would be included environmental, social, and governance dimensions; and
- It is increasingly complex, a point made in a 2004 IFAC report by Peter Wong, a former President of the HKICPA.

But there has been a long history of dissatisfaction with the current financial reporting model and many attempts to develop alternative reporting models. I think there are two reasons to believe that current efforts, in which the accounting profession is deeply involved, may have a better prospect of success:

- The International Integrated Reporting Council (IIRC) is made up of a very persuasive group of organizations that are collectively seeking to advance this agenda
- In South Africa, as you will hear from Graham Terry later, integrated reporting is required as a listing requirement of the Johannesburg Stock Exchange. I believe that having some real life examples of what integrated reporting looks like will do a lot to make it seem like a practical and "doable" solution to a serious problem. The pilot program which is part of the activity of the International Integrated Reporting Committee will similarly generate real-life examples, in this case from countries around the world

But there are hurdles to overcome, and we should not expect to see the dismantling of the current financial reporting regimes any time soon. The IIRC will be producing a discussion paper, the development of which has had to confront a long list of difficult and contentious issues, contentious even between those who think IR is a good idea. The creation of a globally accepted framework that brings together financial, environmental, social, and governance information in a clear, concise, consistent, and comparable format is the core objective of the IIRC.

IFAC, in its G-20 recommendations, recommended the G-20 support the development of these new tools and metrics to achieve global sustainability. I do think this is an area in which we, as a profession, will have a significant role, both as preparers and as providers of assurance.

The Role of the Audit

Here, too, you have a later session which will deal with this issue in more detail.

The financial crisis has re-invigorated debate over the role of audit and of the structure of the audit market. As I noted earlier, there have been a number of enquiries into audit and the audit market. The one with the most transparently international agenda is the European Commission's Green Paper. At this stage we do not really have very much idea what will emerge in coming months from the Commission, though the recent parliamentary report reduced the likelihood of some of the more radical options raised for consideration by the Green paper.

Given the overwhelming support for the adoption of International Standards of Auditing (ISA) by both respondents to the Green Paper and the Parliamentary report, we certainly do hope that there will be some progress in this area. At this stage I would be doing little more than speculating if I offered a view as to what might happen in relation to issues raised in the Green Paper such as joint audits, mandatory firm rotation, or mandatory re-tendering.

So I will address one area where I think we can be confident that things will change, and that is the audit report. There have been a number of improvements to the standard auditor's report over the past few years—including clarification of the scope of the audit and the respective responsibilities of management and the auditor—to address the expectations gap and promote international consistency in auditor reporting. Nevertheless, some market participants have suggested that now is the time for a more fundamental review of auditor reporting. These suggestions have been made because of perceptions that auditor reporting is not meeting the information needs of financial statement users in a global business environment with increasingly complex financial reporting requirements.

The issue is not confined to audit; more broadly, there is an acknowledgement of an information gap. Users recognize there is richer information about the entity and about the audit itself than is currently being provided through the audited financial statements and other corporate disclosure mechanisms, and through the auditor's report – this takes us back a little to the pressures leading to integrated reporting. Users wish to obtain this richer information directly from the entity and/or through communications about the auditor's insight into such matters. They believe such information would assist them in assessing the financial condition and performance of the entity, as well as the quality of its corporate reporting and the quality of the audit. Policy makers very much have this on their radar screens, e.g. EC, IOSCO, PCAOB, etc, as does the International Auditing and Assurance Standards Board (IAASB.)

The IAASB recently released a consultation paper: *Enhancing the Value of Auditor Reporting: Exploring Options for Change*. The PCAOB also has a project in this area and should be releasing a paper in the next couple of months. We are at a point where we have the capacity to influence the future shape of the audit report. You have until September 16, 2011to submit your views to the IAASB and I would encourage you to read the consultation paper and comment on it.

Public Sector Financial Reporting

The sovereign debt crisis, which is deepening by the day will, I suspect and hope, lead to a radical re-assessment of public sector accounting and potentially bring it into the 20th Century. (21^{st} Century?)

In the same way that Enron has come to be seen as symbolic of the need for higher quality audit, I think it highly likely that the financial reporting fraud by the Greek Government will come to be seen as the symbol of irresponsible financial reporting behavior by governments.

The Global Financial Crisis and Sovereign Debt Crisis made it abundantly clear that governments in general are accounting very badly for their financial performance and position. Many use cash-basis accounting, which means that many significant items, such as liabilities for public sector pensions and financial instruments, are not accounted for appropriately. The extension of that is that they are also not well managed.

