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Improving the Quality of Statutory Audits in the Philippines
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LIST OF ACRONYMS

AARG	ASEAN Audit Regulator's Group
AOCoP	Audit Oversight Community of Practice
AQI	Audit Quality Indicator
BIR	Bureau of Internal Revenue
BOA	Board of Accountancy
BSP	Central Bank
CDA	Cooperative Development Authority
CPA	Certified Public Accountant
CPD	Continuing Professional Development
DoF	Department of Finance
FSF	Financial Sector Forum
IC	Insurance Commission
IFAC	International Federation of Accountants
IFIAR	International Forum of Independent Audit Regulators
MOA	Memorandum of Agreement
OPP	Operational Policies and Procedures
PHP	Philippines Peso
PICPA	Philippines Institute of Certified Public Accountants
PIE	Public Interest Entity
PMO	Project Management Office
POB	Public Oversight Body
POS	Public Oversight
PRC	Professional Regulations Commission
PSA	Philippine Standards of Auditing
PSQC	Philippine Standards for Quality Control
QA	Quality Assurance
QAR	Quality Assurance Review
QARD	Quality Assurance Review Department
QAREC	Quality Assurance Review Executive Committee
QARP	Quality Assurance Review Program
RRR	Revised Rules and Regulations
SEC	Securities and Exchange Commission
SMOs	Statement of Membership Obligations

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EXECUTIVE SUMMARY

Since 2003, the Philippines has been striving to implement reforms aimed at improving audit quality. Oversight of the audit profession is a key control over the financial reporting architecture of a country's private sector. A Quality Assurance Review system over audit practitioners is a subset of oversight which serves as a key monitoring control over the integrity of financial reporting. Without such a control in place, little reliance is placed by investors, creditors, and other users on financial information, and consequently investing and lending activities are constrained and private sector growth is hindered.

In keeping with the country's strategic priority of boosting private sector development by improving the investment climate for firms of all sizes, including greater access to finance, legislation was enacted to support the objective of increasing the integrity of private sector financial reporting through improved audit quality. Accordingly, the Board of Accountancy was mandated with the power to conduct oversight into the quality of audits of financial statements through a review of the quality control measures instituted by auditors in order to ensure compliance with the accounting and auditing standards and practices. In 2010, a Quality Assurance Review Program was developed in fulfillment of this objective and mandated upon auditors, however rollout ceased due to a court injunction filed by a group of practitioners. Efforts have been made to move forward, including stakeholder awareness workshops, mediation with petitioners, and rollout of a Voluntary Quality Assurance Review Program. However, the injunction remains in place and, accordingly, implementation of the mandated Quality Assurance Review Program may not move forward.

In the absence of a comprehensive system of public oversight including audit quality assurance in the Philippines, regulators have taken alternative measures in an attempt to gain some level of assurance over audit quality. Although a level of collaboration among regulators exists, several separate initiatives have been undertaken and most recently, a question of jurisdictional authority for audit oversight has arisen among the group. A reform of the legal framework is needed in order to achieve the establishment of a professional and effective legal regulatory function. The rationalization of statutory audit thresholds is a key element of the needed reform measures. Under the present structure, there are simply not enough auditors in the country to complete the required number of statutory audits in accordance with generally accepted auditing standards. The result is a degeneration in audit quality which provides little assurance on the integrity of financial reporting.

Several concrete steps should be taken in order to effectively move forward with the rollout of a comprehensive system of public oversight including audit quality assurance in the Philippines. These include (1) reforming the legal framework to establish an effective audit oversight system with sufficient legal power and authority (2) rationalizing the statutory audit threshold to minimize the conditions contributing to low quality audits, (3) building

support among key stakeholder groups by properly addressing their concerns to the extent possible, (4) ensuring coordination of efforts among regulators to eliminate gaps and overlaps and foster collaboration among the group, and (5) establishing a dedicated Project Management Office to oversee the rollout of a Quality Assurance Review Program over audit practitioners. Each of these steps is discussed in more detail in Section 3 of the report.

COUNTRY CONTEXT

The Philippines is one of the most dynamic economies in the East Asia region, with sound economic fundamentals and a globally recognized competitive workforce. Growth in the Philippines has been on average above 5% in the past decade, significantly higher than in previous decades.

For the Philippines, a country with a population of 91 million, a GDP of USD 285 billion, market capitalization of approximately USD 262 billion¹, and one of the fastest growing economies in the world, a comprehensive system of audit oversight including a rigorous audit quality assurance mechanism is a vital component of the financial reporting infrastructure of the country's private sector. The country's strategic priorities include promoting economic policy reform for inclusive growth, boosting private sector development by improving the investment climate for firms of all sizes, including greater access to finance, and increasing productivity and job creation. In keeping with this strategic priority, legislation was enacted in the Philippines to support the objective of increasing the integrity of private sector financial reporting through improved audit quality.

The Philippines is a member of the ASEAN Economic Community and is represented in the International Federation of Accountants (IFAC) through the Philippines Institute of Certified Public Accountants (PICPA). Philippine Financial Reporting Standards are based on International Financial reporting Standards and likewise, Philippine Standards on Auditing are based on International Standards on Auditing. The Philippines has been participating in the joint initiative of the World Bank and the International Monetary Fund (IMF) to prepare Reports on the Observance of Standards and Codes, which is an assessment focusing on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting for private sector entities. The World Bank completed its latest Report on Standards and Codes over Accounting and Auditing Practices in the Philippines in 2006. Among other recommendations, the report highlighted the need for a monitoring and enforcement mechanism for quality control review over audits as well as rationalization of the statutory audit threshold.

¹ 2014, World Bank <http://data.worldbank.org/country/philippines>

BASIS FOR A SYSTEM OF PUBLIC OVERSIGHT INCLUDING AUDIT QUALITY ASSURANCE

There are many benefits of having public oversight of the audit profession. Audit oversight includes approval of audit firms and individual auditors, approval of auditing standards, setting Continuing Professional Development requirements, implementing an assurance mechanism over the quality of audits, conducting investigations, and imposing sanctions. An increasing number of countries, including most leading economies, have established audit quality assurance mechanisms, having concluded that the benefits exceed the costs. Implementing a sound system of public audit oversight assists in the development of the profession and enhances the reliability and credibility of financial reporting, thereby encouraging more investment and lending which contributes to private sector growth and development.

The requirement for an audit quality assurance review (QAR) system to be implemented in the Philippines arises from:

- The Accountancy Law, RA 9828;
- A requirement by the international accounting profession (IFAC);
- ASEAN Mutual Recognition Agreement requirements over the accounting profession.

The Accountancy Law and its Implementing Regulations

The Accountancy Law (RA9298) was enacted with the objective of supervising, controlling and regulating the practice of accountancy in the Philippines (Sec. 3). The law gives the power to the Board of Accountancy (BOA) to supervise the registration, licensure and practice of accountancy in the Philippines (Sec. 9c). The law also gives the BOA the power to conduct an oversight of the quality of audits of financial statements through a review of the quality control measures instituted by auditors in order to ensure compliance with the accounting and auditing standards and practices.

The requirements for audit quality control at the firm and engagement levels are contained in two auditing standards –

- Philippine Standards of Auditing (PSA) No. 220, Quality Control for an Audit of Financial Statements. This standard deals with specific responsibilities of personnel of CPA practitioners regarding quality control procedures for an audit of financial statements.
- Philippine Standards for Quality Control (PSQC) No. 1, Quality Control for Firms that Perform Audits and Review of Financial Statements, and Other Assurance and Related Services Engagements. This standard deals with the CPA practitioners' obligation to

establish a system of quality control designed to provide them with reasonable assurance that (1) the firm and its personnel comply with professional standards and regulatory and legal requirements, and (2) the auditors' reports issued by the firm or engagement partners are appropriate in the circumstances.

