

# DÁIL ÉIREANN

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## AN COMHCHOISTE UM POIST, FIONTAIR AGUS NUÁLAÍOCHT

## JOINT COMMITTEE ON JOBS, ENTERPRISE AND INNOVATION

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*Dé Máirt, 18 Nollaig 2012*

*Tuesday, 18 December 2012*

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The Joint Committee met at 1.30 p.m.

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### MEMBERS PRESENT:

Deputy Áine Collins,	Senator Deirdre Clune,
Deputy Michael Conaghan,	Senator Feargal Quinn,
Deputy Seán Kyne,	Senator Mary M. White.
Deputy Anthony Lawlor,	
Deputy Peadar Tóibín,	

DEPUTY DAMIEN ENGLISH IN THE CHAIR.

*The joint committee met in private session until 2.05 p.m.*

### **Scrutiny of EU Legislative Proposals**

**Chairman:** We continue our scrutiny of COM (2011) 778, a proposal for a directive on statutory audits of annual accounts and consolidated accounts and COM (2011) 779, a proposal for a regulation on statutory audits of public interest entities.

I welcome Ms Karen Erwin, chairperson, Mr. Joe O'Toole, board member, Ms Helen Hall, head of regulatory and monitoring supervision and Ms Marie Colivet, project manager, regulatory and monitoring supervision, of the Irish Auditing and Accounting Supervisory Authority. I also welcome Mr. Pat Houlihan, principal officer, company law, and Ms Marie Dempsey, HEO, from the Department of Jobs, Enterprise and Innovation.

Ms Erwin will be invited to make a presentation to the committee, which will be followed by an opening statement by Mr. Pat Houlihan and a question and answer session. Before we begin, I wish to advise the witnesses that by virtue of section 17(2)(I) of the Defamation Act 2009, witnesses are protected by absolute privilege in respect of the evidence they are to give to this committee. If they are directed by it to cease giving evidence on a particular matter and continue to so do, they are entitled thereafter only to qualified privilege in respect of their evidence. They are directed that only evidence connected with the subject matter of these proceedings is to be given and asked to respect the parliamentary practice to the effect that, where possible, they should not criticise or make charges against a person or persons or an entity by name or in such a way as to make him, her or it identifiable. Members are reminded of the long-standing ruling of the Chair to the effect that they should not comment on, criticise or make charges against a person outside the Houses or an official by name or in such a way as to make him or her identifiable.

**Mr. Joe O'Toole:** I am glad to hear I am so well protected.

**Chairman:** I welcome all of our witnesses and invite Ms Erwin to make her presentation.

**Ms Karen Erwin:** I thank the committee for the invitation to appear before it to discuss the important topic of audit reform. Before commencing my presentation I would like to inform the committee that if the answers were easy and simple we would have had them long since. As members will be aware, many people have been grappling with the problems of audit reform. This means there are no probably no right or easy solutions. We are here today to tease out this issue with members and to help them understand the process. As I said, there are no right or easy solutions or guarantees that what is decided will work. There are almost as many different views on this as there are people working on it. As such, we can only do our best.

The Irish Auditing and Accounting Supervisory Authority, IAASA, has a short- and long-term solution to audit reform. During my presentation I will explain, albeit briefly, how IAASA operates and the current model to which it operates. I will then speak a little about quality assurance, which is what we can work to probably within a year. I will then move on to speak about the draft directive and regulation.

As requested, we focused our presentation on audit reform. We can get back to the committee about questions that arise today which we may not be able to answer. Members will be aware that there are a number of different sets of proceedings and reviews under way. As such,

another difficulty that arises is that off-the-cuff remarks by us in response to a question could put some of those processes in jeopardy. We may have to refrain from answering some questions for this reason. However, we will come to the committee at a later stage with an answer to them.

IAASA had its origin in the DIRT inquiry. Subsequent to that, an auditing review group in 2000 recommended the establishment of an oversight body under a supervised self-regulation model. I will come back to that issue later. IAASA was established by statute in December 2005. In terms of size, our resources in 2013 are €2.69 million, of which €1.38 million is provided by the Exchequer and €1.31 million is provided by the profession. We have a total staff of 13, of whom five are in the regulation area. Members will see from the organogram where those five people sit. They will also note from the organogram that the head of regulatory and monitoring supervision is Ms Helen Hall. As of 8.30 a.m. today, Ms Hall is the chief executive of IAASA and will be moving upwards, leaving us to appoint a new person to her position.

Our current regulatory model is one of delegated regulation. Approximately 31,000 accountants are members of prescribed accountancy bodies, of which there are approximately nine. Some of those accountants are also auditors and are members of some of those nine prescribed accountancy bodies, which regulate those individuals. We do not have any direct regulation function over auditors or accountants. The prescribed accountancy bodies do the regulating. Each of those bodies has its own separate rules, regulations, disciplinary codes of ethics and so on. Our role is to supervise those nine bodies. We do not have direct regulation of either accountants or auditors. I think it is important that members understand that is the way the Act prescribes how we behave. We do not have direct regulation.

On the next slide, we have listed the recognised accountancy bodies and I am honing in on audit. If one is an auditor, one must be a member of one of these recognised accountancy bodies. That body will govern you as an auditor. We will supervise those recognised accountancy bodies, known as RABs.

