

**DAVID DEVLIN'S REMARKS TO FEE CONFERENCE
"CONTRIBUTION OF FINANCIAL REPORTING TO FINANCIAL STABILITY
AND TRANSPARENCY"**

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INTRODUCTION

I would like to spend a few minutes explaining the rationale behind the Conference theme of "the Contribution of Financial Reporting to Financial Stability and Transparency".

Under this theme we aim to pull together the various strands of our profession's main role – objective reporting – and set them in a context – financial stability and transparency – which reminds all of us why the quality of our work matters.

Although much remains to be done to implement and refine the legislation, regulation and standard setting of the last few years, I believe that we need to raise our sights a bit and look beyond the difficult work of implementing recent reforms.

I say this because we need to make sure that continuing reform and the structures around it are correctly designed and working in the right direction. I don't think we should take it for granted that such is the case.

First a few questions or issues for you to consider:

- Are the needs of investors and others for information about companies and enterprises really so well defined?

- Are there effective forums for continuous dialogue between the various stakeholders? I have in mind preparers, regulators, investors and other users, standard setters and auditors. Do these structures provide sufficient alignment and support for sound and widely accepted conclusions?

- We can at least see the shape of globally consistent standards for reporting and auditing even if we are not yet “there”, so to speak, but there are still questions to be asked about the due process in place to safeguard stakeholder interests during the development of those standards, their nature and how they are enforced.
- Many of the recent reforms grew out of large collusive, management directed frauds in business and since it is unlikely that we have seen the last of them for ever, I think we need a fresh look in everybody’s interest at how to narrow the expectation gap around fraud.
- Is our profession vibrant and sustainable? Is there sufficient choice for the audit of the largest and most complex enterprises? How do smaller firms of auditors cope with the rapidly increasing complexity of standards and regulation and how do mid-tier firms create the critical mass in an increasingly litigious environment that is needed to break into the top end of the audit market?
- Finally, we are still working on the audit of historical financial statements – itself indeed a challenge at times - but people increasingly rely on the internet for information. Investors and others are already able to access up to date financial data about companies, but is it reliable and is there a role for auditors?

The fact that it is possible to pose such questions tells me that even if there are not immediate easy answers to all of them, they are well worth debating and we should press forward as a profession with such a debate.

Let me pick three examples:

First, consider financial reporting standards. The EU initiative of some years ago to adopt IFRS has been copied now by nearly 100 countries, which have undertaken to adopt international financial reporting standards. On its own this goes a good way to establishing global standards for reporting. The convergence project between the IASB and the US Financial Accounting Standards Board is very promising and merits strong support. In FEE we have always supported global standards.

That said, we have also been careful to emphasise that the standards should be principle-based. This is because we want to keep the size of the standards

reasonable, to foster the use of professional judgment and to avoid the otherwise inevitable growth of ever more specific and prescriptive standards, which would inevitably risk making preparation of financial statements an overly mechanical exercise. We also strongly support the IASB's intention to prepare a simplified standard for use by smaller entities.

To its credit the IASB has extremely elaborate and transparent due process arrangements in place. Nevertheless, there is some concern as to whether issues raised during this process are actually addressed and about the direction in which the standards will go. As an example, how far should the use of fair value go in financial reporting? This is an absolutely fundamental point and some have seen in it a contrast between relevance and reliability, or stewardship if you like. As you can see from the Conference programme, Vice President Hans van Damme, will moderate a panel on the subject of fair value reporting, around the theme of whether there is a conflict between transparency and stability.

Principle-based standards, whether they are for financial reporting or auditing, emphasise the crucial role of reasonable judgment in providing high quality solutions. Therefore principle-based standards inherently admit that there might indeed be more than one legitimate answer, more than one way of respecting a principle, while staying within the parameters of reasonable professional judgment. This needs to be clearly recognised by those responsible for enforcement, whether of financial reporting or auditing judgments; it is crucial for success.

My second example of the need for debate on the future direction of events is auditing, even though on 12 October we had a major conference on the theme of audit regulation.