International Professional Requirements of IFAC

IFAC has issued seven (7) Statement of Membership Obligations (SMOs), which are meant to assist members like PICPA in ensuring high quality performance by professional accountants. They cover the member body's obligations to support the work of IFAC, the work of the International Accounting Standards Board, and obligations regarding quality assurance, investigations and discipline.

SMO 1 covers the subject Quality Assurance. This subject is addressed at three levels - the engagement level, the firm level and the member body level. For specific engagements, PSA 220 is relevant. For firm's responsibilities, PSQC 1 is relevant. For member body's responsibilities, SMO 1 is relevant.

SMO 1 requires a member body to ensure a mandatory quality assurance review program is in place for those of its members performing statutory audits. Where government, regulators or other appointed authorities perform any of the quality control functions, member bodies should (a) use their best efforts to encourage those responsible for those functions to follow the SMO in implementing them, and (b) assist them in that implementation where appropriate. Additionally, government may delegate the responsibility for quality assurance to PICPA even if this may be mandated to be done by other regulatory authorities.

ASEAN Mutual Recognition Agreement Requirements over the Accounting Profession

The ASEAN Mutual recognition Agreement is a multilateral arrangement among ASEAN countries or bilateral arrangement between two ASEAN countries to enable professionals registered in its signatory countries to be equally recognized in another signatory country. For accountants, the mutual recognition framework covers education, licenses, demonstration of competency, experience, and compliance with IFAC standards and guidelines. As such, the professional competencies and qualifications threshold for the practice of accountancy in ASEAN Member States shall be established, maintained and

upheld according to the IFAC standards taking into consideration the Domestic Regulations of each ASEAN Member State.²

BACKGROUND AND CURRENT STATUS

In response to latest Report on Standards and Codes over Accounting and Auditing Practices in the Philippines (2006), a strategic plan was issued in 2009 to provide for the adoption and implementation of a QAR program for auditing firms in the Philippines, as well as a study on QAR in the Philippines which included the following recommendations:

- Set up an independent oversight body to coordinate the QAR program and to provide appropriate transparency in carrying out the QAR function;
- Set up QAR teams of full time qualified professionals who report directly to this oversight body
- Place the QAR function under an organization that would be able to recruit qualified personnel with commensurate compensation;
- Design quality assurance procedures appropriate to audit firms to be reviewed.

In response to this study, a Quality Assurance Review Department (QARD) and Quality Assurance Review Executive Committee (QAREC) were created by the BOA in 2009 and approved by the Professional Regulation Commission. The QAREC was granted full power and authority to set policies and supervise the operations of the QARD, which would carry out the activities of the QARP. This was followed by the creation of a Council for Accreditation and Quality Control of Practicing CPAs (“Council”) under a Memorandum of Agreement (MOA) executed on August 12, 2009 by BOA, Securities and Exchange Commission (SEC), the Central Bank (BSP) and the Insurance Commission (IC).

The Council was created to act as a technical working group of the Financial Sector Forum (FSF) and its member-agencies, to provide advisory assistance in the areas of accreditation/selection of external auditors and adherence to quality control standards in the conduct of audit. The primary objective of the Council is to promote the reliability and integrity of financial statements of entities under regulation and supervision of FSF member-agencies. The Council serves as a forum for its members to discuss policy issues on quality control standards applicable to accredited/selected external auditors, coordinate among regulatory agencies the accreditation requirements for auditors, and otherwise share information. The Council is intended to meet quarterly, however in practice meetings occur less frequently.

A further MOA was executed between BOA and PICPA in 2010, providing that PICPA “provide the necessary infrastructure, facilities and mechanisms by which the QARD can

² http://asean.org/?static_post=asean-mutual-recognition-arrangement-framework-on-accountancy-services

operate efficiently and independently.” Professional Regulations Commission (PRC)-BOA Resolution No. 23, Series of 2010 for the adoption of QARP was published in the Philippines Official Gazette on April 7, 2010. A handbook on QARP was published in 2010 and distributed for free to all public practitioners and a number of information dissemination conferences were conducted across the country, jointly by BOA and PICPA. The collection of fees from practitioners for the QARP was initiated by PICPA.

The rollout of the QARP ceased in 2011, when a group of practitioners filed a case with the Regional Trial Court of Caloocan City. The group was able to secure a temporary restraining order (TRO) against the implementation of PRC-BOA Resolution No.23, citing the QAR fees as being overly onerous. PRC and BOA as respondents are represented in court by the Solicitor General of the Philippines. The Regional Trial Court dismissed the case, however the petitioners filed a Motion for Reconsideration. The case is still pending with the court. Consequently, the QAREC and QARD are no longer in place.

As an alternative measure, the PICPA Committee on QA spearheaded a Voluntary QAR Program (VQARP) in 2013 for practitioners willing to submit their practices to a quality review. Two modules have been developed to prepare the practitioners and examiners for reviews under the VQARP. To date, a limited number of practitioners (two) have participated in the program.

A number of steps have been taken to mediate with the petitioners and in July 2014, an agreement was reached (the “Cebu Accord”) whereby BOA agreed to revise the QARP such that (1) the program will be developmental rather than punitive in nature, (2) fees for the program shall be equitable in nature, (3) for an initial period of three years the coverage of the program shall apply only to auditors of public interest entities (PIEs), after which the coverage shall apply to all practitioners (4) existing QARP modules/templates shall be updated, and (5) care shall be taken in the sourcing of reviewers such that the risk of “pirating” clients shall be minimized. In response to this agreement, BOA issued Revised Rules and Regulations (RRR) for the Conduct of Oversight into the Quality of Audits of Financial Statements and Operations of CPA Practitioners, which were adopted via BOA Resolution 2015-244 and became effective in March 2016. The RRR provided for a three-year deferral of the QARP for audit practitioners and partnerships which conduct no audits of PIEs. However, the RRR provides no provision for development; made no changes to the fee structure applicable to audit practitioners and partnerships, but instead mandated additional fees to be imposed on audit clients; and made no provisions that address the “pirating of clients”. Another provision of the RRR is to eliminate the requirement for firms to be subject to the QARP, such that only individual practitioners and partnerships are subject to review.

A number of other measures have been initiated by BOA in the absence of a QARP in the Philippines. These are summarized in Table 1.

In a separate initiative, the SEC has proposed amendments to its Rule 68, governing accreditation of auditors of PIEs. The proposed amendment introduces the SEC Oversight Assurance Review (SOAR) Program under which accredited auditors of PIEs will be subject to QAR by the SEC. The details of the SOAR program are not publicly available, however the SEC describes this as a measure which reviews compliance with IAASB standards at both the engagement level (ISA 220) and the firm level (ISQC 1), thereby providing QA over auditors of publicly listed entities. USAID is providing technical assistance to draft the guidelines, manual and other materials for the SOAR program. The SEC has received an appropriation in the 2016 GAA to accommodate for 13 additional staff to operate the program, however it is not expected that the salary scale will be commensurate with “Big 4” rates necessary to attract an appropriate level of highly qualified staff.

The SEC claims the authority for QA of SEC accredited auditors under Corporation Code of the Philippines, Section 141, *Annual report of corporations*, which states that “Every corporation, domestic or foreign, lawfully doing business in the Philippines shall submit to the Securities and Exchange Commission an annual report of its operations, together with a financial statement of its assets and liabilities, certified by any independent certified public accountant in appropriate cases, covering the preceding fiscal year **and such other requirements as the Securities and Exchange Commission may require.**” Section 141 only specifically refers to certified financial statements of companies, however, and does not specifically refer to auditor oversight by the SEC. Nor does this Section include language regarding objectives, operations and standards to be followed, such as regulating power and corrective measurements to be applied, which normally would be included in such a Section concerning a legal regulator.

