



**Remarks of Ian Drennan to the
Chartered Accountants Ireland forum on
*'The Future of Statutory Audit'***

Good morning ladies and gentlemen.

At the outset, I would like to thank the Institute for inviting IAASA to participate in this timely event. I look forward to what promises to be a fruitful discussion and exchange of perspectives.

Context for today's discussion

Today's discussion takes place against a backdrop of the severe economic adjustment that Ireland continues to experience. The scale and rapid onset of that adjustment has given rise to a dramatic shift in the fortunes of many households and businesses.

Unarguably, the highest profile examples of this have been the financial institutions. Macro economic factors and the consequences of imprudent lending practices have, when combined with the effect of applying applicable financial reporting standards, resulted in the reporting of very substantial impairment losses following periods in which relatively low levels of such losses were reported.

Added to this, details of serious governance and risk management failures in our banking system have emerged, together with high profile revelations regarding certain practices and transactions in that sector.

The combined effect of these factors has been to give rise to suggestions that financial reporting has been unreliable, misleading or perhaps even fraudulent.

In addition, by virtue of having provided unqualified opinions in respect of reporting periods:

- immediately preceding the reporting of substantial, and in some instances catastrophic, losses; and
- during which certain practices and transactions have subsequently emerged as having occurred,

concerns have also been expressed regarding the performance of the audit profession.

The result has been a significant loss of confidence in both financial reporting and in the audit profession.

Factors contributing to the loss in confidence

A more detailed analysis would suggest that one or more of the following factors have contributed to this loss of confidence:

- i. firstly, a financial reporting expectation gap - in other words a gap between the information provided by historical, general purpose financial statements and users' expectations in that regard;
- ii. secondly, an audit expectation gap - in other words a gap between the purpose of statutory audit, as provided for by law and professional standards, and public expectations in this regard;
- iii. thirdly, a perception that financial statements, or other public documents containing financial information, have been materially misstated, intentionally or otherwise;
- iv. fourthly, a perception that auditors have failed to properly discharge their duties by not drawing attention at an earlier juncture to issues that have subsequently come to light.

Overview of IAASA's role

Before discussing these issues further, I would like to briefly outline IAASA's principal statutory functions. In summary, these include:

- i. supervising the regulatory and monitoring activities of nine accountancy bodies; and
- ii. monitoring the periodic financial reporting of approximately 170 listed entities.

In the context of the former, the regulatory model in place is one of supervised self regulation - that is to say a model under which the accountancy bodies have responsibility for regulating and monitoring their members and member firms under IAASA's general supervision. This model was introduced with the enactment of the Companies (Auditing and Accounting) Act 2003, the relevant provisions of which were commenced in early 2006¹.

The latter function was conferred in 2007 in the context of the transposition of the EU Transparency Directive. Under the transposing Regulations the first annual financial reports to come within scope were, in the case of most issuers, those in respect of the year ended 31 December, 2008.

¹ S.I. No. 56 of 2006

Responses to date

I would now like to briefly outline how IAASA has responded to certain of the matters referred to earlier.

Financial reporting

IAASA's ongoing risk based review of listed entities' financial reporting takes account of the financial reporting risks associated with changes in macro economic conditions generally. In addition to that ongoing activity, IAASA has devoted substantial resources to examining the financial reporting issues raised by certain information that has come into the public domain - most notably the issue of certain transactions between institutions. Insofar as coming within the scope of the Transparency Regulations, the refinancing of certain loans has also been examined.

In examining these issues we have sought to work in co-operation with other regulatory authorities having an interest in these matters. For example, we have shared a substantial volume of documentation with the Financial Regulator as well as with An Garda Síochána and the Director of Corporate Enforcement, both of whom have initiated criminal investigations.

More broadly, and consistent with our risk based selection methodologies, we have engaged extensively with those financial institutions coming within our remit on a range of other financial reporting issues, such as for example:

- accounting for loan impairments;
- transfers to NAMA² and other matters associated with State intervention in the banking system; and
- the valuation of financial instruments in illiquid markets.

Under the Transparency Regulations, IAASA's remit extends to listed entities only. Accordingly, whilst AIB, Anglo, Bank of Ireland and IL&P come within our remit, institutions such as the Irish Nationwide and EBS Building Societies and Quinn Insurance do not.

Accountancy profession

In response to the circumstances which gave rise to the resignations of Anglo's former Chairman and Chief Executive respectively, IAASA took the decision in, December 2008, to appoint a senior staff member to observe this Institute's Complaints Committee's response. The Complaints Committee subsequently appointed a Special Investigator to examine the role that certain members may have played in those events.