Much of what I said about establishing globally consistent standards for reporting also applies to auditing. The International Audit and Assurance Standards Board (IAASB) has a major project underway to restructure, clarify and complete its suite of audit standards. Indeed this programme is expected to result in about twenty six new exposure drafts over the next year or so. The US audit standard setter, the Public Company Accounting Oversight Board, is an observer in the work of the IAASB. IAASB standards aim to be principle-based and to avoid what some have considered to be PCAOB's tendency to be rather overly prescriptive in its standards. Certainly the PCAOB's AS2 standard on internal controls has been criticised for being overly

prescriptive at some 300 pages, though much of the criticism is misinformed in my opinion. If there is an underlying aim to have broadly consistent audit standards from both the IAASB and PCAOB, which approach will predominate? An explicit drive towards convergence would in time force resolution on the point. Without the adoption of globally agreed and consistently applied audit standards, however, consistent audit quality is that much harder to achieve.

A critical point for global acceptance of IAASB standards is the EU plan to adopt them under the terms of the Statutory Audit Directive, though the means of recognition and the timing remain open at the moment.

It is important that auditing standards remain principle-based and really do give highly trained auditors the opportunity to exercise their professional judgment, without turning their work into primarily a box ticking, file building exercise which, whatever the intention, will have the inevitable effect of focusing on the clerical rather than the substantive when conducting audits.

This brings me to the question of enforcement through external quality assurance or inspection of auditors under public oversight. If external quality assurance is focused to an excessive degree on whether the audit files are perfect, rather than on the more substantive point of whether the audit effort is well planned and directed and carefully executed, I believe that the quality of audit will suffer and that the role of auditors and their staff will be devalued. By contrast an approach which, while lacking nothing in rigour, emphasises the scope for continuous improvement and raising of standards in areas of relative weakness has every prospect of reinforcing the high quality of audit work and the retention of outstanding people in our profession.

The oversight of auditors is an immensely complex task in a rapidly globalising world. Both the Sarbanes-Oxley Act and the Statutory Audit Directive provide for some extraterritorial inspection of audit work. There is no doubt that multiple regulatory and enforcement regimes increase complexity, raise the cost of performing audits and may even inadvertently undermine the equivalence of audits performed in different countries. That is why it is important to take care with the structures for auditor oversight, to ensure that they are strongly based on the home country principle, that there are not gaps in important markets in the oversight and quality assurance regime and that the regulators involved equip themselves with the means of ensuring equivalence in their work. After all we do want globally consistent high

quality audits, do we not, in all parts of the audit market? It is not just large companies whose audited financial statements are used globally but increasingly those of smaller companies, whose markets and suppliers are often found far afield these days.

Oversight bodies self evidently need to cooperate closely and build confidence in each others' work. In Europe, FEE has welcomed the formation of the European Commission's committee on oversight, the EGAOB (European Group of Auditor Oversight Bodies). However, we believe that there are good reasons to continue to press for establishment of a legal entity dedicated to effective coordination of auditor oversight. At global level, the International Forum of Independent Audit Regulators (IFIAR) has recently been formed. It aims to foster sharing practical experience in auditor oversight, to help reduce inefficiencies and costs and to promote best practice in the audit oversight function and it will discuss related issues. How these oversight structures undertake their work will affect many parties and will have a fundamental effect on all auditors in our profession. It needs public debate therefore. We trust that oversight bodies will listen carefully to the profession's views and involve us appropriately to ensure that we continue to have a vibrant and sustainable audit profession.

I should mention two other factors which can affect the sustainability of auditing and issues of competition, market access and choice. These are auditor independence and liability exposures.