If there were to be recognition that you cannot manage organizations as complex as modern governments with cash-based financial management systems, there would be significant implications for the profession, both in terms in achieving the necessary financial management system development and in the ongoing requirement for accounting skills in government agencies. In those few governments that do have modern financial management systems, the need for accounting skills is not dissimilar to the needs of a company of similar size.

Just to be clear, failure of governments to meet their financial obligations is not that rare. The table below shows those governments that have restructured their debt since 1990.

Countries with Sovereign Restructuring since 1990 (Agreement Date)[1]

Algeria (07/1996)	Pakistan (12/1999)
Argentina (04/1993, 04/2005)	Panama (05/1996)
Brazil (04/1994)	Peru (03/1997)
Bulgaria (06/1994)	Philippines (12/1992)
Chile (12/1990)	Poland (10/1994)
Cote d'Ivoire (03/1998)	Russia (08/2000)
Croatia (07/1996)	South Africa (09/1993)
Dominican Rep.(08/1994, 05/2005)	Ukraine (04/2000)
Ecuador (02/1995, 08/2000)	Uruguay (05/2003)
Mexico (05/1990)	Venezuela (12/1990)
Morocco (09/1990)	Vietnam (12/1997)
Nigeria (12/1991)	Serbia & Montenegro (07/2004)

Source: Cruces J and Trebesch C, *Sovereign Defaults: The Price of Haircuts* (Preliminary Paper) December 2010

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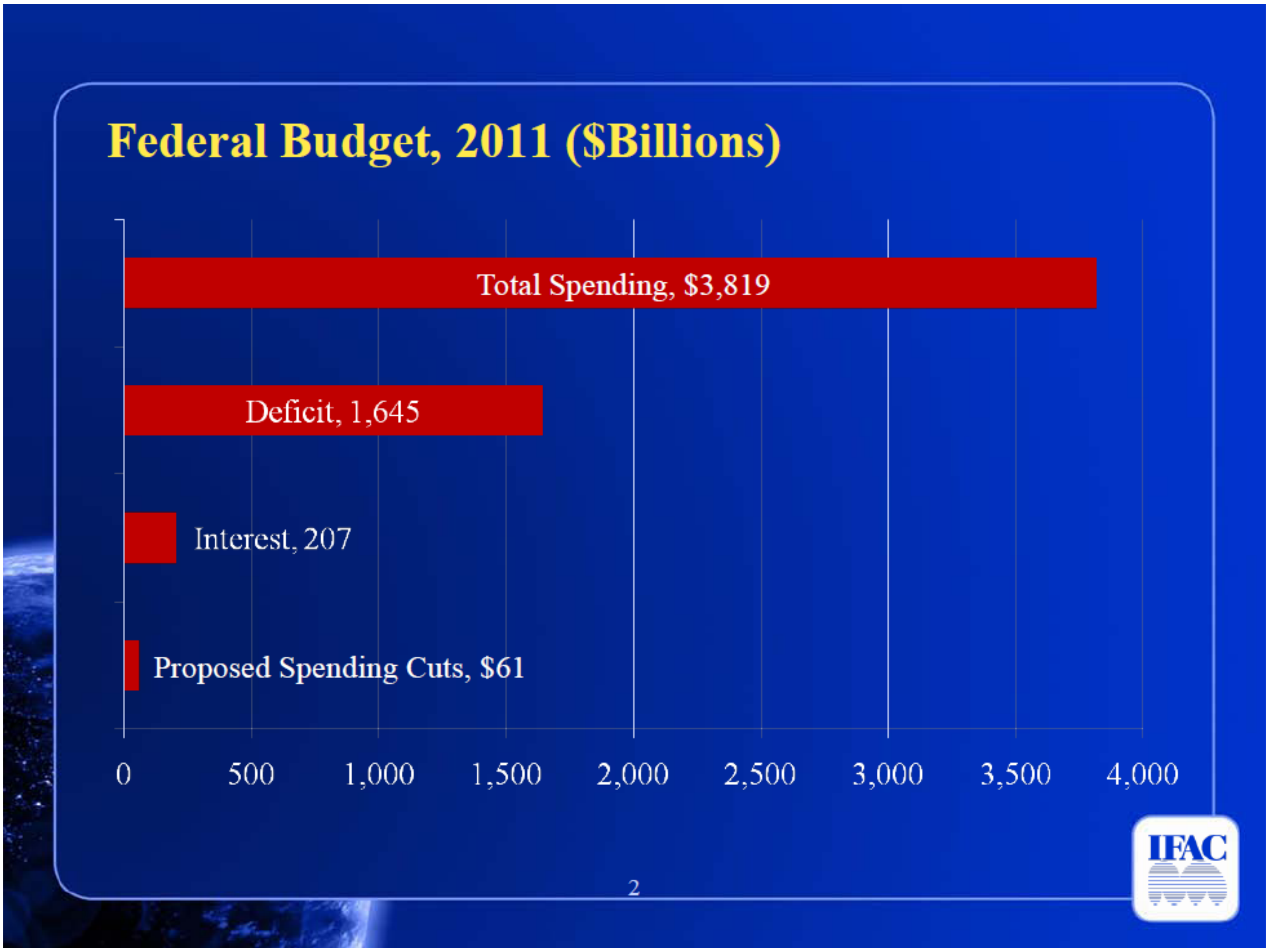
And the problem is by no means confined to Europe. This bar chart below shows the current financial performance of the US Government. In considering the significance of this, one should answer two questions:

- How long is this position sustainable?
- How well is the US political system equipped to resolve the imbalance between spending and revenue?

It should be noted that the proposed savings on the chart are those of the Republican members of Congress, the Democrats propose much smaller savings.

And it seems that increasingly, citizens are seeing that the situation is serious:



- Increasing doubt by citizens that their governments are financially sustainable [1]
  - In the US 54% believe their government is not financially sustainable
  - In the UK the percentage is 42%
  - In Germany 31%
  - In France 52%

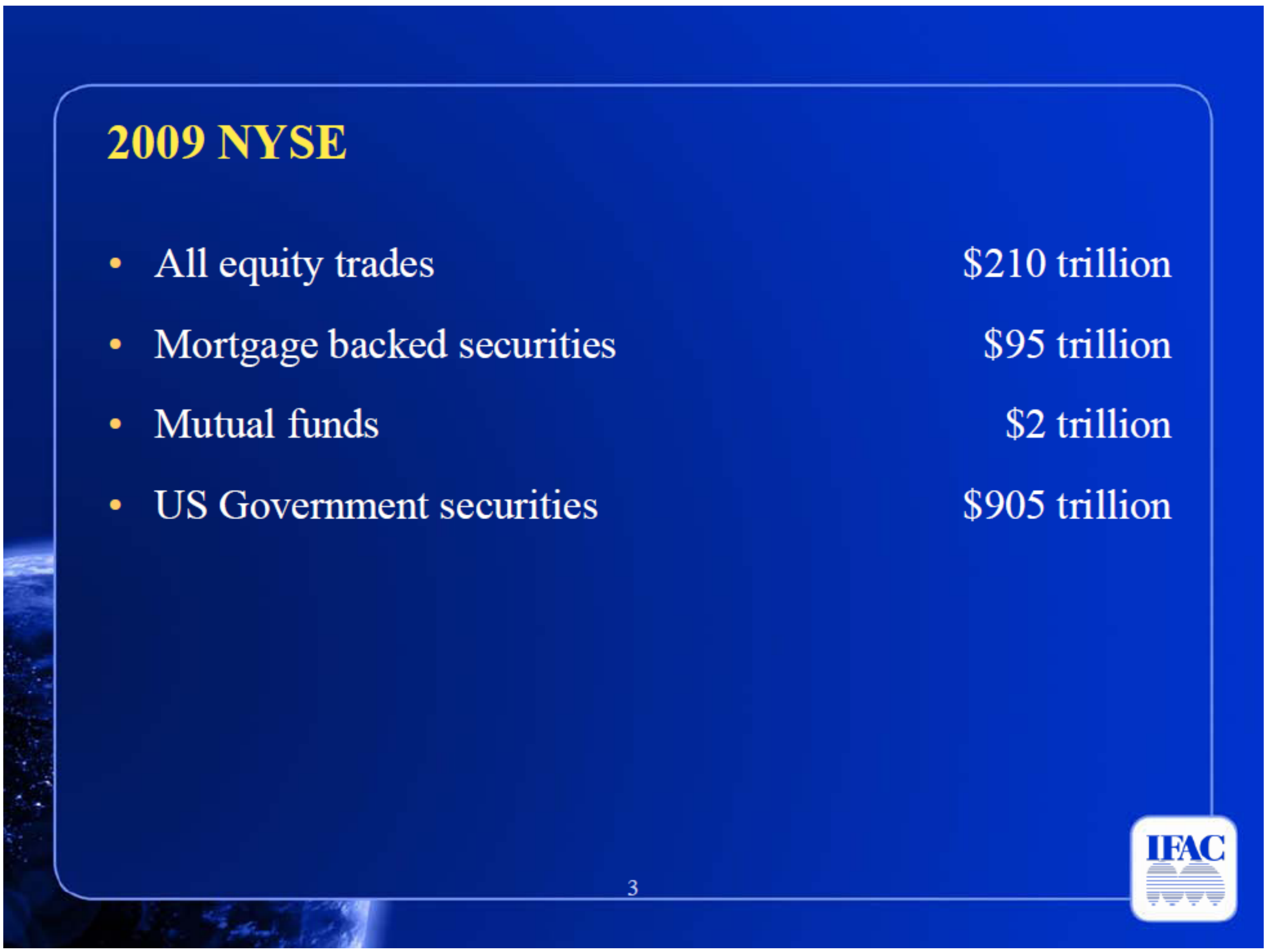
- Increasing concerns by investors over the quality of information they have in regards to sovereign “balance sheets”

[1] Ralph Atkins, Financial Times, *Public Fears over Default on the Rise,* June 13, 2011.