² National Asset Management Agency

In addition to the powers available to him under the Institute's Bye-laws, the Special Investigator also has substantial statutory powers of investigation. Those powers include:

- the power to require the production of documents;
- the power to examine relevant persons on oath; and
- the right to certify refusal to co-operate to the High Court.

That complex and large scale investigation, which is being conducted under IAASA's supervision, is also charged with examining the performance of Anglo's, then, auditors *vis-a-vis* these matters.

Consistent with our statutory confidentiality obligations, IAASA has also sought to be of assistance to the Special Investigator by sharing a substantial volume of documentation with him.

More broadly, in response to the credit crisis and economic downturn, IAASA engaged with the accountancy bodies at an early juncture and emphasised to those bodies the importance of factoring the resultant risks into their monitoring processes.

Further responses

Clearly, the foregoing professional, supervisory and criminal processes will, notwithstanding their differing focus and objectives, serve to address some of the specific concerns that have been expressed regarding financial reporting and the audit profession.

Nevertheless, it seems clear that, if confidence is to be restored in the profession more broadly, notwithstanding that the expectation gap may be a valid consideration, the performance of financial institutions' auditors more generally will need to be evaluated.

Notwithstanding that its primary focus lies elsewhere, as currently drafted the Terms of Reference of the proposed Banking Commission³ provide for a review of the extent to which auditors' reports, or other communications with covered institutions, referred to certain matters. This exercise will, therefore, similarly serve to address certain aspects of auditors' performance.

It is suggested, however, that a comprehensive assessment of performance will require, *inter alia*, a detailed review of relevant engagement files and of the sufficiency and appropriateness of evidence supporting the key judgements underpinning the associated opinions.

³ Having considered the recently published reports of Professor Honohan and Herr Regling/Mr. Watson respectively, the Government has indicated its intention to charge the proposed Banking Commission with establishing, *inter alia*:

- whether the auditors of the covered institutions commented in their reports, or in other communications to those institutions, on the failure of those institutions to implement and adhere to appropriate standards and controls, as a result of which exceptional financial support has had to be provided by the State; and
- whether the auditors of Anglo and Irish Nationwide Building Society commented in their reports, or in other communications to those institutions, on the main causes for the adoption by those institutions of business models that resulted in severe financial distress.

That being the case, and having regard to their responsibilities in a system of supervised self regulation, there is a clear opportunity for professional bodies to contribute to the restoration of confidence through the initiation of appropriately formulated responses.

Of course, any such responses would need to be capable of satisfying key stakeholders as regards considerations including scope, credibility, timeliness and transparency.

Availing of this opportunity would serve the interests of all concerned. Were a credible exercise to conclude that audit deficiencies have not been a feature, the resultant outputs would serve to explain and communicate the basis for that conclusion in a transparent manner, thereby allaying the concerns that have been expressed.

Conversely, were such an exercise to conclude that there have been deficiencies; it would be in the interests of the profession, and those who rely upon its outputs, that any such deficiencies be addressed in a timely manner.

The expectation gap

I would now like to turn briefly to the subject of the expectation gap. Any discussion of this issue must have regard to the fact that financial reporting and auditing standards are increasingly set internationally, while associated legislation is largely set at EU level.

That said, there have been a number of interesting suggestions as to how users' expectations might be better catered for in the future such as, for example, through the provision of expected loss data to supplement incurred loss data, the introduction of dynamic provisioning in financial institutions' financial reports and the provision of additional commentary in auditors' reports.

In addition to those suggestions, and to whatever might emanate from national and international standard setters' deliberations, there may, in a domestic context, be certain opportunities to bridge the gap that currently exists.

For example, perhaps the experience of recent events suggests that now is an opportune time to revisit the un-commenced section 45 of the Companies (Auditing and Accounting) Act 2003, which provided for the introduction of Directors' Compliance Statements.

In particular, consideration might be given to exploring whether the concerns that have previously been expressed by a range of stakeholders could be addressed whilst retaining:

- additional discipline for Boards; and
- the value of associated assurance, as envisaged by the provision.

In a not dissimilar vein, the Comptroller & Auditor General has recently recommended that financial institutions' auditors should provide positive assurance regarding the functioning of those entities' governance and risk management arrangements⁴ and, as we have just heard, the Central Bank intends to consult on this issue next month with a view to implementation in early 2011.

It is, perhaps, also worth noting that financial statements comprise only one element of issuers' public reporting, with other elements including issuers' statutory obligations to report on risk and uncertainty⁵ and other periodic announcements to the market, which do not come within scope of audit.

