

MAY 2006

FIRST PUBLIC REPORT  
OF THE  
**PIOB**



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**Public Interest Oversight Board**

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*overseeing international audit, ethics and education standards for the accounting profession*



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## CHAIRMAN'S MESSAGE

*I am happy to present the first public report of the Public Interest Oversight Board, an international oversight body for standard setting in the areas of auditing, ethics and education for the accounting profession.*

*The PIOB is releasing this report a full year after commencing its operations. During this year we made good progress on several fronts:*

- *organizing and executing a program of active and comprehensive oversight of the public interest activities undertaken by the International Federation of Accountants;*
- *establishing the PIOB's legal and physical presence;*
- *promoting our presence and mission through a number of public presentations; and,*
- *building close links with relevant authorities at both national and regional levels.*

*This has also been a year of hard work. It can be a risky task to superimpose oversight upon pre-existing activities and those charged with this task must tread a careful path. On the one hand, poorly targeted oversight risks destabilizing, and ultimately harming, the activities that oversight was intended to improve. On the other, overly timid oversight may have no impact, rendering the function ineffective. I believe that we successfully traversed that path during our first year and were able to establish both authority and credibility through exerting pressure where required, and without creating disorder in the underlying activities.*

*I can safely predict that we will continue to grow in effectiveness as we deepen our understanding and gain further experience in this role. The excellent co-operation I have observed among all PIOB members, observers and our secretary general, the constructive rapport that we have established with IFAC and the standard-setting and compliance bodies under its auspices, our open and constructive dialogue with regulatory organizations that make up the Monitoring Group, and our close links with other entities such as national standard setters and audit regulators that share our goals, are our guarantee for future success.*

*I firmly believe that high quality standards in the areas of audit, ethics and education for the accounting profession can be instrumental in the re-establishment of confidence in the audit process and in promoting the integrity of firms and markets. I also believe that high quality standards, if and when uniformly applied, create an international "public good" that represents a very important part of the governance arrangements for our world financial system. That the standards are also being formulated in the broad public interest is a further safeguard that these arrangements will foster stability and development around the world.*



Stavros B. Thomadakis  
Chairman

## I. ORIGINS AND MANDATE OF THE PUBLIC INTEREST OVERSIGHT BOARD

### 1. ORIGINS OF THE PIOB

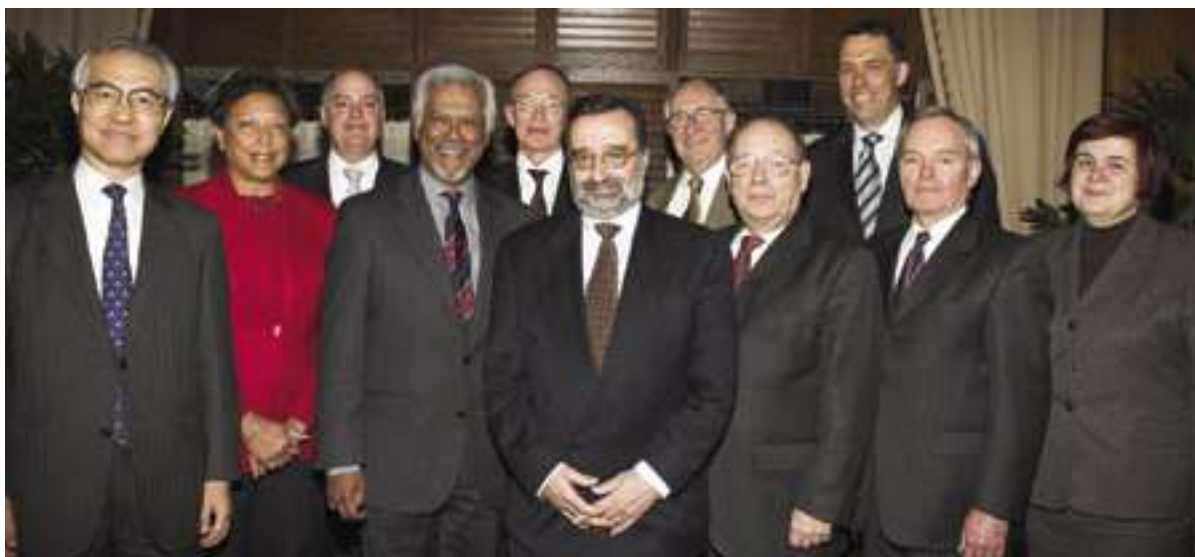
THE last decade of the 20th Century and the first few years of the 21st were marked by regional financial instability, high profile accounting scandals and corporate failures that resulted in significant losses of shareholder value in the United States, Europe and Asia. These incidents were seen primarily as failures of management integrity and of financial reporting rules and audits, although the financial instability experienced in some regions could also be traced back to significant underlying macro-economic factors. The public's confidence in capital markets was undermined, and those assessing the situation called for improved corporate governance, increased transparency in the corporate financial reporting process and more dependable audits.

These developments also sparked another pent-up and longstanding need for change. Much earlier, international regulators and other observers of global capital markets had already recognized the dangers

posed by fragmented accounting and auditing standards, inconsistent financial reporting rules and non-comparable financial statements. In their view, these separate factors underscored the need for a more robust international standard-setting process that could produce high quality standards capable of commanding the respect of national regulatory authorities, financial statement users, and national and international policy makers alike.

The International Federation of Accountants (IFAC) responded to these events by seeking to initiate reforms that could restore public confidence in both the process of auditing financial statements and the audit profession itself. The unifying element within such IFAC reform was to be that every policy adopted, process implemented, and procedure established must serve the public interest.

