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Key foundations for high-quality corporate reporting: Good practices of monitoring and enforcement, and compliance mechanisms

Note by the UNCTAD secretariat

Executive summary

Since 2010, the UNCTAD Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) has been developing an Accounting Development Tool for high-quality corporate reporting. The findings of pilot tests of the Accounting Development Tool, carried out in 2012 and 2013, and discussions of the findings at ISAR sessions reflected that countries require further guidance on building efficient mechanisms for the monitoring of compliance and enforcement. At its thirtieth session, ISAR proposed to focus its deliberations during the thirty-first session on such mechanisms.

The present note was prepared by UNCTAD to facilitate the discussions on this topic. It describes the key elements that need to be considered when building efficient monitoring and enforcement systems for companies, audit firms and professional accountants, highlights standards and guidance issued by international and regional bodies and selected national good practices and discusses the main challenges faced by countries in their efforts to establish efficient mechanisms for the monitoring of compliance and enforcement.



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I. Introduction and background

1. The UNCTAD-ISAR Accounting Development Tool consists of an accounting development framework and a set of accounting development indicators.¹ Its objective is to assist policymakers and other stakeholders in their efforts to strengthen their accounting and reporting infrastructures, to achieve high-quality and internationally comparable corporate reporting. The annex to the present note provides a graph of the Accounting Development Tool scores of three sample countries, for illustrative purposes.

2. A series of international benchmarks related to corporate reporting has emerged over the last two decades. The benefits of high-quality standards cannot be attained, however, unless they are properly implemented. Countries need to apply a comprehensive approach to ensure the establishment of an efficient system of mechanisms for the monitoring of compliance and enforcement (MCE) and their proper implementation by companies and audit firms. It is also important to ensure the implementation and enforcement of requirements for professional accountants, defined by the UNCTAD-ISAR guidelines on national requirements for the qualification of professional accountants as persons who are qualified to be, or who are, members of a recognized professional body of accountants or auditors, or who are recognized as such by a regulatory body.

3. Different studies have shown evidence of the positive impact of enforcement on corporate transparency and the quality of reporting. For example, Christensen et al. (2011) found that the capital market effects of two directives issued in the European Union to reduce market abuse and improve transparency regulation and enforcement were stronger in countries with stricter securities regulation, better public enforcement regimes and a history of higher regulatory quality.² Christensen et al. (2013) reported that the benefits of International Financial Reporting Standards were seen in countries that increased their accounting enforcement activity at the time of adoption of the Standards in 2005.³ Brown et al. (2014) found that audit and accounting enforcement was crucial to the application of International Financial Reporting Standards and that the effectiveness of adoption of the Standards might be hampered by differences in institutional settings across countries.⁴

4. At regional levels and the international level, there are key organizations in charge of strengthening practices of regulation, supervision and monitoring in the different economic sectors, including major bodies such as the Basel Committee, which is the global standard-setter for the prudential regulation of banks, European Commission, European Group of Auditors' Oversight Bodies, European Securities and Markets Authority (ESMA; formerly the Committee of European Securities Regulators), Financial Stability Board, International Federation of Accountants, International Forum of Independent Audit Regulators and International Organization of Securities Commissions.

5. In recent years, a number of pronouncements, standards and guidelines have been issued with regard to MCE at international and regional levels, including the following:

¹ TD/B/C.II/ISAR/56.

² H B Christensen, L Hail and C Leuz, 2011, Capital-market effects of securities regulation: Hysteresis, implementation and enforcement, National Bureau of Economic Research Working Paper 16737, available at <http://www.nber.org/papers/w16737.pdf> (accessed 30 July 2014).

³ H B Christensen, L Hail and C Leuz, 2013, Mandatory International Financial Reporting Standards reporting and changes in enforcement, *Journal of Accounting and Economics*, 56:147–177.

⁴ P Brown, J Preiato and A Tarca, 2014, Measuring country differences in enforcement of accounting standards: An audit and enforcement proxy, *Journal of Business Finance and Accounting*, 41:1–52, available at <http://onlinelibrary.wiley.com/doi/10.1111/jbfa.12066/pdf> (accessed 30 July 2014).

guidance on the cooperation between competent authorities within the European Union, by the European Group of Auditors' Oversight Bodies; policy position on the regulation of the accountancy profession, by the International Federation of Accountants; core principles for independent audit regulators, by the International Forum of Independent Audit Regulators; and objectives and principles of securities regulation, by the International Organization of Securities Commissions. Two standards on the enforcement of financial information and coordination were developed by the Committee of European Securities Regulators and issued in April 2003 and April 2004.⁵ Guidelines on the enforcement of financial information were published by ESMA in July 2013 as a consultation paper and in July 2014 as a final report, and replaced these two standards.⁶

6. Building a sound MCE system remains a challenge in many countries, particularly developing countries and economies in transition, due to the complexity of such a system, its relative novelty and its significant interdependence with the different institutional and legal settings of national jurisdictions, as well as the required resources and the lack of awareness of good practices and of studies and guidance on the implementation of international requirements in this area. Existing national regulatory bodies frequently lack the mandates, resources and methodologies required to monitor and enforce accounting and auditing requirements.

7. The findings of Accounting Development Tool pilot tests carried out in 2012 and 2013 and discussions of the findings at ISAR sessions reflected that countries require further guidance on building efficient mechanisms for MCE. In some cases, MCE systems are non-existent or ineffective. Many developing countries also lack a qualification process for professional accountants and licensing mechanisms for audit professionals⁷ and face many other MCE-related challenges in building a solid infrastructure for high-quality reporting.

8. In response to these challenges, ISAR at its thirtieth session proposed to focus its deliberations during the thirty-first session on mechanisms for MCE.

