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The global audit profession and the international financial architecture: Understanding regulatory relationships at a time of financial crisis

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A B S T R A C T

This paper explores how regulatory relationships in the global audit arena are being affected by the current financial crisis. Key policy initiatives and debates are analyzed, along with institutional interactions, in particular between the International Federation of Accountants (IFAC), international regulators and the large audit firms. The events are placed in the context of the new international financial architecture which has developed over the last decade. Using the illustrative lens of bank auditing, questions are asked of the nature and status of audit practice and the regulatory arrangements governing such practice. The paper shows the active nature of the regulatory responses to the crisis and the shifting and competing influences among key regulatory and professional participants in the global audit arena. Emphasis is placed on the need for audit researchers to be sensitive to the developing global financial architecture, and its potential implications for the study of audit practice in different national and international contexts.

> "(T)he auditing profession may face some very severe challenges. The continued success of the profession depends in part on its response to these challenges. Research has a role in clarifying the nature of these challenges and in exploring the possible responses. To do this successfully, this research has to explore fundamental questions about why and where the auditor's authority and power in society reside and how this location changes over time."
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> (Bromwich & Hopwood, 1982, p. 21)

The current global financial crisis has proved to be a particularly interesting one from the perspective of auditing. At one level, attention has been drawn to the limits and limited capabilities of auditing, the need to reform aspects of practice and regulation – including placing further constraints on the (non-audit) services provided by auditors and the relative silence of the profession at such a fundamentally important time (see Sikka, in press). However, at another level, the crisis has proved distinctive in that the typical questioning in the aftermath of major banking collapses as to 'where were the auditors?' has been less prevalent than in the past. The many regulatory and government reports now published on the financial crisis acknowledge that its causes lie in the interaction of a range of complex and global factors (e.g., see De Larosiere, 2009; Ricol, 2008; Treasury Committee, 2009). Criticism and blame has focused primarily on individual banking institutions and the strength of their management and business models, remuneration structures and incentive based cultures. The financial regulators and credit rating agenciesz have also found themselves subject to serious questioning, but auditors have largely escaped critical comment and the apportionment of blame. Indeed, the profession has been able to respond, in some jurisdictions, to criticism by relying

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on official assurances by independent oversight bodies as to the general quality of audit work (see AIU, 2008) and declarations, by senior international regulators, that the auditing profession appears to have had 'a good crisis'.[1]

This paper does not concentrate on the causes of the current financial crisis and where blame should or should not be apportioned (for a discussion of the relative merits of this, see Miller, 2008). Rather, it delves behind a claimed 'silence' by the profession to highlight the scale of 'behind-the-scenes' activity and policy responses on the part of the auditing profession. In this regard, the paper's contribution is threefold.

Firstly, the paper stresses the importance of studying auditing within its context – and, how nowadays, this increasingly means researching auditing within the context of what is commonly known in the field of global governance, as the international financial architecture.[2] In particular, it is argued that audit researchers need to be aware of (a) the wide range of institutions (and individual key players within them) with whom the auditing profession interacts in the global sphere and (b) the ways in which such bodies and interactions increasingly set the boundaries for both audit practice and the ideas and thought processes that shape practice.

Secondly, the paper takes a number of components of the current global financial crisis and the associated regulatory response to highlight the potential challenges that it provides for the external audit function. Lastly, using the specific example of bank auditing, the paper pinpoints key questions that can be asked both of current practice and the path that future developments in practice may take. Such questioning is undertaken from the perspectives of audit practitioners, researchers and regulators; encouraging more open and visible dialogue (and the establishment of the contextual circumstances that will permit such dialogue) on the nature, capacities and achievements of audit practice.

The emergence of an international financial architecture

The need for an international financial architecture[3] had its roots in the discussions raised in the mid-1990s about how to prevent the type of financial chaos which developed as a result of Mexico's devaluation of the peso in 1994. However, it was not until the widespread financial crisis in Asia in 1997/8 that action was taken (Wade, 2007a). 'Financial stability' began to be seen as a potential problem in a rapidly globalising world. There were varying explanations of the Asian crisis and many different ideas as to how such a crisis could be prevented in the future (see Muchhala, 2007; Rahman, 1998). The G7 Finance Ministers took responsibility for finding a solution. They rejected wide-ranging suggestions like the setting up of a supranational authority to supervise global financial markets or a new World Financial Authority (Eatwell & Taylor, 2000). These moves would have drastically reduced national sovereignty which was unacceptable to the participants. While some blamed the IMF for having exacerbated the crisis (Weisbrot, 2007), others pinpointed weaknesses in the countries concerned, including poor supervision of banks, weak corporate governance and misleading financial reports. The solution arrived at focused on dealing with such weaknesses, and was represented in a system of standards and codes to ensure good financial practice (IMF & World Bank, 2005). The theory was that the countries whose institutions complied with these standards would gain better access to finance both from the IMF, and more widely from financial markets. This would further induce the use of the standards, and boost financial stability (Wade, 2007b). A new organisation, the Financial Stability Forum (FSF) was set up by the G7 in 1999, its key mandate being to set up this system of standards. By 2000, 12 key standards for achieving financial stability had been agreed; these included international accounting standards (IFRS/IAS) and international auditing standards (ISAs) (FSF, 2008a; Humphrey & Loft, 2009). Wade identified this new focus on standards as a move from a doctrine of 'liberalize the market' to one of 'standardize the market' (Wade, 2007b, p. 74). However these two doctrines were not incompatible, for although standardizing brings more 'government' it is carried out (in theory at least) with the aim of establishing a framework of standards in which the free market can operate.

The inclusion of ISAs in the FSFs recommended list of standards (which also included the IMF's 'Code of Good Practices on Fiscal Transparency' and BCBS's 'Core Principles for Effective Banking Supervision') was significant. The ISAs are set by the International Auditing and Assurance Standards Board (IAASB)[4] under the International Federation of Accountants (IFAC). Public authority was accordingly being placed behind private standards, giving them a more important status not just in terms of processes of corporate reporting but also to the larger project of ensuring financial stability.[5]

It was also recognised that while setting standards was important, the extent to which the standards were actually used was crucial, and the IMF and World Bank developed a program of 'Reports on Standards and Codes' (ROSC), with one specific program dealing with accounting and auditing. These focus on making detailed assessments of national institutional frameworks, and the observance and enforcement of standards, using IFRS/IAS and ISA as the benchmark. To date the World Bank has published accounting and auditing ROSC's on 72 developing or emerging economies.[6] Developed countries like Japan and

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[1] A conclusion reached by Paul Boyle, the head of the UK's Financial Reporting Council and the International Forum of Independent Audit Regulators (IFIAR) – see Comment made in his address to the Pan Accountancy Profession Lunch, Mansion House, London, 23 October 2008. http://www.frc.org.uk/images/uploaded/documents/Mansion%20House%20Speech%20October%202008%20-%20published1.pdf.

[2] Advice provided by G.E. Storey in the development of this paper is gratefully acknowledged.

[3] See Appendix A for a full list of the abbreviations used to identify organizations in the regulatory architecture which are referred to in this paper.

[4] The IAASB was not operational until 2002 – prior to that the International Auditing Practices Committee (IAPC) set the standards.

[5] This added to the interest in ISAs as potential EU audit standards already expressed by the European Commission and interest in the by IOSCO, as the standard for cross-border audits.

[6] http://www.worldbank.org/ifa/rosc_aa.html (note that some countries may not permit publication, so the number carried out is in fact greater).