IFAC's development of this reform program benefited greatly from ongoing consultations with the inter-



The PIOB (*left to right*): Kosuke Nakahira, Aulana Peters, Michael Hafeman, Fayez Choudhury, Arnold Schilder, Stavros Thomadakis (Chairman), Sir Bryan Nicholson, Antoine Bracchi, Kai-Uwe Marten, David Brown, Donna Bovolaneas (Secretary General).

national regulatory community. To promote coherent discussions, the Financial Stability Forum<sup>1</sup> and regulators closely involved in preserving the integrity and stability of financial markets – the International Organization of Securities Commissions (IOSCO), the Basel Committee on Banking Supervision (BCBS) and the International Association of Insurance Supervisors (IAIS) – together with The World Bank established their own forum known as “The Monitoring Group.”

Based on the understandings and agreements reached during this dialogue, IFAC moved forward expeditiously to adopt a program of comprehensive reforms. These reforms included specific steps to enhance, strengthen and protect the independence of IFAC standard-setting committees and the formation of a compliance panel focused on IFAC member bodies’ adherence to membership rules. To address equally important questions of accountability, the reforms also called for the creation of an independent body that would exercise comprehensive oversight over all IFAC activities affecting the public interest to ensure that such activities in fact served the public interest.

Thus, the PIOB, a world co-operative venture, was born.

The first step required to set up the PIOB was a process for selecting the initial board members. Members of The Monitoring Group took on the task of identifying individuals independent of the accounting profession who had demonstrated a commitment to the public interest through public service and with the capacity to understand the complexities of formulating international standards. The Monitoring Group as a whole then focused

on achieving a balance of experience in international and national public service, expertise in various fields of regulatory practice, familiarity with the due process of international standard setting, independence from the audit profession, and geographical representation.<sup>2</sup> After collectively reviewing and vetting these candidates, the Nominating Committee of The Monitoring Group subsequently appointed the following individuals to the PIOB for an initial term of three years:

- **Dr. Stavros Thomadakis, Chairman**  
Professor of Finance, University of Athens, Greece. Former Chairman of the Hellenic Capital Market Commission, the European Regional Committee of IOSCO, and the expert group on Market Abuse of the Committee of European Securities Regulators
- **Mr. Antoine Bracchi**  
Président, Conseil National de la Comptabilité, France
- **Mr. David A. Brown, Q.C.**  
Former Chairman of the Ontario Securities Commission, Canada. Founding chair of the Council of Governors of the Canadian Public Accountability Board. Member of the Council of Senior Advisors to the Auditor General of Canada
- **Mr. Fayezul Choudhury**  
Vice-President and Controller, The World Bank
- **Mr. Michael Hafeman**  
Actuary and independent consultant on supervisory issues. Former Assistant Superintendent of Financial Institutions, Canada
- **Mr. Kosuke Nakahira**  
President and Chief Executive, Shinkin Central

<sup>1</sup> The Financial Stability Forum (FSF) seeks to co-ordinate the efforts of various national and international regulatory bodies in order to promote international financial stability, improve the functioning of markets, and reduce systemic risk.

<sup>2</sup> The Monitoring Group determined that IOSCO should nominate four candidates while The World Bank, the BCBS and the IAIS would each nominate one. IFAC would also nominate candidates from whom The Monitoring Group would select one, and, although not a formal member of The Monitoring Group, the European Commission would nominate two.

Bank. Former Vice-Minister of Finance for International Affairs, Ministry of Finance, Japan

- **The Hon. Aulana L. Peters**  
Retired lawyer. Former Commissioner of the U.S. Securities and Exchange Commission and former member of the Public Oversight Board of the American Institute of Certified Public Accountants. Member, Accountability Advisory Board to U.S. Comptroller General
- **Professor Dr. Arnold Schilder, RA**  
Executive Director, De Nederlandsche Bank NV, Netherlands. Member of the Basel Committee on Banking Supervision and Chairman of the Basel Committee’s Accounting Task Force

The PIOB was launched on February 28, 2005 in Paris at a joint meeting of The Monitoring Group, the leadership of IFAC and PIOB members. The joint press release issued on that day stated:

“The establishment of the PIOB is the result of a collaborative effort by the international financial regulatory community, working with IFAC, to ensure that the auditing standards set by IFAC and its committees are set in the public interest. Establishment of higher quality standards, coupled with strengthened auditor oversight nationally are part of the substantive reforms that regulators have identified as necessary to achieve a step-up in the quality of external audits of individual companies around the world. The PIOB will strengthen international auditing standards by injecting informed oversight in the public interest into IFAC’s standard-setting activities, and by enhancing the transparency and consultative processes of these activities.”

On March 1, 2005, the PIOB held its first meeting.

The European Commission had an early and close involvement in the development of IFAC reforms and the creation of independent oversight of IFAC’s standard-setting processes. In October 2005 The Monitor-

ing Group appointed two observers nominated by the European Commission to the PIOB:

- **Sir Bryan Nicholson**  
Former Chairman of the UK Financial Reporting Council
- **Professor Dr. Kai-Uwe Marten**  
Professor of Accounting and Auditing, University of Ulm, Germany. Deputy Chairman of the Auditor Oversight Commission, Federal Republic of Germany

The role set out for these observers by the European Commission was to “...participate in the PIOB meetings and contribute actively to the discussions, but... not take part in any vote.”

THE PIOB WAS LAUNCHED ON FEBRUARY 28, 2005 IN PARIS AT A JOINT MEETING OF THE MONITORING GROUP, THE LEADERSHIP OF IFAC AND PIOB MEMBERS.

## 2. THE PIOB MANDATE

The mandate of the PIOB described in the reform document and agreed upon between The Monitoring Group and IFAC reads as follows:

“The objective of the PIOB is to increase the confidence of investors and others that the public interest activities of IFAC (including the setting of standards by IFAC boards and committees) are properly responsive to the public interest.”

Specifically, the PIOB mandate contemplates the exercise of oversight for all of IFAC’s “public interest activity committees” (PIACs) which include the work of the International Auditing and Assurance Standards Board (IAASB), the International Ethics Standards Board for Accountants (IESBA), the International Accounting Education Standards Board (IAESB) and their respective Consultative Advisory Groups (CAGs).