9. The present note was prepared by UNCTAD to facilitate the discussions on this topic. It details the main components required for a strong MCE system for high-quality corporate reporting, highlights standards and guidance issued by international and regional bodies and provides illustrative examples of selected national requirements and practices. The note also addresses MCE-specific issues with regard to the implementation of accounting and audit standards and discusses mechanisms of compliance and enforcement of requirements for professional accountants. Finally, the main cross-cutting challenges faced by countries in their efforts to establish efficient mechanisms for MCE are outlined. Important evolving areas such as MCE of non-financial requirements and public sector reporting are not included in this note as further research is required.

⁵ Committee of European Securities Regulators, 2003, Standard no. 1: Enforcement of standards on financial information in Europe and 2004, Standard no. 2: Coordination of enforcement activities, available at http://www.esma.europa.eu/system/files/03_073.pdf and http://www.esma.europa.eu/system/files/03_317c.pdf (accessed 30 July 2014).

⁶ ESMA, 2014, Guidelines on enforcement of financial information, available at <http://www.esma.europa.eu/content/Final-Report-ESMA-Guidelines-enforcement-financial-information> (accessed 30 July 2014).

⁷ The International Auditing and Assurance Standards Board defines an audit professional as a professional accountant who has responsibility, or has been delegated responsibility, for significant judgements in an audit of historical financial information.

II. Definitions and main elements of the monitoring of compliance and enforcement

10. A sound national MCE system requires a clear understanding of the concept, objective and scope, taking into account interrelations with other aspects of the legal and institutional systems of the country. Such a system also requires the following: designing a set of MCE-related activities and methodologies for both the prevention and correction phases; allocating appropriate human, financial and technological resources; and establishing an adequate organizational structure that promotes a fair, transparent and efficient process, including coordination mechanisms with other areas of legislation and regulation and other authoritative bodies at national and international levels, as well as at the regional level if regional enforcement mechanisms exist, as for example in the European Union.

11. Compliance is understood as the adherence to laws, regulations and rules. Monitoring and supervision seek to discourage non-compliance, while enforcement is a disciplinary function that seeks to ensure that there are consequences to the violation of rules, involving a set of tools used to punish breaches of laws and regulations and to deter future violations. However, enforcement may also be understood in a broader manner, i.e. including compliance as part of the enforcement system. In each case it is critical, while designing and implementing an MCE system, to consider the interdependence of the legal framework, supervision and enforcement.⁸

12. The International Organization of Securities Commissions, in its objectives and principles of securities regulation, establishes that enforcement should be interpreted broadly enough to encompass powers of surveillance and inspection, as well as investigation, such that regulators should be expected to have the ability, the means and a variety of measures to detect, deter, enforce, sanction, redress and correct violations of securities laws.⁹ The principles do not prescribe any specific model to be followed since their implementation requires a consideration of the legal system in which a regulator operates.

13. The ESMA guidelines on the enforcement of financial information define such enforcement as examining the compliance of financial information with the relevant reporting framework, taking appropriate measures when infringements are discovered during the enforcement process in accordance with the rules applicable under the transparency directive and taking other measures relevant for the purpose of enforcement. Accounting enforcement has also been defined as the activities undertaken by independent bodies, such as monitoring, reviewing, educating and sanctioning, to promote the compliance of firms with accounting standards in their statutory financial statements.¹⁰

14. In the present note, the term MCE includes the complete cycle of such monitoring, from the selection of companies, audit firms or professional accountants to be reviewed to the execution of corrective measures and sanctions when required. Monitoring of compliance refers to the supervision and investigation conducted to verify compliance, and

⁸ A Carvajal and J Elliott, 2009, The challenge of enforcement in securities markets: Mission impossible?, International Monetary Fund Working Paper 09/168, available at <https://www.imf.org/external/pubs/ft/wp/2009/wp09168.pdf> (accessed 30 July 2014).

⁹ International Organization of Securities Commissions, 2013, Methodology for assessing implementation of the International Organization of Securities Commissions objectives and principles of securities regulation, Report no. FR08/11, available at <http://www.iosco.org/library/index.cfm?section=pubdocs&year=2011> (accessed 30 July 2014).

¹⁰ P Brown, J Preiato and A Tarca, 2014.

enforcement refers to the action of obliging adherence to the respective requirements and the implementation of sanctions when violations are found.

15. To ensure an efficient MCE system it is important to define the objective and scope of such a system. For example, the ESMA guidelines state that the objective of enforcement included in harmonized documents is to contribute to a consistent application of the relevant reporting framework and to the transparency of financial information relevant to the decision-making process of investors and other users. Such consistency and transparency are important for financial stability, in avoiding regulatory arbitrage, in increasing supervisory convergence in a region and in fostering investor confidence. In this regard, a clear division of responsibilities between major players within a reporting chain, such as enforcers, preparers and auditors, is critical. For example, one of the issues raised in the consultation process preceding the finalization of the ESMA guidelines was the importance of ensuring that an enforcer does not assume some standard-setter and audit functions while avoiding issuing interpretations of accounting standards.

16. Several other issues may arise in defining the scope of an MCE system, including who to subject to MCE-related actions and what kinds of information should be assessed. Consideration should also be given to which elements within a reporting chain should fall under the scope of an MCE system. For example, some sources consider the following attributes of institutional functions that promote the quality of financial reporting: rule of law; regulatory quality; control of corruption; government effectiveness; political stability; and voice and accountability.¹¹ Additional factors include manager incentives, auditor quality and incentives, regulation, enforcement, ownership structure and other institutional features of the economy.¹² The Federation of European Accountants identifies essential characteristics, such as the legal system, corporate governance, statutory audits, the institutional oversight system, courts and public and press sanctions.¹³ (Compliance with reporting standards depends on various factors, including internal controls and risk management. However, the particularities of this topic are beyond the scope of the present note.)