Over the last several years I have repeatedly pointed out that public confidence in our profession depends on whether we are believed to be objective and that means demonstrating our independence. We are perhaps unique as a profession in having a global ethics code, which is to our credit, but as part of the reforms of recent years, independence rules have also been imposed increasingly by regulation and legislation. The Statutory Audit Directive is an example. The SEC codified what had been a very complex set of rules and precedents in 2000 and further revised its independence rules for auditors in the wake of the Sarbanes-Oxley Act. The PCAOB has also issued some rules on independence. In Europe many governments adopted legislation on auditor independence which is extremely restrictive. More alarmingly, and France is a clear example, some national independence rules were drafted so as to have an extraterritorial effect. Quite simply this is unwise as, if every country were to do so, the result might well be that the rules become virtually

inoperable due to their complexity. The exact detail of the rules to be observed would depend on the status of the entity, whether it was an affiliate of a foreign company and whether the auditors were, or were not, part of a network. In a single EU market, let alone a globalising capital market, it cannot make sense for every audit regulator to seek to impose on auditors in other countries their own version of the appropriate auditor independence rules.

I have two suggestions to make. First of all, I beg regulators to cease introducing new rules at this point. Let us pause for reflection and see how the extensive new independence codes work out in practice. In other words let us have a stable platform of the kind which has been put in place for the introduction of IFRS. In saying this I make an exception for the necessary update to the International Ethics Standards Board's Code for which an exposure draft is expected soon.

Secondly, roll back the extraterritorial impact of independence rules. Not only is it self-evidently appropriate to do this within the EU single market, but it would make great sense also if, for example, the US Authorities, the SEC and PCAOB, were to do the same. This would then leave open the question of how to ensure the independence of auditors of foreign affiliates. May I commend the approach of the UK's Auditing Practices Board, which regards as acceptable the application by auditors of foreign affiliates of UK companies the IFAC Code of Ethics, which is now under the aegis of the IESBA.

This may seem a radical set of proposals but I do not believe it is. I believe it is sensible. First of all, as to rolling back extra-territorial impacts, Belgium has recently taken the step and is to be applauded. Secondly, leading regulators, including the EU Commission and IOSCO for example, take part in the public oversight structures of IFAC. They seem content with the due process arrangements and the composition of the boards which set standards, including independence standards, under the IFAC umbrella. Why therefore should there be any reluctance to rely on the resulting standards? If, for example, the independence standards of the IESBA are not to be so relied on, I ask why the regulators are investing in oversight of their preparation?

In no sense is what I have said an attempt to put in place more convenient or softer independence codes. Rather it is a plea for a rational approach to the application of complex independence rules. I do not see how the 1,700 staff of my firm in Dublin

can sensibly be expected to master and apply many sets of independence rules each with unique features, as well as many common features, nor is it the best use of time to achieve audit quality. This is not a sensible way to proceed and is a recipe for inadvertent infractions which cause needless trouble to auditors, regulators and their clients.

Independence rules also affect competition and choice. Notably scope of service rules at times prohibit auditors from providing quite a wide range of services to their audit clients. If such rules are combined with a two year cooling off period during which prospective auditors must not have provided such prohibited services, the inevitable effect is to reduce the number of audit firms eligible to be appointed auditors. This reduces competition and choice. I ask therefore if a more discriminating approach to the range of prohibited services and a reduction in the cooling off period might not be worth examining.

The second factor I mentioned which can affect the sustainability of auditing and market access is auditor liability. We will all have studied closely the London Economics report which independently sets out the public interest case for auditor liability reform and, more particularly, a cap on auditor liability, for which several models are advanced. It is not appropriate here for me to rehearse or summarise the detail of this report. But I would like to quote to you an extract from a recent letter of FEE's Chief Executive, Olivier Boutellis-Taft, to our Member Bodies:

- *“Auditors’ liability is a genuine internal market issue as, even in countries where a limitation exists, audit firms may be negatively impacted by claims originating from another Member State, for instance in the case of group audits; the new provision defining networks provides another example of the internationalisation of the issue to which national solutions alone are unable to respond. At minimum, European action is required to obtain the expected results in today’s global economy.*
- *The study provides analytical and empirical evidence that limiting auditors’ liability will not adversely impact audit quality and that joint and several liability is not a marker for quality.”*

As you know, the European Commission is due soon to prepare a report for Council and the Parliament on auditor liability.