The creation of robust CAGs to provide public scrutiny and input to various standard-setting processes has been an important architectural element of IFAC reform. Previously, only the International Auditing Practices Committee<sup>3</sup> sought the input of a CAG as part of its standard-setting process. However, one serious deficiency of this model was the lack of an independent CAG chair. Thus, under IFAC reforms, the new architecture now includes CAGs – under the leadership of an independent chair – for each of the standard-setting boards overseen by the PIOB. The membership of these consultative groups comprises representatives of stakeholder organizations such as regulators, users and preparers of financial statements and development institutions. The role of the CAGs is to provide organized and regular fora where technical consultation on proposed new or revised standards can take place between CAG member bodies and the standard-setting boards.

Furthermore, the PIOB is required to oversee the Compliance Advisory Panel (CAP) of IFAC, a group which evaluates member body compliance with IFAC membership rules, including each member's commitment to implement IFAC audit, ethics and education standards.

Of significance, the PIOB has the power to approve or reject nominations of members to all the bodies that it oversees, and to request the removal of the chair if deemed necessary. This authority is viewed as key to enhancing and preserving the independence of IFAC PIACs. In addition, in recognition of the potential and importance of these bodies to the full realization of IFAC reforms, the PIOB has been given the power to approve the appointment of independent CAG chairs and to monitor and receive reports from these groups.

The PIOB is required to prepare an annual report that discusses its own activities and evaluates how

the public interest has been reflected in the activities that it oversees. This public report is to be made available to the membership of IFAC, the Financial Stability Forum, authorities responsible for the regulation of the profession on a national and international basis and the general public.

The PIOB will also be subject to periodic evaluation by The Monitoring Group. In accordance with the IFAC reform document, The Monitoring Group has the authority to renew the terms of the current PIOB members, to remove the members for cause and to nominate candidates to replace members.

In addition to receiving input on which issues are of most concern from various international bodies and others interested in the quality and effectiveness of the audit process, the PIOB also expects to benefit from a close and collaborative relationship with The Monitoring Group. It will take the opportunity to engage in ongoing dialogue with respect to issues of market order, financial stability, and the protection of investors and other users of the financial system.

### **3. THE ORGANIZATION AND LEGAL STRUCTURE OF THE PIOB**

In addition to initiating its oversight activities immediately<sup>4</sup>, the PIOB moved quickly to set up an administrative structure that would support the independent operation of its mandate. One of the first imperatives to be addressed was the selection of a suitable location for PIOB headquarters and an appropriate legal form for conducting PIOB activities. After considering several alternatives, the Board decided to accept the offer of the Spanish government to recognize the PIOB's legal structure as a tax-exempt international organization and to make Madrid the official seat of the PIOB in the same premises as the IOSCO headquarters. The proximity of the PIOB to IOSCO is expected to be mutu-

<sup>3</sup> Predecessor to the IAASB.

<sup>4</sup> See Section II of this report.

ally beneficial and cost-effective for both organizations by allowing, where appropriate, the joint utilization of facilities, administrative resources and experience. In addition, the PIOB's settlement in Madrid has been facilitated through the direct assistance and ongoing support of La Comisión Nacional del Mercado de Valores (CNMV)<sup>5</sup>.

Concurrently, the PIOB solicited applications for the position of its Secretary General and selected Donna Bovolaneas from among several highly qualified candidates. Donna brings to the post of PIOB Secretary General significant national and international experience in regulation, standard setting, financial reporting and auditing. She relocated to Madrid in mid-September 2005 and, in addition to her normal duties and under the supervision of the PIOB, undertook to work with the CNMV and local counsel to identify and set up an appropriate legal structure to support PIOB operations in the manner contemplated under IFAC reforms.

With the advice of legal counsel, the PIOB decided that the most appropriate legal form for this purpose would be a Spanish non-profit foundation. The PIOB was subsequently established as the "Fundación Consejo Internacional de Supervisión Pública en Estándares de Auditoría, Ética Profesional y Materias Relacionadas" on December 15, 2005, followed by formal registration of the foundation on February 8, 2006. Three of the international regulatory organizations that launched the PIOB – IOSCO, IAIS, and the BCBS with the assistance of the Bank for International Settlements – acted as the formal founders of the "Fundación" and contributed equally to its initial capitalization.

As a non-profit foundation, the PIOB is authorized to conduct operations and engage in fund raising and other financial operations. The PIOB's legal

form also requires that it be supervised by a local foundations regulator and adhere to the requirements of relevant Spanish laws. However, the government of Spain has granted the foundation tax-free status similar to that enjoyed by IOSCO as well as other special benefits accorded to international entities operating in Spain. Members of the PIOB also serve as trustees of the foundation.

The PIOB's plan is to set up a compact, efficient administrative organization that will enable it to respond in the best way possible to the challenges of conducting oversight in an international setting. The PIOB expects to complete its infrastructure and achieve full operational capability by the end of 2006. The principal tasks remaining are recruitment of a small number of competent staff, building of the necessary information and communication facilities, establishment of administrative policies and procedures and, as it becomes necessary, adoption of a Code of Conduct and rules of procedure for the PIOB and PIOB employees. The PIOB wishes to acknowledge the role of IFAC in providing not only practical advice but also significant logistical support during this transitional period.

As part of the IFAC reform agreement, IFAC has also committed up to 1.5 million US dollars per year to support the first five years of the PIOB's operations. Nevertheless, in the opinion of the PIOB and all its sponsors, it is in the public interest – both real and perceived – that the current funding arrangement be diversified and expanded for two important reasons. First, anticipated future needs of the PIOB will require funds beyond those already committed. Second, the independence of an oversight body is compatible with sustainable and diversified sources of financial support. ■

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<sup>5</sup> The Spanish National Securities Commission.