17. An MCE system should have a solid institutional basis and be carried out by competent administrative authorities, with clear responsibilities and comprehensive investigation and enforcement powers. The International Organization of Securities Commissions emphasizes in its methodology for assessing the implementation of its objectives and principles of securities regulation that in an effective and credible enforcement system, the regulator should be able to perform the following activities:

- (a) Detect suspected breaches of law in an effective and timely manner;
- (b) Gather the relevant information for its investigation;
- (c) Take action when a breach is identified;
- (d) Demonstrate that it has programmes in place and utilizes its resources to effectively exercise its activities;
- (e) Require a compliance system to be in place for regulated entities, which includes inspections and is aimed at preventing, detecting and correcting any violations.

¹¹ Ibid.

¹² RW Holthausen, 2009, Accounting standards, financial reporting outcomes and enforcement, *Journal of Accounting Research*, 47:447–458.

¹³ Federation of European Accountants, 2001, Enforcement mechanisms in Europe: A preliminary investigation of oversight systems, available at <http://www.iasplus.com/en/binary/resource/fee0104.pdf> (accessed 30 July 2014).

18. The Organization also states that it is not necessary for responsibility for all aspects of enforcement of securities regulations to be given to a single body. There are several effective models, including models in which responsibilities are shared with self-regulatory organizations, defined as organizations that exercise some direct oversight responsibility for their respective areas of competence.

19. An MCE system also includes a number of activities and methodologies, such as selection methods and examination procedures, which are addressed in more detail in chapter III.A. of the present note. In addition, an MCE system should include a set of enforcement actions such as corrective measures, incentives and sanctions. For example, with regard to securities regulations, the International Organization of Securities Commissions states that regulators must demonstrate that there are a variety of sanctions available, which are proportionate, dissuasive, effective and sufficient to cover the spectrum of securities violations, examples of which include the following: fines; disqualification; suspension and revocation of authority to do business; asset freezes; action against unlicensed persons in conducting securities transactions or referral of such activities to criminal authorities; and measures to enforce disclosure and financial reporting requirements for issuers.

20. To achieve an efficient MCE system, it is important to develop a set of indicators to assess the impact of implemented actions and to identify gaps and priorities for further improvement. Examples of metrics include the following: resources dedicated to an enforcement programme; level of fines imposed per year; number of cases filed per year; and number and types of investigations conducted per year. Several studies have been conducted to assess the efficiency of national MCE systems.¹⁴

21. The Accounting Development Tool includes several quantitative indicators that are directly related to the level of development of the MCE system in a given country.¹⁵ The indicators contain questions and checklists to ensure that key elements are present in a country's MCE system for high-quality corporate reporting, including the following: existence of MCE-related functions; need for independent, adequately funded and well-staffed institutions; selection criteria for inspections; methods for reporting findings; imposition of public sanctions; licence requirements for auditors; codes of ethics and committees of investigation, discipline and appeals for professional accountants; and coordination mechanisms for national institutions.¹⁶

22. Many factors and issues thus affect the quality of corporate reporting. However, such aspects as adherence to a statutory reporting framework and audit and professional requirements for accountants and auditors most directly impact the quality of reporting. Specific issues regarding MCE in these areas are discussed in more detail in chapter III of the present note.

¹⁴ Ibid. and P Brown, J Preiato and A Tarca, 2014.

¹⁵ UNCTAD, 2013, *Accounting Development Tool: Assessment questionnaire on a country's capacity for high-quality corporate reporting*, available at <http://adt.unctad.org/wp-content/uploads/2014/01/ADT-18-March2013-final.pdf> (accessed 30 July 2014).

¹⁶ UNCTAD, forthcoming, *Accounting Development Tool: Building accounting for development*, United Nations publication.

III. Monitoring of compliance and enforcement of corporate reporting requirements, auditing requirements and quality assurance and requirements for professional accountants

A. Monitoring of compliance and enforcement of accounting and corporate reporting requirements

23. As noted, accounting enforcement refers to the functions performed by independent regulators to ensure the compliance of a company's financial information with accounting standards and the relevant reporting framework required by a country.

24. Mechanisms for MCE in most countries are focused on listed companies and public interest entities due to their role in the economy. However, some enforcers, such as in Denmark, Switzerland and the United Kingdom of Great Britain and Northern Ireland, are also responsible for certain non-listed companies.¹⁷

25. The enforcer, i.e. the competent authority conducting enforcement activities, varies depending on the institutional arrangements in a country. The majority of countries have one institution in charge of conducting such activities, i.e. a one-tier system. In many countries, the securities and exchange commission or the superintendencies of companies, banking and/or the insurance sector represent the authority in charge of conducting such activities. Other countries, such as Austria and Germany, have a two-tier system in which two separate institutions participate in the related activities at different stages. The two-tier system in Germany is described in box 1.

Box 1. Two-tier enforcement system for companies in Germany

Procedures at the first level are conducted by the Financial Reporting Enforcement Panel.¹⁸ An examination of individual and consolidated annual financial statements is initiated if there are concrete indications of an infringement, if a request is received from the Federal Financial Supervisory Authority¹⁹ or based on random sampling. The Authority publishes a list of the companies subject to enforcement.

If a company does not cooperate with the examination or does not agree with the findings or there are substantial doubts as to whether the examination was properly conducted, the Authority enters at the second level and can take supervisory measures.

Whenever erroneous accounting is established by the Panel or the Authority, the latter requires firms to disclose these findings in a dedicated press release, aired via the electronic platform of the federal registry and, in addition, published in at least three daily financial newspapers or through an electronic information provider. The Authority requires firms to refrain from comments or additions. The publication of an error finding mechanically triggers an investigation of the auditor by the auditing oversight authorities.