A representative from the SEC has been regularly participating in the regional ASEAN Audit Regulator’s Group (AARG) meetings as an observer. AARG has expressed an interest in assisting the Philippines in establishing a system of public oversight.

With no independent system of public oversight in place, the Philippines is not a member of International Forum of Independent Audit Regulators (IFIAR) or (AARG), PICPA does not meet the membership requirements of IFAC, and the Philippines does not meet the ASEAN mutual recognition criteria over accountants.

Table 1: BOA initiatives

- Encouragement of practitioners to participate in VQAR until such time that they are covered within the scope of the QARP;
- Required accreditation of all audit partners, CPA staff members, partnerships, and firms pursuant to BOA Res. 295-2015 in which CPD requirements will be validated;
- Office verification of CPAs in public practice required pursuant to BOA Res. 5-2016. This initiative requires for the initial application, renewal of accreditation, or current accreditation of CPAs in public practice (1) an office visit by a BOA deputy during which accomplishment of a Quality Assurance Checklist will take place, and (2) submission of Certificate of PICPA Membership in Good Standing. The QA checklist collects information such as partner: staff ratio, source of revenue by engagement type, available resource tools, description of QA manual, and CPD history;
- Submission of engagement reports by all CPA firms, partnerships and sole practitioners each semester required pursuant to BOA Res. 2-2016, which states that the information captured in the report is relevant in the implementation of the QARP. The Engagement Report contains information on the specified services of (1) financial auditing service, (2) accounting review services, and (3) compilation of financial statement services. Information such as engagement fee, client industry and location, total engagement hours, audit opinion rendered and number of years as a client are captured in the report;
- Development of a Risk Based Red Flag system over audit reports in which benchmarks will be analyzed to determine high risk engagements. The information collected in the engagement reports (BOA Res. 2-2016) will provide the data for the system;
- Proposed increase of statutory audit threshold mandated by the Bureau of Internal Revenue (BIR) from quarterly sales of 150,000 PHP (approximately USD 13,000 annually) to 2.5M PHP (approximately USD 222,000 annually). The proposal introduces the requirement for statutory compilations and reviews for levels of gross receipts below the audit threshold;
- Proposed amendment of Accountancy Law. This proposal is being considered by the BOA to address concerns that, under the current law (1) BOA as a government entity would not have the ability to hire and pay market rates for qualified personnel to act as reviewers under the QARP, (2) BOA does not have any budget appropriations at all, and (3) BOA, as a government entity with politically appointed members with no restriction on current involvement in public practice, may not have, per se, the level of transparency or independence for administration of such a program as required by international standards. The BOA is initiating a series of stakeholder consultations to gather input on a proposed amendment to the Accountancy Law.

MOVING FORWARD

Faced with the challenges that have been presented, the commitment demonstrated by the various regulators in establishing a Quality Assurance system over the audit profession in the Philippines is commendable. However, many factors remain in play at this juncture and the resolution of these factors will have a significant impact on the structure of the system of audit oversight. Despite the various moving parts, certain concrete steps should be taken in order to move forward and accomplish effective realization of a mechanism for audit quality assurance. These steps are outlined below.

1. Legal Framework for Audit Oversight

Three key preconditions for successful public oversight of the auditing profession include an adequate legal framework and authority, adequate staffing, and adequate and stable funding. Each of these is discussed further below. The primary legislation addressing audit oversight did not address the funding structure of the oversight entity and any related fees applicable to practitioners to support a quality assurance mechanism over the audit profession. This omission provided a window of opportunity for the profession to prevent the rollout of the mandated QARP. The injunction filed by practitioners highlights the need for reform of the legal framework for audit oversight. Given the importance of the issues raised in the Cebu Accord, they should be addressed in primary legislation rather than through negotiation.

The Accountancy Law (RA 9298, Sec. 3) gives the power and authority to supervise the registration, licensure and practice of accountancy in very clear and specific wording to the BOA. This law also gives the BOA the power and authority to conduct the legal oversight role regarding the quality of audits of financial statements. However, the SEC also claims, with reference to CCP Section 141, to have the legal authority to perform quality assurance of auditors of listed companies. This ambiguity in jurisdictional authority over audit quality assurance creates confusion on all sides, and results in disjointed efforts as regulators work independently to establish systems of their own. Some regulators cite the need for a wholly independent oversight body to be created. Others expressed preference for a dual structure, in which oversight of auditors of publicly listed entities would be executed by the SEC, while the remaining auditors would be subject to a more developmental program.

Resolution of the ambiguity in jurisdictional authority must be attained in order to achieve the establishment of a professional and effective legal regulatory function and reduce the risks of misunderstandings, overlaps, and gaps in the system. Clearly addressing the issue of jurisdictional authority through legislation will clarify the issue for all parties involved.

The Government may consider the formulation of a working group to propose key aspects of a new legal framework such that the chances of successful implementation are increased. Such a working group should ideally comprise representatives from the various stakeholder groups, including a representative from each of the regulatory agencies. A DoF appointed Chairperson could serve to moderate discussions among the group, gain consensus, and ensure coordination of efforts among the regulators. The working group might consider the overall form, structure, scope, coverage and funding of a proposed oversight system and develop a high-level plan for its establishment, considering any necessary budgetary allocations and required amendments to legislation.

The BOA has proposed an update to the Accountancy Law to realign legislation with international best practices and promote compliance with international standards, and has initiated consultations with practitioners to solicit input into the process. In particular, the BOA expressed concerns regarding the situation of the audit oversight function and difficulties in implementing the QARP under the current structure.

If an amendment to the Accountancy Law is pursued, the process should be an inclusive and collaborative process which solicits input from all stakeholder groups, including practitioners, regulators, educators, industry, and government agencies. It is recommended that a working group including representatives from key stakeholder groups be formed to drive the process. The working group should be led by a high-level government official with sufficient decision-making authority to moderate the process. Input could be solicited from stakeholders through surveys, request for public comment, stakeholder forums or other means.

In considering the situation of the oversight authority, **three key preconditions for successful public oversight** of the auditing profession should be carefully considered in establishing such a body:

- **Adequate legal framework and authority to supervise the profession:** The public oversight body (POB) should have sufficient legal authority and specific legal powers to oversee the audit profession to help assure audit quality, particularly for the highest risk audits. The framework should ensure that the oversight body is fully independent from the profession, transparent, and acts in the public interest.
- **Adequate staffing:** If the POB is to conduct audit quality assurance inspections and impose discipline for auditors of public interest entities (PIEs), it must be staffed with sophisticated and experienced personnel with the required expertise to conduct audit quality assurance reviews of banks, insurance companies, and other specialized entities. For example, inspectors cannot meaningfully review the audits and quality assurance functions of “Big Four” audit firms unless they have substantial prior experience in similar “international network” firms or their equivalents performing complex modern audits, with well-developed internal audit quality assurance systems.

Similarly, the POB must be able to attract members with sufficient expertise and interest to guide and develop the body.

- **Adequate and stable funding and the ability to provide competitive compensation to audit inspectors:** To adequately address the risk of PIE audits, the POB must be able to pay salaries sufficient to attract and retain inspectors with substantial audit experience (a minimum of about six years and attainment of senior manager level) as auditors with international network firms or their equivalents. The commission may be able to offer some compensating benefits (such as more reasonable working hours) to allow for somewhat lower pay scales than in private audit practice, but salaries cannot be significantly lower that quality inspections becomes an unattractive career choice for talented and experienced auditors. Ordinary civil service pay scales are often too low to attract and retain a sufficient number of inspectors with the right experience, competence, and motivation. Therefore, to be adequately funded, the public oversight system must have both a sufficient and stable source of funds and the ability to use them to pay competitive compensation to audit inspectors.