One of the important aspects of regulation is the inspection of auditors of public interest entities, PIEs. I think members will have heard Mr. Pat Houlihan explain to the committee on 16 October what a public interest entity is - it is a company or other body corporate whose securities are admitted to trading on a regulated market, a credit institution or an insurance undertaking. There were approximately 1,200 of those entities in October 2011. There are eight audit firms in Ireland responsible for audits of public interest entities, PIEs. When we are looking at risk, the big risk is what the public interest entity will do and so that risk is scoped down to eight auditing firms. All eight auditing firms are members of the same recognised accountancy body, the Institute of Chartered Accountants in Ireland, ICAI. ICAI has its own regulatory arm, which is known as CARB. One of the things I found when I took office as Chairperson was that one has to be an absolute expert at acronyms. I do apologise but that is just the way it falls out. The direct inspections of these eight audit firms who audit the public interest entities are carried out by the Institute of Chartered Accountants in Ireland. We do not have a role in direct inspection.

In May 2008, the European Commission recommended that there would be direct inspection, which is known as quality assurance of the PIE audit firms. That suited the Irish Auditing and Accounting Supervisory Authority, IAASO, because we believe the best way to regulate is by direct regulation. We were fortunate in that a decision was taken by the Department in July 2010 to implement that recommendation, that is, that we would directly regulate the auditors of the PIEs. As a result, and we can come back to this in detail later, we submitted a detailed im-

plementation plan in 2011. We understand that its implementation is under active consideration by the Department. When I said that there is a short-term solution or difference in approach that could come up, if direct inspection, that is the quality assurance were to go ahead now, probably within a year, we could actually implement direct inspection of auditors of public interest entities, PIEs. That is something we can do in the short term. Even if there is still a debate on the European audit reform, we could implement direct inspection. Of course, it will come as no surprise that if we do that we will need resources. We can answer questions on it but we think we will need an additional 11 staff because we will be taking over the function from the Institute of Chartered Accountants in Ireland.

I hope members did not get a fright when they saw these endless lines of powerpoint slides. I do not intend to go through them in detail at this point, but we felt it might be helpful to members to have them front and centre for the later question and answer session. We have been working at European level with the European Commission on the Green Paper and with the Department on audit reforms. The scope of the proposals is contained on slide 12. The problems identified by the European Commission have been set out before.

We have 13 different strategies to address the problem of audit reform proposals. We are happy to talk through any of them with members.

In slide 16, we have taken the proposals and given a broad outline as to whether we support them or not. Let me give one example on the mandatory rotation of audit firms, IAASO. is supportive of that rotation after eight to ten years. We are not supportive of joint audits, but are supportive of regular tendering. Rather than reading out the information, I think we can come to it in the question and answer session.

**Deputy Anthony Lawlor:** In the slide on the Ban of the Big Four clauses.

**Ms Karen Erwin:** We are supportive.

**Deputy Anthony Lawlor:** We do not have a copy of the presentation.

**Ms Karen Erwin:** I apologise.

**Chairman:** It would have been an attachment on the e-mail.

**Ms Karen Erwin:** I am happy to give a very brief overview and members can then come back on the issues. Would the Chairman like me to do that?

**Chairman:** Yes. I have a couple of copies.

**Ms Karen Erwin:** I will give members a sense of what we are talking about while the copies are being circulated.

Slide 16 entitled mandatory rotation of audit firms. We believe there should be mandatory rotation of firms every eight to ten years. We are not supportive of mandatory joint audits but are supportive of regular mandatory tendering. We are supportive of the proposal to ban Big Four clauses, which require auditors to be from the Big Four firms only. I am assuming that members know the names of the Big Four firms.

In relation to non-audit services, we are not supportive of an outright ban on the basis that it has implications for audit quality and the cost of audit. We are supportive of the current APB model. We are supportive of raising capital from external sources, subject of course to the

safeguarding of auditor's independence, that is in relation to the voting rights in firms. In relation to transparency reporting, we are supportive of proposals on transparency reporting from a public interest perspective but note that the current system of transparency reporting still needs to be assessed. On the European passport, we are not supportive of the European passport in the context that the success of the recently introduced existing system should be assessed before making changes. In relation to the international standards, we are supportive of the introduction of international standards across Europe. These are already in use in Ireland.

In relation to the proportionate application of standards for SMEs, we are not supportive of the concept of limited audits the ISAs already allow for scalability. The expectation gap could be widened if limited audits were implemented. It was suggested that it may be preferable to increase audit exemption limits.

We are supportive of an expanded audit report. The view is that additional detail on audit methodology employed could narrow the expectation gap. It is suggested that auditors provide more detail on aspects of the audit where professional judgment was central and the considerations in arriving at such key judgments.

If these proposals go through, it will have an impact on IAASO as it will be the potential end of self-regulation by the profession. As I said earlier, that may end anyway if the quality assurance comes in. There will be immediate applicability of measures if the regulation comes in. There will be a broader definition of PIEs and the definition of PIEs will expand. We can talk about that later. There will be significant powers given to the European Securities Markets Authority, ESMA, and we will not be sitting on ESMA, as a person from the Central Bank sits on that board and we are not represented on it. It would give significantly increased responsibilities because then we would be directly responsible for not just audits of PIEs but of all audits and that would hugely increase our remit.