¹⁷ A Berger, 2010, The development and status of enforcement in the European Union, *Accounting in Europe*, 7:15–35.

¹⁸ Financial Reporting Enforcement Panel, 2014, Examination process, available at http://www.frep.info/pruefverfahren/ablauf_eines_pruefverfahrens_en.php (accessed 30 July 2014).

¹⁹ Federal Financial Supervisory Authority, Financial reporting enforcement, available at http://www.bafin.de/EN/Supervision/StockExchangesMarkets/FinancialReportingEnforcement/financialreportingenforcement_node.html (accessed 30 July 2014).

26. As noted, an essential element of an enforcement system is the methodology for selecting the companies to be reviewed. For example, according to the ESMA guidelines, enforcers select companies to inspect based on a combination of a risk-based approach and either random sampling or rotation or both. Risk determination is based on a combination of the probability of infringements and the possible impact of a potentially significant infringement on financial markets. Characteristics such as the complexity of financial statements, risk profile of the issuer and experience of management and auditors are also considered. Other aspects that may be considered in developing selection criteria include risks related to a specific sector, the relevance of the financial information to other issuers, common findings from previous examinations, complaints received, referrals by other regulatory bodies and issues raised in the press.

27. Another important decision to be made is the nature of the examination procedure to be chosen. For example, guideline six of the ESMA states that enforcers can either use unlimited scope examination or a combination of unlimited scope and focused examinations of the financial information of issuers selected for enforcement. According to the ESMA guidelines, an unlimited scope examination of financial information (previously called a full review) is the evaluation of the entire content of financial information to identify issues or areas that need further analysis and to assess whether the financial information complies with the relevant financial reporting framework. A focused examination (previously called a partial review) is the evaluation of pre-defined issues in financial information and the assessment of whether the financial information is compliant with the relevant financial reporting framework with respect to those issues. The sole use of focused examination is not considered satisfactory. The guidelines provide examples of examination procedures, including the following:

- (a) Reviewing annual and interim consolidated financial reports
- (b) Asking questions of the issuer concerning areas with significant risks and accounting issues
- (c) Asking questions of auditors
- (d) Referring matters to the bodies responsible for the audit and/or approval of financial information
- (e) Identifying sectorial accounting issues
- (f) Engaging external experts
- (g) Engaging in on-site inspections.

28. The ESMA guidelines recommend documenting the examination techniques used and the conclusions of a review. After a review, identified potential infringements are discussed with the issuer. If the accounting treatment is not acceptable and a material misstatement²⁰ is detected, there are a range of actions available, depending on the jurisdiction, including requiring the issuance of revised financial statements or public corrective notes or other public announcements and the addition of corrections to future financial statements. If the departure from the financial reporting framework is immaterial, the enforcer sends a notification to the issuer and, usually, this is not made public.

29. There are also different requirements with regard to the frequency of reviews. Berger (2010) notes the frequency of examination in some European countries as follows:

²⁰ Materiality should be assessed according to the relevant reporting framework used for the preparation of the financial information.

- (a) Denmark – 20 per cent of the companies each year. Due to use of the risk-based approach, companies may be selected several times within a five-year period;
- (b) France – the 140 largest companies every three years and the rest every five years;
- (c) Netherlands – in addition to risk-based selection, the goal is to examine each equity-issuer every five years and each debt-issuer every seven years;
- (d) Spain – Equity-issuers are examined approximately every two years and debt-issuers approximately every six years;
- (e) Switzerland – in addition to risk-based selection, the goal is to examine each company every six years.

30. The Financial Reporting Enforcement Panel in Germany requires an examination every four to five years of all companies included in a stock index and every 8 to 10 years of all other companies. In 2013, the Panel completed a total of 110 examinations.²¹ Hitz et al. (2012), in a study on the enforcement of accounting standards in Germany, highlighted that risk-based selections made up 15 to 20 per cent of investigations and random sampling accounted for 80 to 85 per cent of investigations.²²

B. Monitoring of compliance and enforcement of auditing requirements and quality assurance

31. With regard to audit activities, there is a global trend to use the term oversight to refer to the MCE-related activities of auditors and audit firms, particularly with respect to listed companies and public interest entities.

32. Many audit oversight bodies have emerged in the last decade, especially in developed countries. Albrecht et al. (2012) noted that mature economies that had established an audit profession oversight body had an advanced auditing profession and a well-developed business regulatory environment.²³ Their study suggested a significant positive relationship between the use of oversight bodies and licensing requirements and a lower perception of corruption.

33. The scope of audit oversight varies across jurisdictions. In many countries oversight is mainly directed to audit firms in charge of reviewing listed companies, while other countries broaden the focus to include public interest entities. There are also variances with regard to whether oversight is conducted only of audit firms or also includes auditors. On the one hand, including individuals adds costs and complexity to the system, while on the other hand there is the advantage of having the direct ability to sanction individuals and prevent those that have been sanctioned while at one audit firm to move to another and continue to undertake audits.

34. At the international level, the International Forum of Independent Audit Regulators has established a set of core principles for independent audit regulators related to oversight

²¹ Financial Reporting Enforcement Panel, 2014, Annual activity report 2013, available at http://www.frep.info/docs/jahresberichte/2013/2013_tb_en.pdf (accessed 30 July 2014).

²² J-M Hitz, J Ernstberger and M Stich, 2012, Enforcement of accounting standards in Europe: Capital market-based evidence for the two-tier mechanism in Germany, *European Accounting Review*, 21:253–281.