Under the present structure, the oversight body (BOA) has no staffing and no funding. Therefore, two out the three preconditions are not met. A proposed amendment to the law would provide an opportunity to address this issue, and also address the issue of independence with respect to the oversight body³. Additionally, it would provide an opportunity to clarify any perceived ambiguity with respect to the responsibility for audit quality oversight.⁴ The law must be clear on the authority for public oversight, however this does not preclude a division of roles and responsibilities whereby the POB delegates responsibility for PIE or non-PIE auditors to a separate entity which is overseen by the POB. A further discussion of a proposed division of roles and responsibilities in the Philippines is explored in Section 3 below.

The Oversight Body should be structured based on international best practices and standards. IFIAR, the International Forum of Independent Audit Regulators, has sought to capture elements of good practice in audit oversight through their membership and through the IFIAR Core Principles for Audit Regulators. IFIAR has approximately 40 Members including US, Japan and the majority of EU states. One driver for international norms is that other countries will try to decide whether they can rely to some degree on the POS of another country. This reliance has the goal of reducing the need to duplicate work in

³ RA 9298 does not address independence from the profession with respect to the composition of the Board of Accountancy, the current oversight body.

⁴ The current Accountancy Law, RA 9828 explicitly gives the BOA the power to conduct an oversight into the quality of audits of financial statements through a review of the quality control measures instituted by auditors in order to ensure compliance with the accounting and auditing standards and practices. However, the authority claimed by the SEC under Sec. 141 of the Corporation Code of the Philippines is a duplication of this authority as applicable to auditors of PIEs.

relation to auditors from country “A” who audit companies listed or established in country “B”.

Considerations in the establishment of effective oversight structures and IFIAR Core Principles are included in the Appendixes A and B.

2. Statutory Audit Threshold

Statutory audit thresholds should be considered in the context of small and micro-sized entities. Statutory audit thresholds that apply to entities with very low levels of sales require small and micro entities to incur significant time and expense to produce audited financial statements under the required framework. This results in not only a higher cost of doing business, but also often produces low quality financial information and sub-standard audit assurance due to the inability of these entities to afford adequate quality of services.

Especially if there is little use of or reliance on their financial statements by outsiders, it is highly questionable whether the benefits of requiring these small enterprises to be audited outweigh the costs. In addition, if the audit threshold is so low that it creates a market demand for auditors who provide audit reports needed for compliance at extremely low cost but perform no genuine auditing, then the overly broad audit requirement may help discredit auditing and the audit profession in the eyes of the public.

The 2009 ROSC highlighted the need to rationalize the statutory audit threshold in the Philippines. This recommendation has not been addressed. The rationalization of the statutory audit threshold should be based on public interest and cost versus benefit considerations and a proper audit exemption regime put in place. Presently, no minimum audit threshold applies for banks, insurance companies, and cooperatives. The SEC mandates an audit for annual revenue over approximately USD 2,000, while statutory audits imposed by the Bureau of Internal Revenue apply to entities with annual revenue over approximately USD 13,000. **This results in approximately 1.5 million entities subject to audit in the Philippines, with only 6,149 registered auditors of which 5,500 operate as sole practitioners.**⁵ On average, this results in 243 audits performed annually by each registered auditor in the Philippines. This statistic is not attainable, and only serves to generate a market for “audit stampers” who sell an audit report rather than provide an audit service.

Several countries prohibit the practice of auditing by sole practitioners due to the limited resources of these practitioners and the difficulties in applying a firm level system of audit quality which requires a level of internal review. In the Philippines, approximately 90% of auditors are registered as sole practitioners. This is another indicator of a low level of compliance with

⁵ As reported by the Board of Accountancy based on industry information and CPA registration data as of April 2016.

audit standards. To address this issue, a system of sole practitioner networks may be introduced whereby these practitioners cooperate with one another in the application of firm level audit quality measures.

Table 2: Statutory Audit Thresholds applied by Regulators in the Philippines

Regulator	Audited Entity	Capital (PHP)	Assets (PHP)	Annual revenue (PHP) *	Capital (USD) **	Assets (USD) **	Annual revenue (USD) **
Bureau of Internal Revenue	Corporations, companies, partnerships, or persons			600,000			13,043
Securities and Exchange Commission	Stock corporations	50,000			1,087		
	Non-stock corporations		500,000	100,000		10,870	2,174
	Branch offices of stock foreign corporations	1,000,000			21,739		
	Branch offices of non-stock corporations		1,000,000			21,739	
	Foreign corporations			1,000,000			21,739
Central Bank	All banks and supervised financial institutions	No minimum			No minimum		
Insurance Commission	All insurance companies and supervised entities	No minimum			No minimum		
Cooperative Development Authority	All cooperatives	No minimum			No minimum		

* The BIR statutory audit threshold is based on quarterly gross receipts of PHP 150,000.

** A foreign exchange rate of .46 is applied to arrive at the approximate USD equivalent.

Alternative levels of assurance for small and micro-sized entities should also be considered, including compilations which provide no assurance and limited assurance reviews, as well as alternative reporting structures. This would allow small and medium sized practitioners to provide appropriate levels of service to their clients, and reduce the market for “audit stampers.” For example, perhaps compiled financial statements prepared on a tax reporting basis may be considered appropriate for family-owned micro-sized entities with no creditors, or reviewed financial statements providing limited assurance appropriate for small entities with limited debt. In order to establish a relevant financial reporting framework, potential users of these financial statements should be identified and their financial reporting needs assessed.

Consideration should also be given to align audit thresholds among regulators. In the Philippines, the BIR mandates the statutory audit threshold of quarterly sales of 150,000 PHP (2.5 million under the proposed amendment), while the audit threshold for the SEC sets the audit threshold at gross annual receipts of 100,000 PHP or more or total assets of 500,000 PHP or more for non-stock corporations. Various audit thresholds are applied by the SEC based on the type of audited entity. These are listed in Table 2.

3. Stakeholder Support

Broad stakeholder support is important in implementing a system of public oversight over statutory audit. Key stakeholder groups such as regulators, government, and practitioners should all be consulted for input into the development of such a system, and given an opportunity to express their needs and concerns. Issues raised by each of these stakeholder groups in the Philippines are discussed below. An effective system of public oversight will take into account the needs of stakeholders and serve to strengthen the technical capability of the profession, increase reliance on audited financial statements, and eliminate overlaps among regulators, thereby increasing the overall integrity of financial reporting on which a highly functioning financial market and broader economy may be based.

3.1. Regulators

Regulators in the Philippines agree that a system of oversight would be beneficial in that it would increase the reliability of audited financial statements and decrease the burden of supervisory activities. Each of the regulators currently has its own auditor accreditation process in place, although some level of mutual recognition exists across the group. The auditor accreditation process allows some level of scrutiny over the auditors of supervised entities prior to engagement of the auditor. At present, no formal monitoring systems over auditors exist, however as previously discussed, the SEC is in the process of developing an audit quality review system pursuant to Rule 68.