## II. OVERSIGHT AND LIAISON ACTIVITIES IN 2005

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### 1. INTRODUCTION

AS noted earlier, the first meeting of the PIOB was held on March 1, 2005. While the IFAC reform document defined a clear mandate and set out explicit Terms of Reference for the PIOB, the manner in which these requirements should be put into operation had not been addressed. The fact that IFAC's standard-setting activities were well developed and ongoing further complicated the task. Also, although they were experienced and knowledgeable, PIOB members were fundamentally independent from IFAC and not necessarily experts in IFAC's organizational structure, policies and procedures.

As a result, the PIOB adopted a four-part startup policy intended to quickly establish its authority and competence to oversee the standard-setting process. First, the PIOB would meet four times a year. Second, it would devote its meetings during the first year to in-depth interviews with both IFAC leadership and the leadership of the standard-setting boards in order to gain a firm understanding of how standard setting worked, the operational concept of "Due Process" and the actual willingness of IFAC bodies to be subjected to independent oversight. Third, the PIOB would immediately commence overseeing activities of the standard-setting boards. Finally, the PIOB would establish contact with international and national regulators and other entities with an interest in enhancing audit quality and increasing public confidence in the capital markets.

### 2. 2005 OVERSIGHT OF PUBLIC INTEREST ACTIVITIES

The PIOB's oversight of IFAC's standard-setting activities started with an intensive program of briefings. The PIOB met with IFAC's President, its Chief Executive, chairs of the standard-setting boards and the compli-

ance panel, the chair of the IAASB CAG, and relevant staff members. All of the interlocutors were co-operative, open and forthcoming about their work, their plans and their goals. They also expressed readiness to accept PIOB oversight and to adjust their perspectives and activities to the PIOB's working definition of monitoring and engagement. Information obtained during these initial meetings laid the foundation for the PIOB's understanding of PIAC operations and for its policy decisions, presented in the next section of this report.

The PIOB decided to engage in *complete monitoring of the ongoing activities of the standard-setting committees and their CAGs* as soon as possible. This involved covering as many meetings as possible of the IAASB, IAESB, the IESBA and their respective CAGs as well as separate monitoring of the work of the CAP. In pursuing these goals, various PIOB members traveled to and observed more than twenty separate meetings during 2005. Through this intensive process, PIOB members were able to form first-hand impressions of the professional quality, efficiency, transparency, and commitment to the public interest of those who actually set the standards as well as those providing public interest input to the process. Furthermore, PIOB members were also able to ascertain through these observations whether the architecture of international standard setting as described in the IFAC reform document was workable and capable of producing audit, ethics and education standards at the desired level of quality, credibility and consistency.

The decision to adopt this complete monitoring approach to oversight has already paid solid dividends. PIOB members are now well acquainted with the object of their oversight and have moved quickly from learning to evaluating what they have seen and

heard. As a result, the PIOB has made preliminary, albeit limited, recommendations for changes to the policies and procedures of both the standard-setting boards and their CAGs which it believes will benefit the public interest. IFAC leadership has moved quickly to adopt all of these recommendations.

In view of these positive results, the PIOB will continue to pursue this policy during 2006.

The PIOB chairman and various other members also participated in meetings of the IFAC Board and IFAC Council and addressed these groups. Through these activities the PIOB was able to introduce itself to IFAC membership and to explain and reinforce its mandate. By establishing and maintaining open lines of communication with the IFAC Board and its governing Council, the PIOB hopes to better assess IFAC member bodies' long-term commitment to an independent standard-setting process, thereby potentially increasing IFAC member bodies' engagement in and commitment to the concept of vigorous and independent oversight.

### 3. THE NOMINATION PROCESS FOR THE STANDARD-SETTING BOARDS AND THE CAP

An important part of the PIOB's mandate is overseeing the nomination process and the approval of nominees proposed by the IFAC Board for membership on the three standard-setting boards and the compliance panel. The appointment of talented, knowledgeable individuals to the standard-setting boards is key to ensuring that these boards produce a quality product. Moreover, both the actual and perceived fairness of the nomination process are essential to the credibility of those setting the standards and the acceptability of the standards themselves.

For these reasons, the PIOB gave top priority to overseeing the 2005 nomination process. At its first meeting, the PIOB decided it would initiate immediate monitoring of the work of the Nominating Com-

mittee, even though the IFAC nomination cycle for the year had already begun. The program undertaken included observing the actual process through attendance at Nominating Committee meetings and exercising the PIOB's explicit authority to approve nominees to the boards.

The first goal of the PIOB was to ascertain the quality, transparency and balance of the nomination process. To accomplish this, the PIOB asked the Nominating Committee to formulate a list of written criteria for screening those candidates proposed by member institutes. The committee complied with this request, and as the criteria were judged by the PIOB to be satisfactory, this document became the guide for final candidate selection and for the PIOB's evaluation of the committee's final results.

THE FIRST GOAL OF THE PIOB WAS TO ASCERTAIN THE QUALITY, TRANSPARENCY AND BALANCE OF THE NOMINATION PROCESS.

The policy guiding the work of the Nominating Committee as it relates to the standard-setting boards is based on three essential criteria: first, candidates must be of high quality and have sufficient expertise; second, there must be a balance between practitioners and non-practitioners, including the participation of two or three "public" members whose explicit role is to represent the public interest; and, finally, consideration must be given to gender, geographic provenance and nature and size of practice to achieve balanced representation of the members of the profession and member bodies.

In observing the 2005 nomination process, the PIOB engaged in discussion with the Nominating Committee to clarify its understanding of the selection process and of how the criteria were being

applied. Based on member reports and its own discussions, the PIOB concluded that the IFAC Nominating Committee had operated with a high level of professionalism and had sought to make high quality choices with a sense of fairness, balance, and objectivity. Consequently, the PIOB approved the slates of candidates proposed by the IFAC Board at the recommendation of the Nominating Committee. These candidates represented one-third of the composition of the standard-setting boards and the compliance panel, i.e., that portion subject to annual rotation.