²³ C Albrecht, R Malagueno, D Holland and M Sanders, 2012, A cross-country perspective on professional oversight, education standards and countries' perceived level of corruption, *Cross Cultural Management: An International Journal*, 19:433–454.

of audit firms and auditors of public interest entities, including listed companies.²⁴ The principles state that a system of audit oversight can only be effective when certain preconditions exist, including high-quality accounting and auditing standards, legal requirements for the preparation and publication of financial statements, an enforcement system for preparers of financial statements, corporate governance arrangements and effective educational and training arrangements for accountants and auditors.

35. Effective oversight of those performing audit services is critical to the reliability and integrity of the financial reporting process. A sound oversight system of public companies generally includes the following:

- (a) Requiring auditors to have adequate qualifications and professional competency before being licensed to perform audits;
- (b) Withdrawing authorization to perform audits if the requirement in (a) is not maintained;
- (c) Requiring auditor independence;
- (d) Having an independent oversight body for auditors or a professional body acting as the oversight body but overseen by a higher authority.

36. Independent audit regulators are normally in charge of the following:

- (a) Conducting regular reviews of audit procedures and practices of firms that audit public issuers;
- (b) Addressing other matters such as professional competency, rotation of audit personnel, employment of audit personnel by audit clients and consulting and other non-audit services;
- (c) Disciplinary activities.

37. Oversight bodies vary across countries. In some cases there is a separate panel in charge of such activities while in others regulators conduct such activities themselves, and still others have professional accountancy organizations regulating audits for some public interest entities or non-public interest entities, with oversight from an independent audit regulator. For example, in the United States of America, the Sarbanes-Oxley Act that came into force in 2002 initiated a new era of audit activities by ending over a century of self-regulation and establishing independent oversight of public company audits by the Public Company Accounting Oversight Board.²⁵ The Act introduced several changes concerning audit committees, strengthened auditor independence, required mandatory rotation of the lead engagement partner every five years and established certain types of non-audit services as off-limits to audit firms that provide auditing services to a public company. Further details are provided in box 2. Many other countries have since followed the United States initiative and created independent oversight institutions.

²⁴ Available at <http://www.ifiar.org/IFIAR/media/Documents/General/Final-Core-Principles.pdf> (accessed 30 July 2014).

²⁵ Ernst and Young, 2012, *The Sarbanes-Oxley Act at 10: Enhancing the reliability of financial reporting and audit quality*, available at [http://www.ey.com/Publication/vwLUAssets/The_Sarbanes-Oxley_Act_at_10__Enhancing_the_reliability_of_financial_reporting_and_audit_quality/\\$FILE/JJ0003.pdf](http://www.ey.com/Publication/vwLUAssets/The_Sarbanes-Oxley_Act_at_10__Enhancing_the_reliability_of_financial_reporting_and_audit_quality/$FILE/JJ0003.pdf) (accessed 30 July 2014).

Box 2. The United States Public Company Accounting Oversight Board

Auditors of public companies, whether located in the United States or abroad, must be registered with and inspected by the Public Company Accounting Oversight Board. In some jurisdictions, the Board requires a cooperative agreement to conduct inspections.

The Securities and Exchange Commission is responsible for appointing and removing Board members and for approving the Board's annual budget and accounting support fee. Adverse inspection reports of the Board, remediation determinations and disciplinary actions against registered firms and their associated persons are subject to review by the Commission.

The Board establishes auditing and related professional practice standards for registered public accounting firms and before adopting new standards or making amendments to existing standards publishes them for comment. All Board standards must be approved by the Commission before they become effective.

Registered firms that issue audit reports for more than 100 public companies and other issuers are required to be inspected annually. Registered firms that issue audit reports for 100 or fewer issuers are inspected at least once every three years. At any time, the Board may also inspect any other registered firm. The review of a firm's work typically focuses on engagements and areas of those engagements presenting more significant risks of financial reporting misstatements and related auditing challenges and audit deficiencies.

The Board prepares a report of each inspection and makes portions of each report publicly available, subject to statutory restrictions on public disclosure. If an inspection report includes criticisms of or identifies potential defects in a firm's system of quality control, the Board is prohibited from publicly disclosing the criticisms if the firm addresses them to the Board's satisfaction within 12 months of the issuance of the report. Otherwise, they are made public.

At the end of 2012, there were 2,363 firms registered with the Board, including 1,452 domestic firms and 911 non-United States firms, located in 87 jurisdictions.²⁶ In 2012, the Board had a total of 766 employees.

38. Deloitte (2013), which includes data from Australia, Canada, Singapore, the United Kingdom, the United States and the European Union, states that regulatory oversight in these key jurisdictions includes registration, inspection, investigation, enforcement, standard setting and continuing professional education activities.²⁷ In general, the recurring inspections process comprises the following:

- (a) Selection of the audit firm to be inspected. Many countries use a risk-based approach to select the firms to be inspected. The review frequency varies, but in the United Kingdom, the largest four audit firms are subject to inspection on an annual basis, while the other major firms that audit public interest entities are reviewed on an extended cycle.
- (b) Appointment of an inspection team with appropriate expertise and competence in auditing and financial reporting and training in regulatory quality

²⁶ Public Company Accounting Oversight Board, 2013, 2012 Annual Report, available at <http://pcaobus.org/About/Ops/Pages/default.aspx> (accessed 30 July 2014).

²⁷ Deloitte, 2013, Report on independent audit oversight, available at http://www.frc.org.hk/pdf_20131010/Full%20Report.pdf (accessed 30 July 2014).

assurance reviews. Deloitte (2013) notes that in the European Union, the selection of reviewers follows a procedure that ensures that there are no conflicts of interest between reviewers and the statutory auditor or audit firm under review. The scope of a quality assurance review, supported by adequate testing of selected audit files, includes an assessment of compliance with applicable auditing standards and independence requirements, the quantity and quality of resources spent, audit fees charged and the internal quality control system of the audit firm.