The regulators emphasize that such a system should focus on the development of the profession, and serve as a vehicle to ensure that even small practitioners are up to date with current standards. Regulators cite lack of familiarity with industry specific accounting standards and prudential reporting requirements and prevalence of substandard audits of small and medium practitioners as a concern. They note that not all supervised entities will be captured by the proposed SEC oversight system, and that its scope will be limited to listed entities. The group expressed some level of disagreement on the form and structure of the proposed oversight system and the legal authority for oversight, citing independence from the profession and freedom from conflicts of interests as key attributes of an oversight body. While some regulators cite the need for a wholly independent oversight body to be created, others expressed preference for a dual structure, in which oversight of auditors of publicly listed entities would be executed by the SEC, while the remaining auditors of public interest entities and non-public interest entities would be subject to a more developmental program.

3.2. Government

The Department of Finance (DoF) is the government's steward of sound fiscal policy and has responsibility over financial market development, however it has had little involvement in the establishment of a system of public oversight which is a key monitoring control over financial reporting infrastructure. For such a system to be effective, the process must be endorsed and led by the highest levels of government.

With the ongoing change in government in the Philippines, a new Secretary of Finance will be appointed effective July 2016. The Secretary may consider overseeing the formulation the aforementioned working group to investigate the issue of over the legal framework for audit oversight and recommend an appropriate structure.

3.3. Practitioners

While larger audit firms in the Philippines have voiced their support for a system of public oversight, small and medium sized practitioners remain reluctant and express concerns regarding a threat to their livelihood. The proposed increase in the statutory audit threshold and introduction of alternate levels of service will be a step in addressing this concern, if these measures are passed.

However, it should be noted that in many countries, the introduction of public oversight has driven some small and medium practitioners with substandard performance from the audit market or forced them to combine and consolidate into larger firms that are more able to implement adequate quality control systems. Such winnowing of the audit profession can be a salutary development for improving audit quality and public perception of the profession. So while legitimate concerns of small and medium practitioners should be

addressed, a rigorous and meaningful public oversight system may not necessarily be welcomed by all current practitioners, nor should that be expected.

The QARP mandated by BOA Resolution 23 may not take full force and effect until the TRO against the implementation of Professional Regulation Commission (PRC) BOA Resolution No.23 filed in the Court of Caloocan City is lifted. Although BOA addressed the concerns of the petitioners in a separate agreement, the RRR does not reflect these concerns or the terms agreed to. The only concession in the RRR is to provide a three-year deferral in the application of the program to non-PIE auditors. The RRR in fact impose additional fees on audit clients. These fees may be misinterpreted by smaller and less sophisticated entities, who may believe these to be audit fees, and in any event may reduce their available resources to pay for auditing. As a result, auditors may receive less in fees, which would likely contribute to a decrease in audit rigor and quality to accommodate for the lower fees. The provisions of the RRR should be re-evaluated with this risk in mind.

Further measures that may be taken to build support and raise awareness of the benefits for an effective system of audit quality assurance include initiating a communications campaign and providing assistance to firms in developing effective quality control measures within the firm. This may include:

- A series of stakeholder workshops and information sessions to build awareness of the benefits of an effective system of audit quality assurance;
- Communicating the risks involved in performing statutory audits;
- Offering CPD programs on audit quality control;
- Publishing explanatory documents about QC and QA;
- Providing guidelines for conducting effective internal inspection systems.

The establishment of the VQAR program offered by PICPA provides an ideal opportunity for firms to obtain an independent, confidential assessment of their QC policies and procedures until such time that a QARP is put in place. However, since its rollout in 2014 only two firms have subjected themselves to review under the VQAR. In order to attract firms, PICPA may consider offering CPD credit for participation in the program. As an additional measure, participating firms may be invited to share the general results of the VQAR and any benefits they see from the process.

4. Coordination of Efforts among Regulators

Regardless of the legal framework for audit oversight, the coordination of efforts among all parties is critical to the establishment of a cohesive system of audit oversight which will make efficient use of available resources and eliminate overlaps. The QAR initiatives among the various regulators and mandated audit thresholds are two areas where coordination of efforts could have a significant impact in improving the functionality of the oversight system and eliminate overlaps and provides an opportunity for all relevant stakeholders to support this important agenda for action.⁶

For example, the SEC is well placed to perform audit oversight of PIEs through the rollout of its SOAR program and budget allocation for additional staff, although the salary structure should be evaluated to determine whether appropriately qualified staff may be attracted and retained for the positions. PICPA, as implementing partner of the QARP under the BOA, has materials from the original QARP circa 2010 which must be updated, and some limited budget consisting of fees collected during the original rollout of the program. In this scenario, it may make best use of both resources to allocate the operations of the QARP such that oversight of PIE auditors falls under the scope of the SEC, while oversight of non-PIE auditors falls under the responsibility of PICPA. In this case, legal authority for oversight may rest with two different agencies, or responsibility may be allocated and overseen by the legally mandated entity which would have ultimate authority for oversight.

The Council for Accreditation and Quality Control of Practicing CPAs provides a forum for the respective regulators to discuss policy issues on quality control standards applicable to auditors, consult on proposed resolutions concerning audit quality assurance, coordinate efforts, and otherwise share information. The Council could and should facilitate an effective and efficient QAR system, thereby accommodating as much as possible the relevant needs and requests of the various stakeholders in this respect, taking into account their own oversight roles and responsibilities, and facilitate communication and cooperation between the agencies. This group does not meet as regularly as intended, however, and not all members participate in the meetings. Regular meetings with compulsory participation and a standard agenda and official minutes of the meeting is recommended.

Council meetings also provide an opportunity to disseminate information from meetings of the ASEAN Audit Regulatory Group (AARG). Participation in AARG meetings provide a forum for regulators within the ASEAN region to discuss common challenges and exchange ideas and information, and engage in capacity building activities. This may be seen as helpful

⁶ IFAC SMO 1 notes that “in some jurisdictions, QAR systems for firms performing audits of listed or other PIEs are operated by an external authority, while systems for firms performing all other audits are operated by IFAC member bodies. In such cases, and for efficiency reasons, IFAC member bodies shall give due consideration to QA systems operated by the other appointed authority to ensure there is no undue overlap between the systems.

preparation for eventual IFIAR membership. The Chairman of the Council has been attending the meetings of the AARG as Philippines representative, however information from the meetings has not been disseminated to the BOA, who has the explicit authority for oversight of auditors. This communication could be facilitated through attendance at Council meetings by all members.

Practitioners have cited concerns relating to coordination of the oversight agencies with respect to accreditation of auditors. Each oversight agency has its own accreditation of CPA practitioners which serve as auditors of entities falling within their regulatory supervision, although some degree of mutual recognition exists. At a minimum, a CPA conducting an audit on the financial statements of companies and business entities is required to be accredited by both the BOA and BIR,. Specific entities require additional accreditation of auditors based on the administering government agency over the business or industry such as the SEC (for publicly listed entities) the Central Bank (for bank and non-bank financial intermediaries), the Cooperative Development Authority (for cooperatives registered under the CDA), and the Insurance Commission (for corporations registered under the IC such as insurance brokers, insurance adjusters and insurance companies). The practice of multiple accreditation requirements for auditors places a burden on practitioners who must therefore comply with a number of accreditation requirements and administrative processes. However, although consistency is important, auditors of public interest entities must be held to a high standard.

5. Establish a dedicated Project Management Office (PMO)

Once the legal framework for audit oversight in the Philippines is resolved, it is recommended to establish a dedicated and properly funded Project Management Office (PMO) for the set up and implementation of QARP in the Philippines. This activity is an undertaking that requires dedicated staff and commitment. A project manager should be appointed and representatives of key stakeholders (e.g. SEC, BSP, IC, PICPA) should be included on the team. The manager of the project team might possibly be the intended QARD Head. Recommended actions of the PMO are included below.