We will continue to provide support and assistance to the Department during the Presidency and the EU audit reform dossier. We will continue to engage with our European counterparts and maintain a watching brief on the proposals as they develop in the European Union. We see what is happening now, what can happen in a year's time and what can happen dependent on the results of everybody's deliberations. That concludes my presentation.

**Chairman:** I thank Ms Erwin. Before we go to questions and answers I will invite a presentation from Mr. Pat Houlihan. I appreciate this is his second time to make a present on the same subject but it will include an update.

**Mr. Pat Houlihan:** I thank the Chairman for the invitation to return to the committee to expedite further consideration of this important EU proposal. We appeared before the committee at its meeting on 16 October to discuss these proposals. On that occasion a robust discussion took place on the proposals and one which indicated a high degree of interest and concern and all the characteristics and enthusiasm a civil servant likes to see in proposals that he or she is trying to move forward. We were very pleased with the nature of that discussion.

As these are extensive proposals it was agreed that we would meet again and go through the issues we did not get around to look at on the first occasion. We did not realise we would have our good colleagues from the Irish Auditing and Accounting Supervisory Authority, IAASA, with us, as we thought they would be provided for separately in terms of their presentation. We are delighted we have comfort and shelter of them. It may enhance the discussion in terms of questions for the Department and IAASA. I congratulate the people who devised the idea of

having us together

**Chairman:** I am surprised that Mr. Houlihan is surprised.

**Mr. Pat Houlihan:** Yes, but of a pleasant nature. At the last meeting much of what we said was the genesis of the proposals, a depiction of the broad outline, the Council negotiations, the current state of play generally in terms of the Council and the European Parliament and providing a flavour of where they were and where they may be going, an idea of where Ireland stood in general on them but we did not get into the details of specific aspects as time did not allow. Many of the contributions made at the last meeting reflected real and genuine concern at the financial crisis, the aftermath and the extent to which audit may have been a contributory factor in that financial crisis.

In a discussion paper of 2011 the UK Financial Reporting Council, FRC, has interesting observations to make on the crisis. One of its comments is that many argued that the crisis demonstrates the need for reform, others point out that companies in the non-financial sectors came through the global recession better than expected, given its speed and depth. That introduces another perspective on the issue. One of the key questions that arose on the last occasion and probably will arise today - IAASA may have a have a useful contribution to make on it - is the expectation gap which the average person would expect an audit to do. One of our colleagues from the other side of the table provided useful and helpful clarity on the role and function of an auditor. Mr. John Moynihan, an accountant, who unfortunately cannot be present, contributed on the legal obligations of an auditor. The expectation gap is one that surfaces periodically. It is not something that happened now. It is a cyclical thing and arises in the wake of an economic crisis where people are trying to understand what happened and at the same time trying to find a scapegoat.

The recessions in the UK in the 1980s and 1990s and the dot.com bubble all ended up in surfacing the idea of what is the audit doing and why did not the auditor warn people. There were recriminations and so on. The manifestation of the expectation gap is cyclical because when things settle down and there is normality people do not wonder about what auditors do but they do when a crisis occurs. The result of these crisis points had been that the auditors have been put on the back foot from time to time and have been obliged to point out that an audit is neither a guarantee against fraud or a future business success. It is neither one thing nor the other. The recent crisis has certainly put it back centre stage and certainly the committee is interested in it and, I hope, we will have time to go into it in greater detail later. In May 2009, the UK Treasury Select Committee inquiry into the banking crisis questioned whether the audit function examines the right issues. It stated:

The fact that some banks failed soon after receiving unqualified audits does not necessarily mean that these audits were deficient. But the fact that the audit process failed to highlight developing problems in the banking sector does cause us to question exactly how useful audit currently is. We are perturbed that the process results in 'tunnel vision', where the big picture that shareholders want to see is lost in a sea of detail and regulatory disclosures.

The nuance there is that there is much information but it must be asked if much of it crucial and germane.

The FRC document to which I referred earlier goes on to state that while we found that audit work could have been more effective if auditors had shown more scepticism. We have established no circumstances where financial statements were materially misstated, rather corporate



and financial reporting was overtaken by exceptional market conditions. During the financial crisis the analyses that were considered reasonable at the time of the report and accounts were finalised became rapidly obsolete as markets deteriorated and the requirements of the listing regime that were intended to ensure that markets were kept properly informed of which development proved inadequate to address the exceptional developments that arose. Audit, by itself, according to this contention, could not have prevented the collapse of the credit markets. That could only have been achieved if action had been taken by those responsible for macro-economic affairs and prudential regulation.

Therefore, the theme pervading those observations is that audit is not the exclusive theatre of blame for the financial crisis and if repetitions are to be so guarded against, or avoided, that other elements in the overall mosaic need to be considered and thought seriously about. This is part of our of our cogitations today.