(c) Notification to the audit firm, an advance documentation request, notification of the selection of audit engagements for review, meetings with management and on-site inspection arrangements. The inspection process is subject to internal quality control within the audit regulator.

39. Oversight bodies should have timely and effective mechanisms for obtaining and processing relevant information and enforcement powers to ensure that their recommendations or findings are addressed, including the ability to impose a range of sanctions that include fines and the removal of an audit licence and/or registration. The actions of oversight bodies should be subject to scrutiny and review, including appeal to a higher authority.

40. Principle 11 of the International Forum of Independent Audit Regulators states that the reporting procedures of audit regulators should include a draft inspection report, a process for the audit firm to respond and a final inspection report. In the European Union, a report containing the main conclusions of a quality assurance review is published annually by member States, along with an annual work programme and activity reports. These are of the system as a whole, not necessarily at an individual firm or audit level. Recommendations in quality reviews must be followed up by auditors within a reasonable period, otherwise auditors are subject to disciplinary actions or penalties and sanctions, including fines, suspensions, the withdrawal of licences, certifications or registrations and requirements to undertake training. In the European Union, countries are obliged to make public the disciplinary sanctions imposed on statutory auditors and audit firms. Countries have different resources for appeal; some countries have an appeals committee, while in others an appeal must be addressed to a court.

41. With regard to the regulation of overseas auditors, different approaches are followed by different regulators. For example, the United States Public Company Accounting Oversight Board applies the same regime to overseas auditors of Securities and Exchange Commission registrants and domestic registrants. The European Union, on the other hand, has an equivalent audit regime, by which it grants certain countries approval to conduct their own audit oversight functions after having evaluated their enforcement systems.

42. In Germany, auditors and audit firms who perform statutory audits of public interest entities are subject to inspections by the Auditor Oversight Commission. Commission inspectors must be qualified as auditors and have several years of experience with audits of large corporations whose accounts are prepared in accordance with national and international accounting standards.²⁸ Audit firms of public interest entities who have undertaken more than 25 relevant audit engagements in the previous year are subject to annual inspections. Firms with fewer relevant audit engagements are reviewed at least every three years. However, audit firms are also selected on a risk basis.

²⁸ Auditor Oversight Commission, 2014, *Inspections: Competence, inspection teams*, available at <http://www.apak-aoc.de/english/inspections/inspections.asp> (accessed 30 July 2014).

43. In Singapore, the four largest firms are inspected once every two years.²⁹ The remaining public interest firms are typically inspected once every three years. Inspections of non-public interest firms are carried out with the assistance of the Institute of Singapore Chartered Accountants, with oversight by the Accounting and Corporate Regulatory Authority. The majority of Singapore's public accountants are in the non-public interest segment and most of them conduct their operations as sole proprietorships and audit mostly small and medium-sized enterprises.

44. The Canadian Public Accountability Board is responsible for the regulation of accounting firms that audit Canadian public companies. Each year, the Board inspects all firms that audit more than 100 reporting issuers.³⁰ The remaining firms are subject to inspection either once every two years or once every three years, depending on their number of reporting issuer clients.

C. Monitoring of compliance and enforcement of requirements for professional accountants

45. A series of changes in the regulation of professional accountants has taken place in many countries. Different institutional arrangements currently exist, including self-regulation by the profession through professional accountancy organizations, self-regulation with public oversight from an independent agency of the Government and external regulation, in which the profession is regulated by the Government through a government or independent agency. The latter has become more common in particular for professional auditors. For example, the Accounting and Corporate Regulatory Authority is the national regulator of business entities and public accountants in Singapore. Its Public Accountants Oversight Committee registers public accountants, determines standards and other professional requirements and manages, among others, a practice monitoring programme and complaint and disciplinary procedures.

46. In 2011, the International Federation of Accountants issued a position statement related to the accountancy profession, including professional accountants and auditors.³¹ The Federation stressed the role of professional accountancy organizations in providing assurance of the quality of services conducted by its membership. Such organizations need to promote high-quality professional practices and oversee the activities of their members even when external regulation of the profession is performed by a government agency.

47. The Federation also established, in 2012, seven Statements of Membership Obligations that contain a framework for credible and high-quality professional accountancy organizations by supporting the adoption and implementation of international standards and maintaining adequate enforcement mechanisms. The Federation set up a member body compliance programme, which is overseen by the Compliance Advisory Panel. Federation members and associates provide self-assessment information about the regulatory and standard-setting frameworks in their countries and the activities of their

²⁹ Accounting and Corporate Regulatory Authority, 2013, Practice monitoring programme – seventh public report, available at http://www.acra.gov.sg/Publications/Reports/Practice_Monitoring_Programme_Public_Reports/ (accessed 30 July 2014).

³⁰ Canadian Public Accountability Board, 2013, Thinking differently about audit quality: 2013 annual report, available at <http://www.cpab-ccrc.ca/en/topics/Reports/Pages/default.aspx> (accessed 30 July 2014).

³¹ International Federation of Accountants, 2011, Regulation of the accountancy profession, Policy position paper no. 1, available at <http://www.ifac.org/publications-resources/regulation-accountancy-profession-1> (accessed 30 July 2014).

organizations in addressing the requirements in the Statements. Based on this information, they develop action plans for improvement. For example, the Institute of Certified Public Accountants of China notes in its action plan that in 2009 it established the China Ethics Standards Board for certified public accountants, which approved a new code of ethics in convergence with the code of ethics of the International Ethics Standards Board for Accountants established by the International Federation of Accountants. In order to promote implementation of the ethics code, the action plan notes that the Institute of Certified Public Accountants of China will conduct quality assurance reviews and that the Institute's Professional Standards and Technical Guidance Department will provide guidelines and explanatory materials.