- The first priority of the project team should be to draw up the QARP Design and Implementation Plan. This plan should cover organizational aspects of the program, independence aspects, funding, sourcing of reviewers and other employees, scope of QAR, transitional considerations during the first three years of the program (including an evaluation at the end of this transition period), time lines, etc. The PMO should also identify long(er) and short term goals of the program.
- As an interim measure, the PMO may wish to encourage the SEC to continue with its efforts to perform inspections of listed entities (SOAR), and collaborate with BOA to sanction auditors as necessary. Other PIEs and non-PIEs could be part of the VQARP in

the interim with proper incentives for involvement (i.e. exemption from 1st cycle in a new system etc.). The PMO could also “oversee” this and aim to bridge the QA resources into the new system in a way that works.

- Any concerns of the small and medium practitioners or the concessions that were previously agreed to in the Cebu Accord that were not addressed by legislation should be considered. The alternative is to risk another injunction be filed against the QARP.
- The need for specialized industry experience for reviewers of banks, insurance companies, and other specialized entities should be addressed. Given the specialized nature of these entities, industry experience is a necessary qualification for reviewers.
- The formulation of Operational Policies and Procedures for the program should include the scope and methodology of administering the program. Items such as frequency of review, coverage of the program, and manner of selection should be included. Sanctions and remedial actions should also be included. The OPP should include actions that take into consideration the development of the profession. For example, instituting education and training as opposed to sanctions for auditors who do not meet QA requirements would be a factor in adapting the plan to be developmental rather than punitive in nature during the transitional period.
- The Risk Based Red Flag System developed by the BOA is a useful concept in identifying risk and directing the focus of QARs. The oversight authority may consider incorporating Audit Quality Indicator (AQI) measures in the system, such as percentage of partner time charged to an audit and the existence of specialized personnel on the team for specialized industry engagements.
- The Handbook under the original QARP was developed in 2010. The Handbook is well set up, and the narrative part (1.1 thru 5.3) is quite comprehensive. The QAR Forms and Questionnaires (6.1 thru 6.83) are sufficiently detailed and comprehensive to enable review teams to perform in depth and complete QARs. However, there are a number of areas where additions/improvements would be beneficial and should be considered. These are described in Appendix C.

APPENDIX A: EFFECTIVENESS OF STRUCTURES - EXAMPLES OF PUBLIC OVERSIGHT SYSTEMS (WORLD BANK, CENTRE FOR FINANCIAL REPORTING REFORM, AUDIT OVERSIGHT COMMUNITY OF PRACTICE)

This section analyses the challenges involved in establishing public oversight systems and gives examples of what others have chosen to do. It addresses the choices and dilemmas involved, including the location of the POS, funding and resourcing issues, finding the right balance of independence from the professions and the type of people needed.

What have others chosen to do?

Member profiles for 35 out of the 37 IFIAR members as of Jan 2011 are available on the IFIAR website at www.ifiar.org. Profiles from four peer countries to the AOCOP countries (Bulgaria, Denmark, Lithuania and Malta) are included in Appendix D, with profiles of current POS systems in AOCOP countries. As noted above, some characteristics are common to all IFIAR Members, including those contained in the Membership Criteria (independence from the profession, responsibility for recurring inspection). However, other characteristics vary across the membership; some characteristics vary even between EU countries governed by the same law, e.g. the SAD. The approaches to funding, governance and inspections are analyzed in the following sections.

A. Situating the POS

One fundamental characteristic is where the POS is situated – is it part of government, part of the securities or financial services regulator, or is it an independent body?

Of the 35 IFIAR members, 9 are situated in or are part of government, 12 are part of the national securities or financial services regulator and 14 are independent bodies. A selection of smaller countries also have a mix of approaches. Hungary's POS is part of government, Bulgaria's is independent, Malta's is part of government, Lithuania's is independent and Greece's is independent.

Sometimes the lines are blurred – bodies can be relatively independent within government, or be independent but closely linked to a sponsoring government body or regulator. There can be some advantages to being part of a wider functioning body such as government or a larger regulator in terms of scale (especially for small companies), influence and synergies with other functions (e.g. securities regulation, especially when public interest entities are

largely listed). However, there can be advantages to independence, including increased or sole focus on audit issues, freedom from civil service constraints (e.g. on pay). There are no clear differences within IFIAR between the 'categories' of audit regulators or obvious impact on approaches to audit inspection and regulation. Those audit regulators that are also securities regulators are also members of IOSCO, the international organization of securities regulators, which addresses audit issues as a non-core activity.

Conclusion

POS's are situated variously in government, within wider-remit regulators or are independent. In smaller countries, they may typically either be part of government or independent but with close links to the sponsoring government department, especially in the start-up phase.

B. Funding mechanisms of POS and relative size of funding

Sources of funding

The funding arrangements differ between the members of IFIAR; some are wholly funded by the government, others are funded by a mixture of government funding and fees from registered firms and individuals/the profession while some are fully funded by fees/levies. Of the 35 IFIAR members, 10 members are funded entirely from state budget; 4 are funded purely from a levy on companies; 10 are funded solely from a levy on registering audit firms and 10 have a mix of funding (one did not clearly state its funding source).

Smaller and more recently established POSs generally receive a larger proportion (or all) of their funding from government sources. The POSs in Hungary, Bulgaria and Lithuania are funded from government sources; Greece's POS has a mixture of funding from auditors and extra if needed from the state budget and in Malta, 50% of the funding comes from government sources and 50% from auditors. The largest IFIAR members in terms of resources, such as US, UK and Germany have little or no state funding. However, another large member, Japan, is 100% state funded.

Amount of funding

The IFIAR profiles do not give the budget of the POS bodies; in some cases the POS is only part of the wider scoped organization, such as a securities regulator, so the individual funding amount may not be available. Some funding amounts are available, however; the following table gives funding for a number of countries and relates it to the population of the country, the estimated number of PIEs and the number of registered auditors.

Country	Funding of POS	Population	Estimated # of PIEs	Estimated # of Registered Auditors
Finland	€1.0m	5.3m	560	1,438
Netherlands	€6.8m	16.4m	1000	2,500
Slovakia	€0.7m	5.4m	283	844
Sweden	€2.4m	9.2m	300	4,108
Switzerland	€3.5m	7.6m	n/a	6,454

Conclusion

There is a range of funding sources and funding amounts among audit regulators; within IFIAR the members' funding sources are almost equally split between government funding, levies on auditors and companies and mixes of both. As POSs evolve, there is a trend towards less reliance on government funding in some, but not all, cases.

C. Optimal division of roles and responsibilities with the professional body(ies)

There are broadly three approaches with regards to the division of roles and responsibilities with the professional bodies in the various IFIAR members:

1. The POS does inspections of PIEs auditors and some non-PIEs auditors
2. The POS does PIE auditors – professional bodies do non-PIEs
3. The professional bodies do the inspections overseen by the POS

Of the 35 members of IFIAR, 26 perform inspections on auditors of public interest entities directly, 5 oversee others performing the inspections and 4 perform inspections jointly with or alongside the professional bodies.

Of the 35 members, 23 only have direct responsibility for auditors or public interest or listed entities whereas 12 members have some broader responsibility for the inspections of auditors of non-PIE auditors.

There is a clear preference for POSs directly inspecting the auditors of PIEs. However, the numbers mask the developmental stage of a number of IFIAR members who oversaw

professional body or peer review inspection systems for a number of years before establishing inspection teams and taking on the inspections of PIE auditors later.

There is also a clear preference for limiting the direct responsibility to oversight of the auditors of PIEs, generally leaving auditors of non-PIEs to the professional bodies. However, many POSs, such as the POSs in UK, Germany and Lithuania, also have oversight responsibility for the professional body(ies). This will typically include 'inspecting' how the professional body educates, registers, inspects and disciplines its auditing members.