Other issues raised at the session on 16 October included the need to strengthen the audit function, the need for independence of the auditor or audit firm from the entity being audited, competition issues, whether the EU audit proposals provide for sanctions and whether it is more appropriate to address issues by means of domestic or EU legislation. These are issues we can provide answers to as we proceed. In my view the audit proposals address the issues I have listed.

To give a brief general update on the progress of the EU audit negotiations in Brussels, the debate is continuing in the European Parliament. Various political groups and committees of the European Parliament are attempting to finalise their positions and the various elements of the audit package. It is difficult to see how the Parliament can arrive at a common view on all of these matters before February, or more than likely, March.

Ireland, in its capacity as Presidency of the European Council, which is also looking at these issues in parallel has provided for a significant number of meetings to try to progress matters, the first of which will take place in the second week in January. We are serious about trying to move that agenda forward and trying to get it to some kind of completion. We are scheduled to have a general approach, which is a title for a Council agreement on this issue, at the competitiveness Council in May. We hope to reach that target and, perhaps, exceed it. Recently the European Parliament was in contact with the people from our representation and were hoping we might make such spectacular progress that we could finish our work in the Council in the first couple of months of the year and move on to the next stage of proceedings which are so-called trialogs with the Council and the European Parliament. If we got an advantageous wind behind us we must just do it but as it is an important dossier we will be striving to bring it to fruition or as far as we can possibly bring it in our six months.

A specific matter was raised by the Chairman at the last meeting. I can suspend my reading of it, if you wish, but I would be happy to read the clarification into the record that you sought at the previous meeting. It is in regard to companies which operate as charities, such as sporting organisations and so on, and the cost of having to carry out an annual audit. The Chairman requested clarification on the petition going forward in regard to charities *vis-à-vis* this exact audit obligation and the following is the situation. I will read from a note prepared on it which states:

The Company Law Review Group ... 2009 Report examined this issue of extending audit exemption to companies limited by guarantee [CLGs]. It made the following recommendations:

(i) Subject in each case to consultation with the Minister for Community, Rural and Gaeltacht Affairs and the charities regulator, the audit exemption regime contained in Part III of the 1999 (No. 2) Act be extended to such class or classes of CLG which are charitable organisations (within the meaning of the Charities Act 2009) so as to bring them into alignment with charitable organisations that are not companies, provided by 10% of the members with voting rights should be able to require an audit. [That the safety mechanism built in].

(ii) The audit exemption regime contained in Part III of the 1999 (No. 2) Act be extended to all CLGs which are not charitable organisations, subject to a veto right, by any one member of the company, and further subject to the requirement that audit exemption in respect of the following year, shall be an item on the agenda of the annual general meeting.

Consideration is being given as to how these issues will be addressed in the context of the companies Bill which is in the process of publication and hopefully it will appear before the end of the year.

I would like to clarify one issue arising from what the chairperson of IAASA said which may have caused some minor confusion. To paraphrase her opening remark, she said that IAASA does not directly regulate auditors. In case an impression may have been created in some quarters that this means that IAASA is at a remove from the process of regulation, it is not. It is not directly hands on involved, but it is not at a remove from the process. The 2003 Companies (Auditing and Accounting) Act requires IAASA to supervise how the PABS, the six audit bodies and the three non-audit bodies, regulate their members. That is a key obligation IAASA has under the legislation.

Moving downwards from IAASA to the next layer, the bodies of which it supervises the regulation, those bodies supervise their members by means of by-laws, rules and regulations and under the 2003 Act all of those are required to be approved by IAASA. In a sense IAASA has, in a slightly indirect fashion, a reach down to the individual auditors being regulated by their bodies because the rules and regulations the bodies apply must be approved by IAASA. Therefore, reaching down to the individual auditors the obligation flows downwards, in a cascade effect, to them to obey those rules, regulations and requirements the bodies have and if they do not the bodies can take them to task and IAASA has powers under the Act to intervene. In case discussions may have got off on a slightly wrong footing, I thought it might be sensible to clarify the position.

**Chairman:** I appreciate that. To return to questions from the members, I call Deputy Tóibín.

**Deputy Peadar Tóibín:** Gabhaim buíochas do na finnétithe as an chur i láthair chruinn sin. In response to a point made by Mr. Houlihan, it is probably the job of Government to make sure that the worst excesses of the cyclical nature of the economy are reduced and that it uses all the financial tools necessary to reduce those swings in the cyclical nature. This is possibly one of the tools that can be used. It is an understatement to say that there is reputational damage done to the auditing industry with regard to what has happened in the past number of years. There seems to be a conflict between the job of working for a client and being the guarantor of the accounts. There is an expectation in terms of the giving of a true and fair view of a company's accounts and it is our job to work on behalf of the citizen to reduce the gap in terms of that expectation. To do that, we need to find a way for auditors to give a clear view of the health of a company and to be able to provide a forecast service by saying this is the health of a company and if X, Y and Z economic circumstances were to arise on the horizon, this is how the company would be able to deal with those. That did not happen during this crisis because banks got certain guarantees and six months later those banks collapsed.