48. According to the International Federation of Accountants, the areas of the accountancy profession that require regulation are as follows:

(a) Entry requirements and certification, qualification and licensing. International education standards, as detailed in the *Handbook of International Education Pronouncements of the International Federation of Accountants*, describe the minimum requirements in terms of education and training. Continuing professional development is necessary to ensure that individuals maintain a certain level of quality.

(b) Monitoring of the behaviour and performance of professional accountants. In practice, auditors are the main group subject to scrutiny and constant monitoring by a government or oversight body. If there is a complaint concerning the behaviour of a professional accountant, professional accountancy organizations rely on their investigation and discipline committees. The International Ethics Standards Board for Accountants issues internationally recognized ethics standards for professional accountants, including auditor independence requirements. For example, the Institute of Chartered Accountants of South Africa has an ethics committee in charge of conducting an ongoing review of the code of professional conduct to ensure its relevance to current practice and of considering matters relating to professional conduct or ethics referred to it.

(c) Discipline and sanction mechanisms, for performing investigations and imposing sanctions depending on the gravity of an offence, including the power to withdraw certifications or licences in the event of misconduct. In many countries, the lack of legal support for professional accountancy organizations does not allow them to impose such sanctions. For example, the Association of Accountants in Chile cannot impose its standards or oblige all professionals to follow them, including the code of ethics and sanctions system.³² The International Federation of Accountants conducts a series of activities to strengthen professional accountancy organizations through its Professional Accountancy Organization Development Committee. In 2013, the Federation published a report highlighting discipline, investigation and quality assurance as areas that require further development, especially in developing countries.³³

³² UNCTAD, 2013, *International Accounting and Reporting Issues 2013 Review* (New York and Geneva, Sales no. E.14.II.D.3, United Nations publication), available at http://unctad.org/en/PublicationsLibrary/diaeed2013d4_en.pdf.

³³ Professional Accountancy Organization, 2013, *Professional Accountancy Organization Global Development Report – Mosaic: Memorandum of Understanding to Strengthen Accountancy and Improve Collaboration*, available at <https://www.ifac.org/publications-resources/professional-accountancy-organization-global-development-report> (accessed 30 July 2014).

49. The efficiency of activities undertaken by professional accountancy organizations is critical. In this regard, the Accounting Development Tool contains indicators and related questions to assess the level of professional accountancy organization development, including enquiries regarding the following: existence of a professional accountancy organization in the country and membership in the International Federation of Accountants; coordination mechanisms; the ability of professional accountancy organizations to comply with the Statements of Membership Obligations, including the sufficiency of human and financial resources; existence of a code of ethics and whether this code is updated; and investigations, discipline and appeals, including the independence of committee members.

IV. Main cross-cutting challenges in the implementation of standards and good practices

50. In addition to the issues and challenges already noted, there are other cross-cutting issues that need to be considered in building a strong MCE system, which are detailed in this chapter.

A. Independence

51. Independence allows regulators and supervisory entities to conduct their activities in an objective and fair manner. For example, the ESMA guidelines state that enforcers should have adequate independence from Government, issuers and auditors, other market participants and regulated market operators. The balance between independence and accountability, including a mechanism for appeals, needs to be considered.

52. The core principles of the International Forum of Independent Audit Regulators define independence as the ability to undertake regulatory activity and make and enforce decisions without external interference by those regulated. Principle five notes that audit regulators should have arrangements in place to ensure that inspectors are independent of the profession. In this regard, for example, the European Commission states that a system of public oversight should be governed by non-practitioners who are knowledgeable in areas relevant to statutory audits.

53. Principle two of the International Organization of Securities Commissions states that regulators should be operationally independent and accountable in the exercise of their functions and powers.

B. Funding

54. The International Organization of Securities Commissions states that regulators should have a stable source of funding, which will enhance their independence. The Australian Securities and Investments Commission, for example, is funded by the federal Government and the amount varies according to government policy priorities and budgetary constraints.

55. The International Forum of Independent Audit Regulators emphasizes the need for audit regulators to have a stable source of funding that is secure and free from influence by auditors and audit firms and sufficient to execute their powers and responsibilities.

56. Deloitte (2013) notes that existing funding models include a levy on listed companies and/or professional bodies and/or directly on audit firms. For example, the United States Public Company Accounting Oversight Board is funded primarily through annual fees assessed on public companies in proportion to their market capitalization and

on brokers and dealers based on their net capital in and outside of the United States. In addition, the Board collects a registration fee and an annual fee from each registered public accounting firm. In Germany, the Financial Reporting Enforcement Panel is financed by levies on listed firms. The Panel has a staff of 16 full-time members, the majority of whom have a senior accounting and/or auditing background.

57. Jackson and Roe (2009), using a resource-based concept of public enforcement efficacy that measured the level of public resources that a country allocated to its financial regulators, scaled to either the economic size or population of the country, observed that higher budgets and greater staffing allowed regulators to perform their duties efficiently.³⁴

C. Balance between transparency and confidentiality

58. Regulators need to observe confidentiality when handling a case and reviewing information. However, their procedures and resolutions need to be transparent and in many cases this means that information must be made public.

59. In this regard, principle four of the International Forum of Independent Audit Regulators states that audit regulators should have public accountability in the use of their powers and resources to ensure that they maintain their integrity and credibility. In addition, transparency should include the publication of annual work plans and activity reports, including the outcome of inspections, either in the aggregate or on an individual basis.