Furthermore, PIOB observation of the 2005 nominating cycle resulted in several recommendations for changes to, or refinements of, IFAC policy. These recommendations are also presented in the next section of this report.

#### **4. APPOINTMENT OF THE IAASB CHAIR**

As the term of the current IAASB chair ends in December 2006, the Nominating Committee has initiated a process to select a new chair for this key standard-setting board. The process has been closely monitored and the PIOB is in regular communication with the Nominating Committee to determine how this critical task is progressing. The PIOB is fully aware of the significance of this appointment which it will be required to review and eventually approve. That significance is derived not only from the IAASB chair's role in the execution of due process, but also the individual's responsibilities, as the IAASB's primary and most important spokesperson, to represent the IAASB in interactions with regulators, the PIOB and other key stakeholders who share an interest in the setting of audit standards. Furthermore, the IAASB chair will be expected to play an even more prominent role over the next few years as various jurisdictions around the world move towards the adoption of International Standards on Auditing.

#### **5. LIAISON WITH ORGANIZATIONS AND GROUPS OF RELATED INTEREST**

Although not explicitly stated in the PIOB's remit, the issue of standards implementation is paramount. By definition, high quality standards must be both usable and susceptible to successful implementation. Furthermore, it is only through implementation and application that standards can be validated and any requirements for revision identified. Thus, the public interest is best served by the successful interaction of the standard-setting and standards implementation processes. It is for this reason that the PIOB has also considered it an indispensable part of its task to maintain close liaison with major national oversight authorities and audit regulators around the world.

In this regard, the Chairman and other PIOB members have visited several of the major national oversight authorities and have exchanged ideas about the possible co-operation between them and the PIOB. In doing so, the PIOB believes that dialogue among national authorities in the important area of standards implementation will create stronger incentives and opportunities for convergence of auditing standards and practice around the world.

For the same reason, the PIOB has also been highly interested in the issue of the quality and consistency of transnational audits conducted by so-called "network audit firms". The PIOB has sought to establish an active liaison with these firms through an IFAC-related umbrella group known as the Forum of Firms. This liaison has taken the form of periodic visits by Forum representatives to meetings of the PIOB as well as participation by PIOB speakers in public functions organized by the Forum or its constituent firms. The Forum has proven to be a good interlocutor, showing a practical willingness to maintain close liaison with the PIOB. ■

### III. THE FIRST POLICY OUTPUTS

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BASED on its mandate to act in the public interest, the PIOB had a clear objective from inception to oversee and encourage rapid implementation of IFAC reforms in those areas where changes to policies, processes, and procedures were still pending. In addition, the PIOB believed it would be desirable to clarify and make its role explicit in a number of working rules and procedures of IFAC's standard-setting boards. Accordingly, the PIOB focused its attention and IFAC's efforts towards four objectives. First, enhanced rules of Due Process applicable to IFAC's standard-setting activities would need to be documented. Second, the Terms of Reference for the several boards and committees subject to PIOB oversight would need to be revised. Third, changes designed to improve the structure and processes of the Consultative Advisory Groups would need to be fully implemented. Finally, the PIOB would need to identify and recommend any required changes to the policy guidelines governing activities of the Nominating Committee insofar as they related to the selection of candidates for the three standard-setting boards and the CAP.

#### 1. DUE PROCESS AND WORKING PROCEDURES FOR STANDARD-SETTING BOARDS

The PIOB decided that it would be beneficial to take a "de novo" look at the procedural rules for IFAC's standard-setting boards to ensure that these rules included due process safeguards such as independence requirements, restrictions on real and perceived conflicts of interest and "sunshine rules" applicable to agendas, debates and the decision-making process.

To this end, the PIOB requested that IFAC leadership prepare and submit an analysis of the rules of procedure, codes of conduct or terms of reference followed by other comparable standard-setting bodies. IFAC prepared this analysis detailing the rules followed

by the Public Company Accounting Oversight Board, the US Auditing Standards Board, the UK Auditing Practices Board, the Australian Auditing and Assurance Standards Board, and the International Accounting Standards Board. The PIOB found this report instructive as it reviewed, debated and approved the new statement of Due Process and Working Procedures for IFAC's standard-setting boards.

The due process approved by the PIOB contains five crucial elements:

- a. The first is *consistency*. All three standard-setting boards must have the same basic rules of due process, diverging from the norm only where required by the specific nature of the subject matter under consideration. Thus, the due process requirements are homogeneous both in scope and content.
- b. The second is *a high level of transparency*. Agenda materials and deliberations of the three standard-setting boards must be open to the public. While closed meetings may be necessary on occasion, they would be by exception; the primary rule is openness.
- c. The third is *explicit recognition of the role of the PIOB* in evaluating the appropriateness of a standard-setting board's working plans and in proposing additional projects that it believes are required to serve the public interest.
- d. The fourth is to establish a process for *open consultation*, in connection with the "exposure period" for new standards. This imposes an obligation on the standard-setting boards to make public the views of commentators received during the exposure period and to respond to those views in a satisfactory fashion.

e. The fifth is the requirement for *the PIOB to satisfy itself prior to final publication of a new standard that the process applied has fully complied with the published rules of due process*. The procedure to be followed will allow the PIOB to fully exercise its role of oversight without burdening the process of issuing of new standards with unnecessary bureaucratic delay.

In recommending and approving these changes, the PIOB has promoted its view of the due process requirements necessary to produce international standards that both embody high quality and inspire confidence.