The issue of accountability is important. Many of the professions in Irish society would have direct accountability. For example, when I worked as a management consultant such consultants would have taken out professional indemnity because if their advice were in some way to have had a negative effect on their clients, they would have been accountable for that. At the last meeting John Moynihan said that auditors could be sued by shareholders but that it was not easy to do so. It is important there is not only accountability to society in general but to shareholders, creditors and the public purse. We probably would have dealt with businesses which gave credit to other businesses which they believed were fully healthy and would be able to deal with the economic turmoil in that regard. What can be done to bridge that expectational gap to ensure there is full direct accountability and even to make it easier for shareholders to sue auditors in the future? How would direct regulation contrast with the system currently in operation where there is slightly indirect regulation? Ms Erwin mentioned that there would be a broader definition of what is meant by PIEs and she might give some detail on that.

**Chairman:** I call Mr. Joe O'Toole.

**Mr. Joe O'Toole:** Tá an méid a dúirt an Teachta thar a bheith tábhachtach agus is breá liom é a chloisteáil. An rud atá ann ná nach féidir linn freagra a thabhairt faoi gach ceann de na ceisteanna sin. Looking back on the transcript of the last meeting, Deputy Collins dealt with the question of the expectation gap and the role of the auditor. The one thing we cannot do is change the role of the auditor. The quality assurance can change that but that will be politically driven and then we can implement it. However, there are things that can be done.

To answer the Deputy's question on the difference between direct and indirect regulation, this all began with the establishment of the DIRT inquiry in 2000. At the end of the DIRT inquiry what astonished the world was that directors did not appear to know what was going on in their companies. The recommendation in the report of the DIRT inquiry from the Committee of Public Accounts was that this should never be allowed happen again. At that time an audit review committee was set up to examine recommendations. I chaired that committee in 2000. On foot of that report the question of direct rather than indirect regulation arose. In terms of direct regulation, it means being established politically and professionally and the rules being set up in a country or perhaps in Europe and then implemented by the auditors on the ground. The auditors body, the accountancy body, checks if those rules are being implemented properly and we check that the accountancy body is doing it correctly.

As the Deputy will know from the role he had previously, an auditor is presented to us as being a watchdog rather than a bloodhound and it is in that respect there is an expectation gap - it is between whether auditors look under stones or take what they get. They work on the basis of the information given to them by the company directors.

I will cover one of the key recommendations from the audit review group and from the DIRT inquiry by taking the Deputy through ten years of this sad story. Directors would issue a compliance statement at the end of each year which, in simple terms, meant as far as we knew that they were complying with the laws of the land and with all their responsibilities, that they had put structures in place to do that and they presented that to their auditors. A provision covering that appeared in section 45 of the 2003 Act. When it appeared in the Act, great pressure was put on the then Minister, Mary Harney, to soften it. Pressure was also put on the Department and on all sides and it was softened, but it passed through in a way which IAASA said at least it operates. It is now ten years later and that section of the Act was never commenced. That is a political issue that I would like people to examine. Following that the Company Law Review Group was established. It took a similar line but the Director of Corporate Enforcement in a

minority report asked that the compliance statement be commenced. A few years later in 2009 I introduced an amendment to the Companies Act. I took exactly the proposal of the Director of Corporate Enforcement about directors saying that they are running a company and that one can have trust and confidence in it and that this is the reason. That has never been introduced. Pages 44, 47, 48 and 49 of the Honohan report deal with directors' compliance statements that have never been implemented. It also shows that the Financial Regulator tried to get them implemented. That is one strand that has come through ten years where no matter what we do with auditors we still have to get company directors to take a particular line. That requires a political decision and regulation. The approach was supported by all parties at various times. I use it to point out how the expectation gap arises.

Most people assume limited liability was introduced to finance and economics 150 or 200 years ago in order that people would be civilised. The payback was that directors would act honestly and earnestly and prudentially. That was a requirement that has come through from the DIRT inquiry, the Office of the Director of Corporate Enforcement, from IAASA on three occasions, and the audit review group. However, although it is in the legislation it has never been commenced.

It is an example of how difficult it will be to do the things that Mr. Houlihan and Ms Erwin have outlined. They are issues that have not been grappled with. It would be great to think that the matter could be done and dusted by May during the Irish Presidency but I cannot see it happening because I am not sure that people will act politically.

**Ms Helen Hall:** I will return to a couple of questions which Deputy Tóibín asked. The first related to the expectation gap and what the proposals contain that might improve things. It is important to clarify the role of auditors so that everyone is clear on it but also to put it formally in the public domain. There is talk of expanding the audit report, of which we are supportive, and giving the reader of the audit report information about certain judgments made by the auditor because up to now it is a binary report. It is a case of either pass or fail, whereas what is being proposed in the recommendations is that more information would be included such as on materiality and the level of testing which would force an auditor to make comments about a going concern. It will never be an auditor's job to give a guarantee on viability. That is just the way commerce works but there is a recognition in the proposals before the committee that something needs to change and that there must be an expansion, in terms of communication at least. Again, we are very supportive of that. With public companies we must also be careful about the information that gets out in the public domain from the point of view of competition and the secrecy of the company's business. One of the other good proposals that we see which should help shareholders and directors is the expanded communication that will be demanded of auditors. They will have to give detailed information to the audit committee.