60. ESMA emphasizes that enforcers should periodically provide information to the public on their enforcement activities and coordination.

D. Staff competency

61. Understaffing and/or a lack of competent staff affect the ability of an enforcer to undertake its duties in an efficient manner. This includes the lack of appropriate technology and the skills to use such technology. Continuous training is required to maintain professional capacities at the highest level of quality. In this regard, guideline two of ESMA states that enforcers should have sufficient human and financial resources and that human resources should be professionally skilled, experienced and sufficient in number. With regard to audit enforcement, staff carrying out reviews of the quality assurance systems of audit firms should have appropriate professional training, relevant experience in auditing and financial reporting and training in regulatory quality assurance reviews. Investigators should have analytical skills and knowledge of the industry and markets, and prosecutors should have a full set of legal and litigation skills and an understanding of financial markets.³⁵ Regulators in general, however, are not only understaffed but also not able to hire personnel with expertise comparable to that of regulated entities.

62. It is also important that enforcers establish professional standards and sanctions to be followed by their staff. The International Forum of Independent Audit Regulators states that audit regulators should have prohibitions in place against conflicts of interest by its governing body and staff and to ensure that confidential information is protected.

³⁴ HE Jackson and MJ Roe, 2009, Public and private enforcement of securities laws: Resource-based evidence, *Journal of Financial Economics*, 93:207–238, available at <http://www.sciencedirect.com/science/article/pii/S0304405X09000786> (accessed 30 July 2014).

³⁵ A Carvajal and J Elliott, 2009.

E. Cooperation and coordination

63. Cooperation and coordination are critical to ensure consistent regulatory requirements for substantially the same type of conduct and product generally and coherent regulation in different sectors. It is also important to have coordination in terms of sharing information or creating a joint registry of auditors and audit firms and in collaborations between domestic authorities and their foreign counterparts, taking into consideration confidentiality issues. Results from the pilot tests of the Accounting Development Tool show that many countries lack coordination among the main stakeholders involved in the corporate reporting chain.

64. In one example with regard to cooperation and regional integration, in 2011, the Accounting and Corporate Regulatory Authority of Singapore, with the independent audit regulators of Malaysia and Thailand, formed an informal cooperation group known as the Association of Southeast Asian Nations Audit Regulators Group, which holds periodic meetings with the four largest regional firms to discuss audit quality matters.³⁶

65. Principle seven of the International Forum of Independent Audit Regulators states that audit regulators should make appropriate arrangements for cooperation with other audit regulators and, where relevant, other third parties. The Forum conducts cooperation efforts and has published a report summarizing the results of a global survey on the inspection of audit firms.³⁷ The European Group of Auditors' Oversight Bodies issued a guidance paper in 2009 establishing a common approach for cooperation within the European Union between the competent authorities of member States with respect to audit firms and auditor oversight, whereby each member State designates a single competent authority as a contact point for the sharing of any information.³⁸

66. The principles of the International Organization of Securities Commissions address measures concerning the sharing of information and the types of assistance between a regulator and its counterpart. For example, in the European Union, ESMA established the European Enforcers Coordination Sessions, a forum of 37 enforcers from European Union member States and two countries in the European Economic Area. The forum constitutes the largest network of enforcers with supervision responsibilities in International Financial Reporting Standards globally. Through the forum, European enforcers share and compare their practical experiences. In 2005, ESMA established an internal database as a platform for sharing information on a continuous basis.

VI. Conclusion

67. To ensure the proper implementation of international standards and codes, countries need to monitor the compliance and enforcement of requirements for companies, audit firms and professional accountants. Enforcers require clear responsibilities and adequate powers and mechanisms to investigate, detect deviations and, when necessary, impose enforcement actions and sanctions. They also require sufficient and competent human and financial resources. In addition, they should be independent while remaining accountable

³⁶ Accounting and Corporate Regulatory Authority, 2013.

³⁷ International Forum of Independent Audit Regulators, 2014, Report on 2013 survey of inspection findings, available at <https://www.ifiar.org/IFIAR-Global-Survey-of-Inspection-Findings.aspx> (accessed 30 July 2014).

³⁸ European Group of Auditors' Oversight Bodies, 2009, Guidance paper on the cooperation between competent authorities within the European Union, available at http://ec.europa.eu/internal_market/auditing/egaob/index_en.htm (accessed 30 July 2014).

and maintaining confidentiality standards. Furthermore, coordination among key stakeholders at national levels and collaboration with other enforcers at the international level are indispensable. Additional research to analyse the strengths and weaknesses of the enforcement systems in individual jurisdictions is important for the design of future MCE-related measures. Technical assistance and capacity-building activities to strengthen legal and institutional frameworks in developing countries is also important.

68. Delegates at the thirty-first session of ISAR may wish to consider the issues outlined in the present note, as well as the following questions:

- (a) What are the key components of an efficient MCE system?
- (b) What are the good practices, main challenges and lessons learned in building an efficient MCE system?
- (c) What are the major international requirements in this area and how might their implementation be facilitated?
- (d) What is the role of international bodies in promoting convergence in the implementation of international requirements and ensuring convergence among MCE systems in different countries?
- (e) What are the essential elements that need to be considered when building MCE systems in other areas such as the public sector, small and medium-sized enterprises and non-financial reporting?
- (f) How might the efficiency of MCE systems be measured? How might the Accounting Development Tool promote and facilitate the assessment of progress and the sharing of best practices and guidance in relation to mechanisms for MCE?

Annex

1. The following spider graph presents the UNCTAD-ISAR Accounting Development Tool scores for three sample countries for 24 quantitative indicators.
2. Indicators A-4, A-5, A-7, A-8, B-4, B-5, B-6, B-7 and B-8 are directly linked to MCE systems.