## 2. TERMS OF REFERENCE FOR STANDARD-SETTING BOARDS

The PIOB also reviewed and recommended revisions to Terms of Reference for the IAASB, the IESBA, and the IAESB. These Terms of Reference, much like a charter, set out the fundamentals of each standard-setter's mandate and scope of responsibility.

Once again, the PIOB's assessment included review of a comparison between the proposed Terms of Reference and analogous documents of other well-recognized and respected standard setters. The PIOB concluded that the final approved Terms of Reference were of high quality.

These Terms of Reference include amendments or clarifications that make the following six concepts explicit:

- a. The first is *functioning in the public interest*. The Terms of Reference expressly state that standard-setting boards should function as independent entities that work in the public interest. The PIOB views this factor as essential to the framework within which the chair, the deputy chair and the members of the standard-setting board are selected and required to discharge their duties.
- b. The second is *consistency*. The Terms of Reference for all standard-setting boards should be

consistent both in structure and content and vary only as necessary to properly describe the scope of activities and output of each standard-setting board.

- c. The third is a requirement that the *objectives* of each standard-setting board *be articulated concisely and in a manner that is consistent with its independence and the primacy of the public interest*.
- d. The fourth requires *explicit recognition of the role of the PIOB* in monitoring the nomination process, as well as the progress and the working environment of each of the three standard-setting bodies.
- e. The fifth is an explicit statement in the Terms of Reference *recognizing the role of consultative advisory groups* as integral parts of the standard-setting process. The importance of these groups in the process is recognized in the IFAC reform document.
- f. The sixth is *the specification in the Terms of Reference of the several membership categories* (public, practitioner, non-practitioner or observer) and a delineation of meeting procedures that are transparent, effective and common to all three boards.

The PIOB believes the above concepts are crucial to the public interest.

In approving these Terms of Reference, the PIOB has promoted both the spirit and the letter of the agreed IFAC reforms. It has also put in place the conditions for effective operation as well as effective outside evaluation of the standard-setting process.

## 3. REFORMING THE STRUCTURE AND PROCESS OF CONSULTATIVE ADVISORY GROUPS

The formation and operation of CAGs for each of the standard-setting boards has been an important part of IFAC reform, as these groups offer fora within which the boards may consult on the intricacies of setting

audit, education and ethics standards during various phases of the process. As noted earlier, CAG members include users and preparers of financial statements, regulatory entities, development institutions, educators and other persons interested in the international standard-setting process.

During the course of 2005, an issue arose with respect to expanding the membership of the CAG to include national standard-setting entities. Because this issue touched on the broader, and potentially more complicated, issue of the nature and scope of input by national standard setters to the establishment of international standards, the PIOB took the matter under advisement.

The PIOB will address this issue at its earliest opportunity.

While the comments and views of the CAGs constitute a critical and salutary input to the standard-setting boards, this information is also very valuable to the PIOB because in many respects the CAGs represent a broad spectrum of “the public.” Therefore, it is important that the PIOB be aware of, and understand, the positions and opinions expressed by the CAGs when reaching its independent conclusions about whether standards being developed by the three boards serve the public interest.

In appreciation of the important role played by the CAGs within the architecture of IFAC reform, the PIOB has, from inception, followed a policy of close and regular dialogue with these groups.

The PIOB has also been reviewing the processes and structure of the Consultative Advisory Groups proactively. In this regard:

- a. It pressed for an active search to identify and appoint *independent chairs for the IESBA and IAESB CAGs*. By the end of 2005 the PIOB was pleased to confirm the appointment of an independent chair for the IAESB CAG, followed by the appointment of an independent chair for

the IESBA CAG in April 2006.

- b. It *reviewed and approved Terms of Reference for the IAASB, IESBA and IAESB CAGs and their chairs*. These Terms of Reference are a novel aspect of the political and procedural framework within which standards are developed. They expressly require that the CAG consider not only the technical content of individual standards but also the related board’s overall work plan. In addition the CAG chair is empowered to convey the views of the CAG directly to the entire standard-setting board by attending PIAC meetings and exercising his or her “right of the floor”. Finally, on behalf of the full CAG, the CAG chair is charged with establishing and maintaining close liaison with the PIOB.
- c. It actively supported the efforts of the chair of the IAASB CAG to establish a “*sunshine*” *policy for CAG meetings* beginning in 2006, allowing provision for closed meetings whenever necessary. It is expected that remaining CAGs will implement a similar policy before the end of 2006.
- d. It also supported the CAG chair’s recruitment of additional member organizations to *improve the regional balance of the IAASB CAG*.

PIOB members will continue to closely monitor the meetings of all three CAGs and the progress they make towards completing the changes contemplated for CAGs under IFAC reform. When implemented, such changes should ensure that the CAGs remain independent and effective in keeping international standard setting aligned with the needs of those using the standards.

#### 4. FIRST POLICY RECOMMENDATIONS FOR THE NOMINATIONS PROCESS

As noted earlier, the PIOB placed great importance on the process by which candidates were identified and

nominated to IFAC standard-setting boards and the CAP. Late in the year, the PIOB reviewed, amended and finally approved the IFAC Nominating Committee's Terms of Reference as they related to nominations to these PIACs. PIOB monitoring of the 2005 nomination cycle also led to several observations for further improvements and adjustments to the nomination process and the following recommendations were passed on to IFAC for implementation over the near term:

- a. The Nominating Committee should strengthen its efforts in 2006 to effect *a change in the balance of practitioners and non-practitioners* on two of the three standard-setting boards. The PIOB notes that, with the exception of the IAESB, there remains a significant imbalance. It has therefore communicated its view that the committee should address this issue with a sense of urgency. All parties accept that the primary reason for rebalancing is to strengthen the boards' independence, improve the breadth of views and opinions expressed and elevate external credibility. The PIOB is confident that the Nominating Committee will respond to its urging appropriately. For its part, the PIOB has assured the committee that it understands that changes made for the sake of balance must not compromise the overall level of expertise and quality on the standard-setting boards.
- b. The Nominating Committee should consider candidates from *an expanded pool of experts* that could extend to, for example, national standard-setting bodies that have adopted

International Standards on Auditing, public sector audit professionals, especially those who actively participate in the International Organization of Supreme Audit Institutions (INTOSAI), and academics. Such persons could qualify for positions as both "public members" and "non-practitioners".