⁴ Special Report 72: Financial Regulator

⁵ The above reference to statutory reporting obligations refers to the obligations of entities coming within scope of the Transparency (Directive 2004/109/EC) Regulations 2007 ('the Regulations'), i.e. listed entities. Under Regulations 4 and 5 and Rule 6.1 of the Financial Regulator's Transparency Rules ('the Transparency Rules'), issuers' annual financial reports are required to include a management report which, *inter alia*, provides a fair review of the development and performance of the business and position of the issuer and the undertakings included in the consolidation taken as a whole, **together with a statement of the principal risks and uncertainties that they face**. The Transparency Rules further provide that issuers' management reports should include reference to, amongst other matters, important events after the balance sheet date, likely future developments and, in the case of issuers that use financial instruments, information regarding financial risk management objectives and policies and issuers' exposure to certain risks (**bold emphasis added**).

Regulations 6 to 8 provide that issuers' half-yearly financial reports are required to include an interim management report which, *inter alia*, includes a fair review of important events that have occurred during the first six months of the year, the impact of those events on the condensed financial statements **and a description of the principal risks and uncertainties for the remaining six months of the year (bold emphasis added)**.

Broadly similar, and more widely applicable, provisions are contained in section 13 of the Companies (Amendment) Act 1986, which prescribes certain information that must be provided in the Directors' Report.

Since commencing our reviews of issuers' periodic financial reports in late 2007, in addition to having identified varying degrees of non-compliance with relevant reporting frameworks, we have observed that the quality of issuers' reporting on forward looking matters such as risk and uncertainty has been varied.

Whilst we continue to engage with relevant issuers' Boards with a view to securing improvements in this area, it may be that:

- in light of recent experience; and
- notwithstanding that the fair and balanced reporting of these matters is clearly the directors' responsibility,

there is merit in considering whether, with a view to further strengthening disclosures in this regard, there is scope for the provision of some form of independent assurance on these matters.

Whilst difficult to judge, it is conceivable that, had Boards been required to submit their assertions in this regard to the scrutiny of their auditors, key users would have been better equipped to challenge those Boards' stewardship at an earlier juncture.

Clearly, however, a range of issues, including the feasibility of providing such assurance within the context of the scope of statutory audit as currently prescribed, would require further consideration amongst interested parties.

The regulatory framework

Investigations

I would now like to offer some thoughts as to how, in IAASA's judgement, the current regulatory framework governing statutory audit might be enhanced in the future.

The current regulatory framework has its genesis in the Report of the Review Group on Auditing, which was established following the DIRT Enquiry⁶. At that time it was concluded that the appropriate regulatory model for the profession was one under which the accountancy bodies would retain responsibility for regulating and monitoring their members under the supervision of a statutory oversight Board.

The 2003 Act subsequently gave effect to those recommendations and some of the more notable characteristics of that Act include the following:

- firstly, a stipulation that the accountancy bodies' '*standards*', which include their investigation and disciplinary procedures, require IAASA's approval, as do any amendments thereto;
- secondly, in conducting investigations into their members and member firms, the accountancy bodies have considerable statutory powers at their disposal. The powers conferred by the Act include: (i) the power to require the production of documents; (ii) the power to examine relevant persons on oath; and (iii) the right to certify non co-operation to the High Court;

⁶ Deposit Interest Retention Tax

- thirdly, a right on IAASA's part to conduct statutory Enquiries in instances of suspected or apparent non-compliance by an accountancy body with its approved investigation and disciplinary procedures. In circumstances where IAASA determines non-compliance with those procedures to have occurred, the options at our disposal include: (i) annulling a disciplinary decision; (ii) requiring that a fresh investigation be conducted; and (iii) the power to impose a monetary sanction of up to €125,000; and
- fourthly, a right on IAASA's part to conduct statutory Investigations into individual members of the profession.

As is clear from the foregoing, rather than being to supplant the role of the accountancy bodies, the intention of the legislation is that IAASA's function is to focus on the operation of their approved investigation and disciplinary processes and, in instances of proven non-compliance therewith, to impose proportionate and dissuasive sanctions.

As a corollary, the significant step of setting aside an accountancy body's disciplinary processes is, under the current legislation, very much a 'nuclear option' - to be exercised in exceptional circumstances. Such circumstances might include, for example:

- where, in IAASA's assessment, an accountancy body has manifestly failed to initiate an investigation in circumstances where one is clearly warranted; or

- where IAASA does not have confidence in the integrity of an accountancy body's investigation and disciplinary processes.

Having regard to the manner in which the current legislation is framed, other factors requiring consideration in assessing the appropriateness of any decision to set aside an accountancy body's disciplinary processes also include the following.

- Firstly, any investigation conducted by IAASA must be funded by the Exchequer to the tune of 40%, with the balance to be provided in aggregate by the nine accountancy bodies. Large scale investigations are costly and carry considerable litigation risk. That being the case, IAASA considers that requiring the Exchequer, or accountancy bodies whose members are not under investigation, to fund such investigations and to bear associated financial risks is inherently inequitable.
- Secondly, were IAASA to set an accountancy body's disciplinary processes aside and subsequently make an adverse finding against an individual or firm, the sanctions available to IAASA are limited to those available to the accountancy body of which the individual or firm is a member.