Mr. O'Toole alluded to the difference with direct regulation. We have been advocating that for some time. The current situation in this country is that eight firms audit the current definition of listed companies - public interest entities. The direct regulation of those is done by the Institute of Chartered Accountants. Like Mr. Houlihan, I am fully supportive of that. It is under IAASA supervision and we take the role seriously. However, the firms the institute regulates are its members. Our European counterparts have moved on from that and they have audit regulators such as IAASA doing the role directly. It would be a case of enhanced independence as we do not have a relationship with any firm. It would also enhance public perception. I do not say by any means that the Institute of Chartered Accountants is not doing a good job. I am just saying that if one removes the supervisory role to an independent authority it would have a

significant benefit as it would add credibility to the process.

Deputy Tóibín also inquired about the expanded role of public interest entities. Currently, we are talking about listed entities on the regulated market plus banks and insurance companies. What is involved in the reform proposals before the committee today is a much wider definition. Mr. Houlihan and I have teased that out on a number of occasions. A wider definition would have significant implications for this country. It is not necessarily that we are afraid of it but it would bring in many investment firms, investment funds and payment institutions and there are concerns that this may impact on the likes of this country more than other countries in that one might be introducing a regulatory process that might not be proportionate in size. We do not have the answer to that question but it is one Mr. Houlihan has raised with the Commission and on which we await a reply.

**Ms Karen Erwin:** To follow up on direct inspection, the jurisdictions that currently have it are the United Kingdom, Germany, France, Luxembourg, Norway, Sweden, Finland and Spain. Worldwide, it also exists in the USA, Japan, Australia and Canada. Direct regulation is the most common approach currently.

**Mr. Pat Houlihan:** With regard to public interest entities, we are concerned about that because as Ms Hall said, it appears that a number of entities that would not seem to merit being deemed to be in that category are in it. A technical sub-group of the Department's main consultation group has been examining the proposals in detail and we are about to make a submission to the Commission. We are questioning what the bag contains and also the subtle undertones. I hope they are still subtle after this meeting. We will seek clarification on exactly what is contained and why certain issues were included.

As Ms Hall has said, in one sense it is unfortunate that we are in a minority position because of the undue proportion of companies in the financial services centre. Only a few other member states have similar concerns. The United Kingdom is one, and Malta and Luxembourg are others that would have raised their heads above the parapet on this particular issue.

To demonstrate what is being done in the proposals on the expectation gap, in essence, almost all of the good features of the regulation put bricks in the place of the big hole that currently exists that constitutes the expectation gap. There are good initiatives on the independence and conflict of interest area, the performance of the statutory audit and audit reporting. Ms Hall has touched on that and on the appointment of the statutory auditors. There is much good material in the proposals, which is being taken seriously at all levels in Brussels, both in the Council and in the Parliament. Nobody is saying that it does not do enough or that we should have something more. The Commission has the right of initiative and in some sense we must consume the helping that we are given. Other than within reason we cannot amend what was put before us. By and large, there is close to unanimity in the Council that this is a useful set of proposals. Some people think it goes too far which is a sign that it is getting something right and is biting somewhere. A similar good discussion is ongoing in the Parliament on all the key aspects of the proposal. I hope we will end up with a decent proposal once we have winnowed out all the elements that do not need to be there.

**Deputy Peadar Tóibín:** How could auditors be held to account for their role in the banking crisis, for example, and how could we be assured that the situation which we have just experienced, which is the biggest crisis with which we as elected representatives have to contend, will not happen again?

**Mr. Joe O'Toole:** It will arise when it gets to the point of asking whether auditors have done the job they were asked to do. The jury is spectacularly out on that question at the moment. We would have difficulty in answering that question although we might have views on it. In terms of what could be done, the laws must be passed. The expectation gap will be filled in, as Mr. Houlihan has just said, by the building blocks of changes made politically. They will then be implemented on the ground. If the audit is not carried out along the lines required by agreed international regulations and legislation, then they are at fault. The question was whether somebody did not do their audit properly last time around, but we do not yet know the answer to that.

**Ms Helen Hall:** I will add to what Mr. O'Toole has said. Deputy Tóibín's question is an interesting one. When a crisis happens we have to do two things: we look back and potentially take action and then look forward at what needs to change. I will give the committee a snapshot of what is still ongoing. I have to be careful about certain ongoing cases, but I am looking at the actions under our remit. A few days after it happened in late 2008, a certain number of individuals who were members of the Institute of Chartered Accountants - I am not saying anything that is not in the public domain - were involved in the Anglo affair, to take that as an example. In our supervisory role we were in contact with the Institute of Chartered Accountants and strongly encouraged it to appoint a special investigator. To be fair, an independent special investigator was appointed by early February 2009. That investigator was a previous Comptroller and Auditor General. It was a facility under the by-laws that IAASA, the Irish Auditing and Accounting Supervisory Authority, approved to ensure that for a public interest case like this it is not just done internally, but that there is an external special investigator.

The investigation phase happened and *prima facie* cases were found against a number of individuals and the auditor involved there. However, because there are ongoing criminal investigations, the DPP requested that those cases be pended. We would all agree that a criminal case must take precedence over a professional body's regulation. Action was taken, however, on whether there was any wrongdoing.