Nor is Europe alone in addressing this issue. Last week the US Committee on Capital Markets published its interim report. Among many other matters it addressed auditor liability, making several recommendations and observations. It urged Congress to explore options for eliminating the risk of destruction of an audit firm as a result of private litigation. It also made clear that any protection against catastrophic liability must be coupled with enhanced efforts to ensure that auditors are held accountable for deficient work or misconduct.

The Committee said, that in addition to protecting investors and capital markets by ensuring the availability of public audits, liability protection for auditors would provide other benefits, including:

- Expanded choice of auditors by encouraging more smaller and medium firms to enter the market for large company audits
- Renewed availability of auditor liability insurance, which would enable audit firms to better price risk and create a recovery source for shareholders
- Cost reductions for business by reducing liability fears that may lead to “defensive auditing”.

I should also refer to the case study on Belgian reform of liability which was presented to our October Conference by André Killesse, President of the Institut des Réviseurs d'Entreprises. The Belgian Government and Parliament clearly recognised that reform for all auditors is essential and acted on that view. I note that proportionate liability is to be available in the UK for the first time. I am aware of other developments in Europe too.

I believe that reform of auditor liability, under the right conditions, will be of clear public benefit. I therefore urge the Commission, Council and Parliament to carry forward the debate and act on the precautionary principle, namely address the self-evident risk of a catastrophic claim damaging the sustainability of our profession. I also urge our Member Bodies immediately to be active at national level in making the case for appropriate reform of auditor liability, so that all Member States come to see the merits of the case.

My third example of the need for debate on our future direction concerns the relevance of the profession's work.

There is no doubt that the foundation of our profession is reporting and auditing. But our Autumn programme alone illustrates the breadth of our interests and our relevance to the business community as well as to investors and the capital markets. We are indeed a multi skilled profession and it is essential for our vitality that this remain the case.

In September in Versailles we had our second conference for SMEs and auditors specialising in them. We all know that almost all employment growth in Europe is generated by SMEs and we want to keep developing FEE's attention to this area.

We also had a joint conference in September with the European Commission on 'Public Sector Accounting'. This has been followed up by a recent Discussion Paper from our Public Sector Working Party on "*New Public Sector Management*".

Recently, we had a Roundtable on Sustainability Assurance, a few weeks after the GRI Conference in Amsterdam. This is a topical area, as was illustrated at the annual dinner in Dublin last week of the Institute of Chartered Accountants in Ireland, hosted by its President Martin Wilson, who is here today and at which Commissioner McCreevy was also present. Ireland's President, Mary McAleese, spoke eloquently about the importance of corporate social responsibility. It is therefore timely that we have just restructured FEE's sustainability work for the future to give it added importance.

Despite these examples of the wide range of the matters to which our profession's diverse skills are relevant, there is still the question I posed earlier. We do still work on the audit of historical financial statements although people increasingly rely on the internet for information. As I enquired: will investors and others be able to access reliable up to date financial data about companies and is there a role for auditors?

In order to expose such issues to debate, Deputy President Jacques Potdevin will chair a panel on the internet on the theme of "*An opportunity to empower investors through accessibility or a risk for the reliability of financial information?*"

I am particularly grateful to Corey Booth of the SEC who has travelled from Washington to contribute to the panel and explain the very strong commitment of SEC Chairman, Christopher Cox, to investing in the use of XBRL for the benefit of investors.

So to recap. Even though much remains to be done to implement and refine the legislation, regulations and standard setting of the last few years, I believe that we do indeed need to raise our sights and look beyond the difficult work of implementing those recent reforms.

As I said, we need to make sure that continuing reform and the structures around it are correctly designed and working in the right direction.

That is true for financial reporting, it is true for auditing and it is true for several other areas, including our profession's capacity to respond to innovative technologies.

I trust that you will find this Conference interesting.

I should now like to offer the floor to Hans van Damme to Chair our first panel. I ask you to contribute actively to the Question and Answer sessions.