This model is, in IAASA's assessment, sub-optimal in a number of respects and warrants review in light of trends that have emerged since the legislation was enacted. In particular, we believe that the following issues merit consideration in any such review:

- i. firstly, whether the *status quo* should be retained or, alternatively, whether the default position should become one under which matters of particular importance are investigated by IAASA rather than by the relevant accountancy body. Such an approach would, for example, mirror the approach that has been adopted in the UK;
- ii. secondly, whether the current funding arrangements should be amended. IAASA's view in this regard is that, in the first instance, the accountancy body whose member is under investigation should meet the costs of the investigation and bear the exposures associated with litigation risk.

Clearly, such a model could further provide for the recouping of the costs involved from the member or member firm involved. It is also recognised that some contingency arrangements might be necessary.

- iii. thirdly, whether the sanctions available in circumstances of an adverse finding should continue to be limited to those available to the body of which the individual or firm is a member - for example, in the area of monetary fines.

Quality assurance

Another aspect of the current regulatory arrangements that, in IAASA's view, merits consideration is that of quality assurance. Historically, quality assurance was conducted by the accountancy bodies voluntarily rather than on a statutory basis.

The Statutory Audit Directive⁷ requires Member States to put quality assurance on a statutory footing and this has recently occurred with the transposition of the Directive. As a result, the accountancy bodies now have a statutory responsibility to perform quality assurance reviews of their member firms.

This is clearly both an important and positive step. For its part, IAASA broadly supports the approach that has been adopted. IAASA does, however, believe that, by virtue of their significance from a public interest perspective, the audits of certain entities - such as for example listed entities - are clearly different and, as such, should be subject to the additional assurance measures proposed by the European Commission in its Quality Assurance Recommendation of 2008⁸.

In its Recommendation the Commission proposed that Member States' oversight authorities should have a direct role in the quality assurance arrangements governing the audits of public interest entities.

⁷ Directive 2006/43/EC

⁸ Recommendation 2008/362/EC

Implementation of the Recommendation would, in IAASA's assessment, yield the following benefits:

- firstly, implementation would strengthen and enhance the independence of the quality assurance arrangements currently applying to the audits of public interest entities, thereby providing users of the associated outputs with an enhanced level of assurance;
- secondly, implementation would bring Ireland into line with what is now widely accepted in the EU and internationally as being best practice;
- thirdly, if structured in an appropriate manner, implementation would contribute to an increased likelihood of third countries' oversight authorities being able to place reliance on aspects of the Irish quality assurance arrangements - for example, in the area of whole firm procedures.

This would serve to avoid the costs associated with unnecessary duplication of regulatory activity. In this context it is important to appreciate that third country oversight authorities such as, for example the US PCAOB, have indicated that they do not consider it appropriate to place reliance on quality assurance systems operated by professional bodies;

- finally, notwithstanding that IAASA has statutory responsibility for oversight of the audit profession, under the current regulatory arrangements IAASA does not have a direct regulatory relationship with those firms that audit public

interest entities. This presents us with very significant challenges in that, unlike most of our EU and international counterparts, we are largely unable to gain an insight into those firms' approach towards, and emphasis on, audit quality and the factors that contribute to same.

At a time when the audit profession is under considerable scrutiny, and is likely to remain so for the foreseeable future, this is, in IAASA's judgement, a significant weakness in the current regulatory arrangements.

Enhancements of this nature would also further present opportunities to support and promote confidence in the profession such as, for example, through the provision of public reports on individual audit firms as is now the norm in jurisdictions such as the UK and the US. Such reports would serve to provide a greater degree of transparency regarding audit firms' performance and emphasis on quality, thereby assisting those charged with external auditor selection and evaluation.

Similarly, a direct regulatory relationship with the firms in question would enhance IAASA's capacity to engage in informed dialogue on other important EU and international developments such as, for example, the Audit Firm Governance Code as recently promulgated in the UK.

Conclusion

In conclusion ladies and gentlemen, whilst, as I suggested at the outset, there has been a loss of confidence in both financial reporting and the audit profession, it is similarly clear that a number of important processes are underway the effect of which should be to address some of the concerns underlying that loss.

Similarly, it is suggested that there are further steps that can be taken to address the concerns that have been voiced and to ensure that the regulatory framework governing the profession into the future is one that is configured in a manner that best serves to achieve the goal that I am sure we all share - namely, of a profession in which the public can have the highest levels of trust and confidence.

For its part, IAASA is committed to continuing to work with the profession and other interested parties with a view to achieving that goal.

Thank you.