One may say that it is not just that. We had seven covered institutions where issues arose. Questions arose in the public mind and in our own minds as to what should and could have been done. I do not know the answers to those questions yet. We looked at our remit, however, and at what we should be doing as a supervisory authority. We engaged with the Institute of Chartered Accountants which has commissioned a banking review to examine key aspects of the audits of all seven covered institutions. That quality assurance review is still ongoing.

The looking forward aspect, which is equally important, is what is before us today. First, we must judge whether everyone did what they were supposed to do. If not, sanctions should go into place. Equally, however, we must ask whether what they were asked to do was wide enough and appropriate. That is what is before the committee today for its consideration.

**Senator Deirdre Clune:** I have a question but as I have to attend the Seanad soon I apologise if I am not here for the answer, although I hope I will be. The witness said she supported the proposal for a rotation of auditors. There may be a danger of a loss of expertise in some difficult technical areas if firms have developed a relationship with individual companies. Have representations been made to the IAASA about this? Multinational companies based here may have different auditors to the parent firm.

**Ms Karen Erwin:** These are issues that we have looked at and Ms Hall might discuss them in some detail. In essence, taking a pragmatic view and looking at the expectation gap and perceived conflict, any professional firm that is too long associated with the body it is auditing

could bring about a suspicion - it may be completely unfounded - that it is getting a bit lazy and relaxed. Therefore, we felt it was better that in time there would be a mandatory rotation. Everybody would know it was there so they would be gearing up to it. A new person on the block would go in and would not really be fettered by previous judgments made either by themselves last year or by the previous audit partner. One would feel almost obliged to support such judgments because one had started down that track. It would, therefore, be a very useful thing to have a brand new, fresh pair of eyes looking at it, and maybe being able to ask what I would describe as a stupid question. They would not take anything for granted but would go in *de novo* asking "Why do you do that?" That is one side of the equation.

The other side of the equation is the significant experience and expertise that auditors build up by virtue of having audited over a period of time and having built up the relationship with management. If one has new auditors going in too often, one then has an very large quantity of management and audit committee time devoted to the learning curve.

We tried to balance both aspects saying that while change is good, it should be proportionate. We came to a view that there was a three-year learning period and a period of five years where one could use that expertise, but knowing that someone else would be coming in to look over one's shoulder. As a professional person, I know there is nothing that concentrates my mind more than thinking that somebody else will be coming in to examine what I have been doing. We said eight to ten years, therefore, although we are not wedded to either eight or ten.

It is interesting to note that in the Netherlands they have just brought in an agreement for mandatory reporting and have picked eight years. It could have been longer or shorter but we have a sense that it is a good thing, and it is seen to be so. Does Ms Hall want to add to that?

**Ms Helen Hall:** Not really. I think Ms Erwin has covered it quite well. I have a couple of comments nonetheless. This is one of the questions that has probably caused most debate. We acknowledge that there are advantages to auditor rotation but there are also disadvantages such as the ones that Ms Erwin mentioned. When we balanced the two up, we felt that the perception of long-term closeness of that relationship probably weighed us down on the side of being in favour of it.

**Senator Deirdre Clune:** Did the witnesses think there was an issue concerning foreign companies based here?

**Ms Helen Hall:** There is certainly a lot of interest in this audit rotation debate. For example, the United States is considering it at the moment. A lot of questions arose in the US about the disadvantages of auditor rotation. There is certainly a danger that if Europe moves in one direction and we have a global situation it is going to cause difficulties. Sometimes, however, the difficult path can be worked out if it is worthwhile.

**Mr. Pat Houlihan:** I will just add to what has been said on the auditor rotation debate. The topic is live in a number of other jurisdictions, such as the United States and Canada. We have factored in the potential dislocation if a multinational has to take on a different auditor here. I have explored it with a number of people who know these matters a lot better than I do. They say that while it is a bit of an issue, it is not an insuperable one.

The topic is high up on the list in Canada and the United States. It is eminently possible that if the EU gives a lead on this matter they may follow us. Therefore, some people's philosophy is to dip a toe in the water and see what happens. The debate, both at the European Council and



the European Parliament, is finely balanced. The parliament would possibly be more in favour of providing for rotation but with a significantly longer timeline involved. As Ms Hall has just said, however, that is the key tie-breaker question in all of these proposals.

**Deputy Anthony Lawlor:** I thank the witnesses for attending the committee. I have a number of points. There is no trust with the auditing companies and accountancy firms. The Nyborg report clarified that the auditors had a major role to play in the banking crisis here. When one looks at the responsibility in the food chain, IAASA is at the top and, therefore, it has responsibility for its failure. I acknowledge it came into being in 2006 but there must be an admission somewhere along the road that the authority's regulatory role makes it in some way culpable. Mr. O'Toole mentioned that the authority's current funding is €2.69 million of which €1.38 million comes from the Exchequer. Does the balance come from member companies?