- c. The Nominating Committee should continue to strive to achieve *better geographic and gender balance* as these remain significant challenges.
- d. The *nomination process for the five positions to be filled by the Forum of Firms*, as agreed in the IFAC reform document *should not be based on a closed and set slate*. Currently, the Forum proposes five candidates for five open positions. The PIOB is urging a change in the process that would encourage the Forum of Firms to establish specific criteria for its candidates in advance, and then to propose more than five candidates meeting these criteria to the Nominating Committee. In this manner the Nominating Committee will be permitted a degree of choice that is lacking at the moment. In addition, this change will make the process more transparent and provide the Nominating Committee with the flexibility it needs to achieve overall balance on each standard-setting board.

PIOB members will continue their active monitoring of the nomination process and their evaluation of its results on the basis of their policy recommendations. ■

#### IV. THE PUBLIC INTEREST IN THE CONTEXT OF GLOBAL MARKETS

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IN considering how it could be most effective in its oversight of IFAC public interest activity committees, the PIOB concluded that it needed to specify the main elements of what is in “the public interest”.

The PIOB’s understanding of the public interest in an international setting guides the PIOB’s deliberative process. The PIOB perceives that in the international arena:

- a. It is in the public interest to produce *international standards that will cover all aspects of the audit process and the education and conduct of those engaged in preparing and auditing financial statements*. Thus, it must be recognized that not only the audit process but the qualification and the behavior of those who conduct it are paramount in determining the quality of the final outcome.
- b. It is in the public interest to produce *standards that are not only of high quality but also of high clarity and usability*. Such attributes are a prerequisite to broad application of these standards by a wide range of entities in numerous jurisdictions throughout the world.
- c. It is in the public interest that those who set international standards *be committed to the public interest, act independently of special or personal interests, and be agile and responsive to emerging needs* of standard users.
- d. It is in the public interest to promote *compliance with IFAC standards by the member bodies of IFAC around the world*. The internal mechanism of compliance that IFAC supports is an important foundation for improvement of global auditing practice at both the national and international level.
- e. It is in the public interest that the *process by which international standards are developed be open, transparent and responsive* to the views and needs of all who will use or be subject to these standards. In addition, the process must involve standard setters who are knowledgeable, experienced, and diverse.

The promotion of all these elements of international public interest will enhance *convergence to a common set of standards worldwide*. The concept of convergence includes not only adoption of common standards but also the consistent implementation of such standards by multinational “network” firms in transnational audits and by national authorities charged with regulating specific jurisdictions.

The PIOB’s understanding of the international public interest is based on the above propositions and these will inform future PIOB policy. It is expected that as the PIOB’s knowledge and understanding of the international standard-setting process increases, and as its approach to and methodology for oversight becomes further refined, the outcome will be more astute and penetrating insights into what serves “the public interest”.

However, the PIOB also believes that the fundamentals of what is in the public interest will not change dramatically over time and that, in the context of IFAC reform and the PIOB’s mandate, the international public interest can already be defined. In the view of the PIOB, the international public interest is that which is coincident and commensurate with promoting and protecting the integrity, transparency and fairness of global markets and enhancing the stability of global financial systems.

In forming their partnership with IFAC, The



Monitoring Group chose to work within the existing international standard-setting structure. Interested parties concluded that proceeding by way of reforms focused on independent oversight, strict due process, open consultation and transparency, would yield high quality international audit, ethics and education standards for the global profession.

The PIOB has been charged with providing that independent oversight and believes that it has made a good start. It is committed to monitoring implementation of the remaining reforms in all their aspects, but more importantly, must undertake to evaluate the effectiveness of these reforms in producing the desired outcome.

One objective of the adopted reforms is that IFAC will more definitively and demonstrably operate as a public interest service organization and, in so doing, command the trust of the global community it serves and gain credibility and acceptability for the standards produced under its auspices. From various observations, including those based on interaction with IFAC leaders, members, and staff, the PIOB has concluded that IFAC made considerable progress towards this goal even before the creation of the PIOB. Furthermore, close and regular contact over the past year has established a process of visible and continuous independent review that, in the PIOB's view, supports and encourages IFAC's resolve to act in the public interest.

Nevertheless, experience teaches that nothing is ever guaranteed, especially in large and multi-functional organizations that depend on member contributions. Constant energy must be expended to maintain and continuously enhance IFAC's character as a public interest service organization operating with full transparency, quality and consistency. This character must be continuously communicated both inside – to IFAC member bodies and their members

– and outside the organization. The high professionalism observed in many collective actions, decisions and public statements by IFAC is an encouraging sign that not only the leadership but also the membership of the organization share this objective.

National audit regulators and oversight authorities have become a very important institutional feature of the regulatory landscape. This has been the result of many national responses to the same proximate causes that spearheaded the creation of the international PIOB: corporate scandals and audit failures. In some cases these new national authorities wield standard-setting powers while in others they do not.

THE PIOB BELIEVES THAT COOPERATION AMONG NATIONAL OVERSIGHT AUTHORITIES IS ESSENTIAL TO THE ACHIEVEMENT OF GLOBAL CONVERGENCE AND INTERNATIONAL STABILITY.

Such authorities constitute a new reality in the world architecture of regulation. In response to the need for cooperation and exchange of information among national enforcement authorities, these bodies are seriously examining the possibility of forming their own international forum. As noted earlier, the PIOB believes that cooperation among national oversight authorities is essential to the achievement of global convergence and international stability.