Conclusion

A clear majority of POSs in IFIAR directly perform the inspection of auditors of PIEs, though many performed oversight of professional bodies' inspections systems in early stages. Most IFIAR members only have responsibility for PIE auditors, though some have a wider remit, and still others have responsibility for oversight of professional bodies in their jurisdiction.

D. Characteristics of POS boards

Of 35 IFIAR members, 3 have effectively a single responsible individual (generally the head of a government department), 6 have 2-5 governing board members, 16 have 6-10 board members and 10 have 10+ members. There is a range of sizes of governing boards among IFIAR members. A majority have more than 6 members, however, the largest POS (US) has 5 board members (all of whom are full-time executives). Of the IFIAR members, only a few members have practicing auditors on their governing board; the majority have no practicing auditors on their governing board.

The above reflects the possibly contradictory views that having auditors on the Board ensures competence and relevant experience, so long as in the minority whereas others believe that practicing auditors should not be on the Board for independence reasons.

Governing Boards at large IFIAR members such as UK and US typically include:

- Retired professionals such as lawyers
- Former audit professionals
- Bankers
- Directors or former directors of leading corporates
- Former civil servants

By contrast, POS Boards in smaller or more recently-established members typically include:

- Representatives of other regulators, government departments
- Academics
- Representatives from the Central Bank

This often reflects the level of development and sizes of auditing and other professions in the larger members and the availability of large pools of retirees and other experts willing to serve on POS Boards, often a little or no cost. Where auditing and other professions are in development phases, greater reliance on government, regulatory and academic Board members is characteristic.

Conclusion

POS Boards are typically 6-10 members, though a wide range of sizes is seen. There is also a wide range of POS Board member backgrounds, often reflecting the history and development of audit and other professions in the jurisdiction.

E. Potential transition or interim solution

With regards to public oversight of the audit function, a World Bank report from 2004 stated that: “Models recently introduced in more developed jurisdictions may not always be applicable in situations where the relative importance of the various stakeholder groups is different, and national regulators do not always have easy access to emerging international best practice and consensus”.⁷

International best practice, where the POS performs its own audit inspections and has sufficient funding and resources to be completely operationally independent of the profession and others may well be the ultimate goal. However in a start-up phase, especially where resources and funding are limited, a more appropriate and effective solution may be more simple oversight of the professional body doing inspections and registration. Many of the members of IFIAR operated such regimes in their early stages (e.g. Austria, Germany and United Kingdom). In an early stage, government funding may also be preferable.

Conclusion

While complete operational independence of the POS may be the longer term best practice, funding and resource constraints in the start-up and early stages of POSs may require transition measures including oversight of professional body inspection systems and

⁷ The World Bank – (September 2004) IMPLEMENTATION OF INTERNATIONAL ACCOUNTING AND AUDITING STANDARDS - Lessons Learned from the World Bank’s Accounting and Auditing ROSC Program

reliance on government funding and resources.

APPENDIX B: IFIAR CORE PRINCIPLES FOR INDEPENDENT AUDIT REGULATORS

Introduction

IFIAR is an organization of independent audit regulators (hereinafter, 'audit regulators'). The organization's primary aim is to enable its Members to share information regarding the audit market environment and practical experiences of independent audit regulatory activity, with a focus on inspections of auditors and audit firms. Consistent with the IFIAR Charter, the Core Principles (hereinafter, 'Principles') seek to promote effective independent audit oversight globally, thereby contributing to Members' overriding objective of serving the public interest and enhancing investor protection by improving audit quality.

An audit regulator's membership in IFIAR is not dependent on its status in implementing the Principles. However, Members are encouraged to work towards implementing them where appropriate in their own jurisdictions, taking account of the risk profile, size and complexity of audit firms in their market. It is recognized that legislative change or other measures by national authorities not in control of the audit regulator may be required to achieve adherence to the Principles.

The Principles are intended to:

- Assist Members in developing their own national arrangements through being able to draw on and hence benefit from the experience of other members;
- Advance widespread adoption of high quality audit oversight practice aimed at fostering high quality audits and promoting public trust in the financial reporting process; and
- Support cooperation between regulators and promote greater consistency of audit oversight.

The Principles may also assist audit regulators who are not already Members of IFIAR to develop effective independent audit oversight arrangements.

The Principles are presented in bold lettering followed by an explanatory text that provides further explanation.

A system of audit oversight and audit regulation can only be effective subject to certain preconditions; that is if it exists within an appropriate external environment. Such preconditions, although often outside the control of the national audit oversight system, in practice have a direct impact on the effectiveness of that system. The main precondition is the existence of a well-developed legal and corporate governance framework as to provide

necessary support for high quality auditing. Elements of this framework will cover the following:

- Comprehensive and well defined accounting and auditing principles and standards that are generally accepted;
- Legal requirements for the preparation and publication of financial statements according to those principles and standards;
- An enforcement system for preparers of financial statements to ensure compliance with accounting standards (e.g. fines, shareholder redress or penalties on responsible managers for non-compliance);
- Corporate governance arrangements and practices that support high-quality corporate reporting and auditing practice; and
- Effective educational and training arrangements for accountants and auditors.

Where shortcomings exist, audit regulators should make the government or other relevant decision makers aware of such matters and their potential impact on audit quality or the operation of an effective audit oversight system. Audit regulators should also act, as part of their normal activities, with the aim of mitigating the effects of such shortcomings on the effectiveness of their oversight, regulation and inspection.

Part A. Structure

Principle 1: The responsibilities and powers of audit regulators should serve the public interest and be clearly and objectively stated in legislation.

Audit regulators should have a mandate to work in the public interest and protect investors by seeking to improve audit quality. The responsibilities and powers of audit regulators should, at a minimum, require independent oversight of the audits of public interest entities. The legal framework for audit oversight should set forth the audit regulator's mandate and responsibilities, and provide the regulator with adequate powers and authority that enable the regulator to perform its audit oversight duties, including powers to address, through inspection and enforcement, compliance with the requirements for the authorization/registration of auditors/audit firms and compliance with applicable auditing, professional and independence standards.

Principle 2: Audit regulators should be operationally independent.

Independence means the ability to undertake regulatory activity and to take and enforce decisions without external interference by those regulated. The audit regulator should be operationally independent from external political interference and from commercial, or other sectoral interests, in the exercise of its functions and powers, including not being

controlled in its governance by audit practitioners. The audit regulator should have a stable source of funding, which is secure and free from influence by auditors and audit firms and sufficient to execute its powers and responsibilities.

Principle 3: Audit regulators should be transparent and accountable.

The audit regulator should have public accountability in the use of its powers and resources to ensure that the audit regulator maintains its integrity and credibility. Further, the decisions and actions of the audit regulator should be subject to appropriate scrutiny and review, including appeal to a higher authority. Transparency should include the publication of annual work plans and activity reports, including the outcome of inspections either in the aggregate or on a firm by firm basis.

Part B. Operations

Principle 4: Audit regulators should have comprehensive enforcement powers which include the capability to ensure that their inspection findings or recommendations are appropriately addressed; these enforcement powers should include the ability to impose a range of sanctions including, for example, fines and the removal of an audit license and/or registration.

Audit regulators should at a minimum be responsible for the system and conduct of recurring inspection of audit firms undertaking audits of public interest entities. Audit regulators should have the authority and ability to enforce inspection findings and recommendations. The audit regulator should have comprehensive enforcement arrangements such as fines, suspensions and the removal of an auditor's or audit firm's license or registration. Audit regulators should have adequate and appropriate mechanisms for enabling information to be brought to their attention by third parties and for then dealing with such information, such as through complaints procedures or through whistle blowing arrangements. These mechanisms should act in a timely and effective manner and their results followed up through an appropriate system of investigations and penalties in relation to cases of inadequate or noncompliant execution of an audit.