I spoke recently at the World Bank's Global Borrowers Forum, where the representative of one of the world's largest banks explained how government debt was no longer seen as risk-free and that investors were looking for the same micro-level of analysis that applies in the private sector.

When investors ask what the balance sheet looks like this banker had to say most governments do not have a balance sheet as we would understand the term—some investors find this very hard to believe!

And to explain the importance of sovereign debt to capital markets:



The situation in Europe is on the front pages almost every day. It is very clear that policy makers are struggling to find a solution to a deep and intractable problem. It is also clear that the consequences are potentially much more serious than were those of Enron. The failure of financial management in government has already led to governments changing and social disorder on the streets.

This situation could, and should, lead to significant reform. As I stated before, financial reporting failure in the private sector led to the passage of the Sarbanes-Oxley Act, and the creation of regulatory bodies for private sector audits in most major countries. But that was the private sector. In this case it is the public sector where the reporting failure has occurred and at least to date there has been very little call for action. There has been a lot of debate about the need for action to reduce deficits and spending, but little serious consideration of the role that accounting and auditing have played in the crisis.

It was, however, refreshing to hear Bill Gates last March calling for accounting reform at the state government level in the United States, where many of the governments face very serious fiscal problems. He is quoted as saying that state governments “use tricks that would make Enron blush.” [2]

There is a solution to hand – we need only to implement it. The International Public Sector Accounting Standards (IPSAS)—the government equivalent of International Financial Reporting Standards (IFRS)—have been adopted by the United Nations, Organisation for Economic Co-operation and Development (OECD), and the European Commission (for its own financial statements), amongst others. IPSASs have also been adopted for some—but not nearly enough—national level governments such as Switzerland, Austria, Peru, and South Africa. The momentum toward adopting IPSASs is definitely building globally, with countries like Brazil and Spain signaling their intent to adopt in the near future. A single set of internationally accepted accounting standards for the public sector would enhance transparency and accountability of governments, and would be solidly in the public interest.

I would like to end this section of my remarks on a more positive note, but only cautiously positive. One of the defining moments for the global adoption of IFRS in the private sector was when they were adopted by the European Union for application to all companies within the Union. In a very recent report, one of the most powerful committees of the European Parliament – the Economic and Monetary Affairs Committee – called for the adoption of IPSAS within three years of the finalization of a forthcoming directive. Now such a recommendation does not mean this will necessarily happen, but it is indicative that some policymakers at least are seeing the need for high-quality financial reporting according to independently set standards, and this is a very significant development.

Structure of the Profession

Finally, I would like to speak briefly to another development which will, I believe, change the face of the profession in coming years. As the market for accounting services (and accountants) transitions from national markets to a global market, professional accounting organizations will follow suit. To a

[2] 2011 TED Conference (Technology, Education, Design), *The Rediscovery of Wonder,* March 1-4, 2011.

significant extent this is happening already. Many IFAC member bodies have their membership spread around the world—I noted earlier that the AICPA has members in 128 countries.

So the question is—How will the market for the services provided by professional accounting organizations like the HKICPA change? I should stress that my comments here are not specifically directed at the HKICPA. While the context I describe may have application in Hong Kong, for Hong Kong I would see the national and regional context being perhaps more critical. What I am describing are the global trends that I see emerging.

Let me just observe a few of the current developments:

- Canadian Institute of Chartered Accountants (CICA) and Certified Management Accountants (CMA) in Canada to explore common challenges—consolidation within countries
- The Institute of Chartered Accountants in Australia (ICAA) and the NZICA—Australasian alliance
- AICPA and CIMA—global management accounting designation

I do not think it is yet clear where this will lead—most regulation is still at a national level so there will be some pressure to retain national designations. Yet, there will be countervailing pressures stemming from:

- The increasingly global nature of business
- The trend to global regulatory and standards convergence
- Pressures for efficiency
- The desire for market share

It would not be surprising for these pressures to have a mirror in the way the organization of the profession develops.

Conclusion

So these are some of the developments that we might well see in the future. I would be happy to address any questions you might have about these issues or indeed any others related to IFAC.

Thank you for your attention.

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