The complementary public interest objectives of the PIOB and such authorities also opens up the potential for synergy and a greater overall contribution to the public interest than might be possible by each on its own. It is therefore important to agree on a well-defined form of liaison between the PIOB and national audit regulators that will enable a bidirectional flow of information on activities, research,

practical goals and, eventually, mutually supportive projects. Communication between the PIOB and the audit regulatory community could develop along several axes such as mutual information about progress, exchanges of agendas and sets of priorities and coordination on potential initiatives directed at the quality of transnational audits and the application of global standards to these audits.

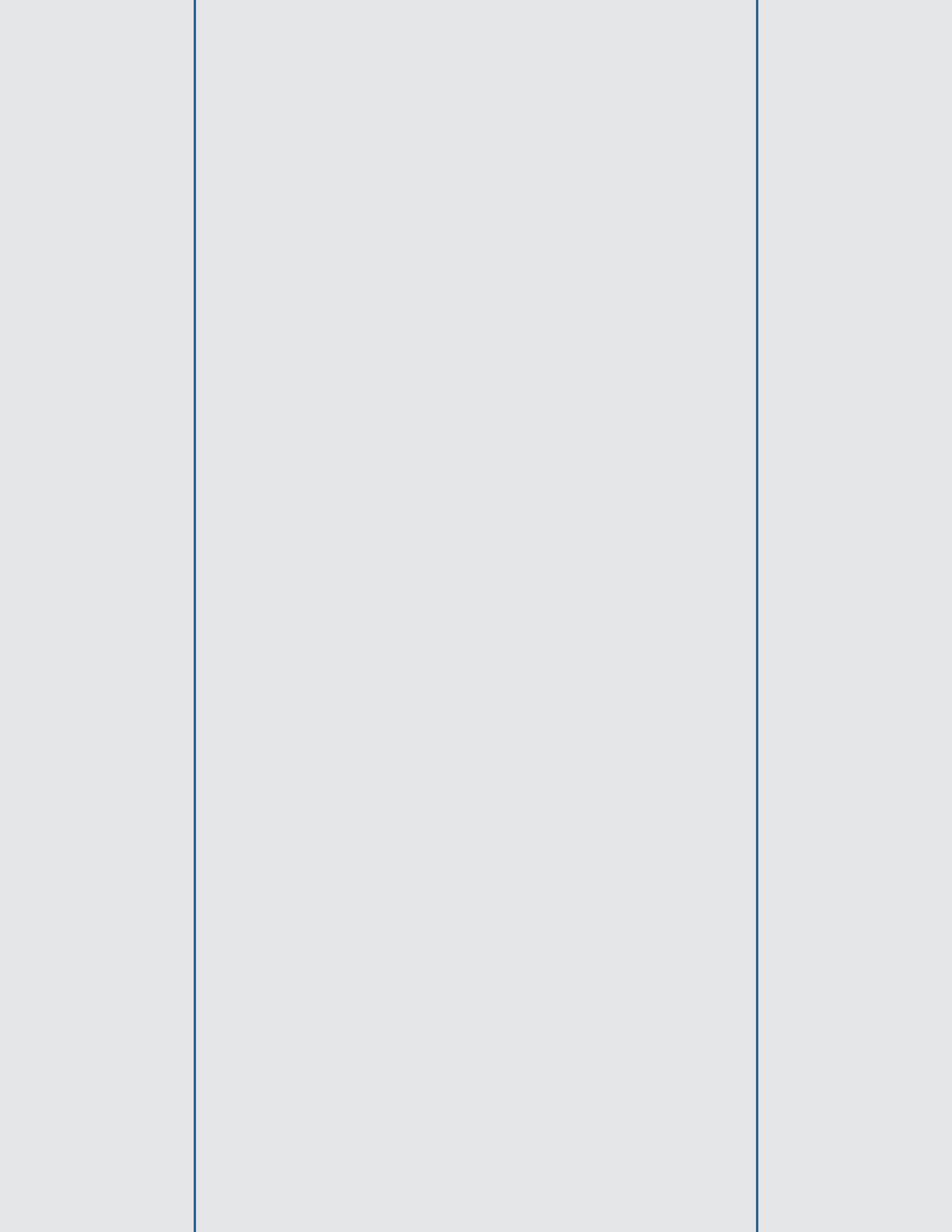
THE PIOB IS DETERMINED TO CONTINUE TO SERVE THE INTERNATIONAL PUBLIC INTEREST AND TO PROVIDE EFFECTIVE OVERSIGHT TO THE PRODUCTION OF HIGH QUALITY INTERNATIONAL STANDARDS.

Having said this, the form and method of providing the input of national oversight authorities into international standard-setting activities is a matter requiring further exploration. When IFAC reforms were agreed, practically none of the present day bodies existed. However, several are already participating as observers at either the standard-setting board or the CAG level, with the result that the present arrangements have become somewhat haphazard

and require further thought. The PIOB would prefer to see a systematic and balanced method for channeling the input of such bodies to international standard-setting at various levels. This forms an important part of the PIOB's future agenda which includes plans for active engagement in consultations with The Monitoring Group, IFAC and its standard-setting boards, the CAGs, and, if established, the "International Forum of Independent Audit Regulators" on this issue.

While over seventy jurisdictions around the world have adopted the International Standards on Auditing, several additional implementations are pending, most notably in the European Union and China. These developments reinforce the need for continuous, credible and effective oversight in relation to all aspects of IFAC's standard-setting activities. They also increase the already large responsibility of the PIOB to exert best efforts to fulfill public expectations.

The PIOB is determined to continue its intensive effort of the past year and to work diligently, with independence of mind and fairness, and to the best of its ability, to serve the international public interest and to provide effective oversight to the production of high quality international standards. ■





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**Public Interest Oversight Board**

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*overseeing international audit, ethics and education standards for the accounting profession*

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