Principle 5: Audit regulators should ensure that their staff is independent from the profession and should have sufficient staff of appropriate competence.

Audit regulators should have arrangements in place to ensure that inspection staff members are independent of the profession. These arrangements will, as a minimum, include ensuring that staff members should not be practicing auditors or employed by or affiliated with an audit firm, and that the arrangements are not controlled in any form by a professional body. In order for audit regulators to be effective, it is a prerequisite that there is sufficient staff of appropriate competence. The persons carrying out the reviews of quality

assurance systems of audit firms should have appropriate professional training and relevant experience in auditing and financial reporting, and training in regulatory quality assurance reviews. This also means that adequate arrangements for consultation and discussion amongst inspectors are in place. New inspectors should be subject to proper supervision and appropriate training.

Principle 6: Audit regulators should be objective, free from conflicts of interest, and maintain appropriate confidentiality arrangements.

Audit regulators should maintain the highest standards of ethical conduct to provide the public with confidence in the objectivity of their decisions. Audit regulators should have in place prohibitions against conflicts of interest by its governing body and staff and ensure that appropriate arrangements are in place to protect confidential information from public dissemination.

Principle 7: Audit regulators should make appropriate arrangements for cooperation with other audit regulators and, where relevant, other third parties.

Taking into account the global nature of the financial markets, where necessary and relevant, cooperation and information sharing with other audit regulators and other third parties, including financial market regulators, is helpful to improve audit quality.

Audit regulators should provide timely assistance to each other within reasonable limits. Arrangements should be in place for sharing information between audit regulators and other regulators (or between parts of the audit oversight system if it involves more than one body), and for protecting the confidentiality of such information.

Part C. Principles for inspections

Principle 8: Audit regulators should as a minimum, conduct recurring inspections of audit firms undertaking audits of public interest entities in order to assess compliance with applicable professional standards, independence requirements and other laws, rules and regulations.

The recurring inspections should be conducted pursuant to a process comprising the selection of the audit firms to inspect, appointment of an inspection teams with appropriate expertise and competence, notification to the audit firm, advance documentation request, notification of selection of audit engagements for review, meetings with management, and on-site inspection arrangements. The inspection process should be subject to appropriate internal quality control within the audit regulator to ensure high quality and consistency.

Principle 9: Audit regulators should ensure that a risk-based inspections program is in place.

Audit regulators should have a process for assessing risks in the audit environment and audit risks in individual regulated firms and their audit engagements. Audit regulators should have a process for taking into account their risk assessment in allocating their inspection resources and in the inspection approaches they adopt. These processes should be commensurate with the size and complexity of the audit firms and their clients. Audit regulators should have an established minimum cycle regarding the frequency of inspections.

Principle 10: Audit regulators should ensure that inspections include effective procedures for both firm wide and file reviews.

The risk-based inspection approach should also be reflected in both firm wide and audit file inspection procedures. The firm wide procedures should address the audit firm's quality control system as reflected in the firm's organization, policies and procedures. ISQC 1 or similar standards should be used as a benchmark in performing firm wide procedures. The inspection process should also include adequate testing of selected audit files in order both to determine the effectiveness of the firm's quality control system and to assess compliance with applicable laws, rules and professional standards.

Principle 11: Audit regulators should have a mechanism for reporting inspections findings to the audit firm and ensuring remediation of findings with the audit firm.

Audit regulators should have a process that ensures that criticisms or potential defects in an audit firm's quality control systems and issues related to an audit firm's performance of audits that are identified during an inspection are reported to the audit firm. Audit regulators' reporting processes should include the preparation and issuance of a draft inspection report, a process for the audit firm to respond, and the preparation and issuance of a final inspection report. In addition, audit regulators should have a process for ensuring that audit firms satisfactorily address inspection findings that were reported to the audit firm by the audit regulator.

APPENDIX C: COMMENTS ON BOA HANDBOOK ON QARP, 2010

The Handbook under the original QARP was developed in 2010. The Handbook is well set up, and the narrative part (1.1 thru 5.3) is quite comprehensive. The QAR Forms and Questionnaires (6.1 thru 6.83) are sufficiently detailed and comprehensive to enable review teams to perform in depth and complete QARs. However, there are a number of areas where additions/improvements are meaningful and should be considered. These are described below and have been discussed in more detail with representatives of the BOA and PICPA.

1. QAR – Chief Inspector & Chief Administration Functions (page 1.6)

The functions of Chief Inspector and Chief of Administration will have some overlapping duties. To improve efficiency, these functions could be combined.

- This function should be at senior partner level (page 1.9)
- The assistant inspectors should be CPAs (page 1.10)

2. Firms Quality Control Systems – Human Resources (3.14).

The narrative part of the Handbook does not mention the training requirements, curriculum and policy procedures for CPA's and non CPA staff. Since training is a very important it is recommended to include some narrative about training in this section.

3. Documenting the Final Conclusion – Office Level Review (5.2).

- Modified Opinion

Recommend to add: An Improvement Plan addressing the material findings should be drawn up by the reviewed firm, agreed to by the Chief Inspector who also should monitor the proper and timely implementation.

- Adverse Opinion

Suggest same additions as under Modified Opinion plus Disciplinary actions to be taken, if any.

4. Documenting the Final Conclusion- Rating on Engagement Level Review (5.3).

The description of the ratings is ambiguous and leaves room for different interpretations.

- A Full or Substantial compliance
- B Substantial compliance with exceptions
- C Minimal compliance or non- compliance

To enhance clarity, the rating might be changed as follows:

- A Complies
- B Does not comply

Rating A *Complies* means that there was overall compliance: there could however be findings or omissions but that the engagement was in all material respects performed in accordance with the auditing standards specified in the auditor's report, the financial statements were presented in all material respects in conformity with the financial reporting framework specified in the auditor's report, and the auditor's report was appropriate in the circumstances.

Rating B *Does not comply* means that the audit was not performed in accordance with the auditing standards specified in the auditor's report, or the financial statements were not presented in conformity with the financial reporting framework specified in the auditor's report, or the auditor's report was not appropriate in the circumstances.

Suggest to add: Refer to 3.9 for corrective and disciplinary actions in case of a Does not comply rating (unsatisfactory conclusion with respect to an engagement QAR).

5. Standards on Quality Control and Auditing (3.9).

Suggest to add at the end of 3.10:

When a QAR report includes an unsatisfactory conclusion, the BOA shall be required to take appropriate action with respect to the practitioner to which that conclusion applies. The BOA may consider various forms of corrective action to be taken to the practitioner, taking into consideration the educative purpose of the QAR, and the level of seriousness of the failure of the practitioner. Such corrective actions may include:

- requiring revisions or additions to quality control policies and procedures or audit methodology
- requiring additional CPD
- requiring additional quality assurance reviews
- restrictions on the type of work a firm can perform, or for taking on new assignments
- admonishments, censures, and reprimands
- fines
- suspension of membership or expulsion

6. Include conclusion in the engagement review questionnaire (C1) as to whether:

- the audit complied with IFAC auditing standards
- the FS were prepared in accordance with applicable accounting principles

- the audit opinion was appropriate in the circumstances
 - the documentation was satisfactory
- 7. Include overall summary and conclusion in the consolidation of findings and recommendation template (D1)**
 - 8. References (last page) may need update and should include reference to SMO-1**