**Mr. Joe O'Toole:** From the auditing and accountancy bodies.

**Deputy Anthony Lawlor:** This makes me nervous.

**Chairman:** It is a levy. They have no choice but to pay it.

**Deputy Anthony Lawlor:** The point is where it is coming from. The ICAI was mentioned. The institute has a view, which depends on its members who pay a levy. The organisation is dictated to by the membership. I am nervous about where the funding will come from as IASA seeks to increase in size. I would rather it came from the Exchequer, which is independent. We might not be able to afford it at the moment but this would ensure independence rather than having the money come from bodies the authority is supposed to be regulating. That is my criticism of the current set up.

Mr. Houlihan referred to the issue of reform. If we analyse this properly, we will recognise that all the building blocks were in place to make sure what happened could not happen but they were not implemented properly. I am sceptical about reform for the sake of it. We have gone over the top in the context of regulation from a position where nothing was regulated, examined and checked to everything being checked, which is stifling companies. The happy medium is in the centre where everyone can get on board. As Mr. O'Toole said, the regulations relating to the responsibilities of directors need to be implemented more quickly than is being suggested because they have responsibilities. I am a director of a charitable company and I have significant responsibilities to make sure the audited accounts are furnished. If one wants to take on the role of director, drink red wine and quaff quail's eggs, there are responsibilities. That happened in the banking sector.

The IASA said it is not happy with joint audits and it does not recommend them. Joint audits provide a double check within a company and if legislation is implemented that provides that companies must change their auditor after eight years, such audits might ease the transition from one auditor to another.

Interested parties were invited to respond with proposals relating to the proposed directive. What role do the big four companies have in making submissions? What role do they have in influencing the Commission's thinking?

The Chairman referred to an issue that also affects charitable organisations, which we hope to address in legislation. Many SMEs are legally required to undergo audits and this puts a financial strain on them. Will the Department include anything in its submission on the directive to protect these companies in order that they can be excluded based on size?

**Ms Karen Erwin:** It is there already.

**Deputy Anthony Lawlor:** I am sorry; I did not realise that.

What legislation will we have to introduce as a result of this directive being adopted? What are the implications of the proposed legislation?

**Mr. Joe O'Toole:** The Deputy raised an interesting point about who should pay. The Government is enthusiastic about a European wide initiative under which the regulated pay for being regulated. The fact that the cost is split 60:40 will never happen again. The Oireachtas is about to pass legislation which will require credit unions to pay completely for all their regulation and there is a strong argument that should not be case. They feel the regulation should be paid for by the Government. It is similar to audit rotation. It is one of these imperfect arguments. One can argue up and down on both sides of it but the current view is that the people who are being regulated should pay for it.

The Deputy also referred to the expectation gap. As he said, if somebody did their job incorrectly and we overlooked that, should we not have to take responsibility? That is a fair point but we have to find out where everything went wrong. He outlined our annual budget and he has the list of the number of companies we work for. The largest bodies around the world such as Fitch Ratings and others gave banks the highest rating through their own devices and not based on what we were telling them over the previous few years. That gives some idea about how hard it is to get to the bottom of these issues but the most important issue is that no matter what legislation we bring in or what level of regulation we apply or inspections we provide for, that will never eradicate criminal activity. Where this becomes important is that the auditor will only do what he or she is required to do under the regulations and he or she can only deal with the information given to him or her. The Deputy makes a reasonable point about whether he or she should be able to find stuff under the carpet and asked whether stuff that should be obvious is not obvious. He also asked whether there is stuff that we as regulators need to know and that is what this meeting is about. We think that to fill the expectation gap, the position can be improved but nobody here will say that an international company, no matter how good their auditors are, will root out somebody in a back office in Johannesburg who is not playing the game fairly. Trust and confidence is the most important element. If there is not trust and confidence in the system, it cannot and will not work. We agree with the Deputy that this is what auditors, accountants and IASA have to do. We have to win trust. We are rightly being questioned about what went wrong. There is a system of regulation. Why it did not root these problems is the question we are trying to answer. We are as uncomfortable about aspects of this as the Deputy.

**Ms Karen Erwin:** As Ms Hall adverted to earlier, there is an ongoing review about what exactly happened. We have an independent non-Irish person looking at this. We were due to meet him tomorrow but that meeting had to be cancelled. He has gone back into the files of the accountants and the auditors and it is only when that is done that one can begin to wonder about what happened, what might have happened and what should have happened and whether there was a gap in what was supposed to be done or not. At the minute, we do not have that information. We do not have direct access to those files. The review will take place and we hope it will finish early in 2013. We will then have a look at that and see what are the results. We do not have detailed results which show that an audit was carried out incorrectly.

Deputy Anthony Lawlor has asked why we do not support joint audits. The main reason is the cost involved in having two people audit the same company. There is potential for a lack of clarity about responsibilities whereby two audits might fail to dovetail fully, creating a crack

through which something might fall through. There is also potential for a duplication of work. The expense of having two sets of auditors would be borne by the company.

**Mr. Pat Houlihan:** Ms Hall has said that when there is a crisis, one looks back to see what happened and forward to prevent a recurrence. We are at that juncture in the present case. The proposals before us raise the bar significantly in terms of the requirements of the auditor. If, as we hope will never happen, there are problems, we will review and look forward. In any review we will ask whether the auditors complied with the new level of expectations provided for in the proposed legislation. If an auditor complied, there will be no need for action. If an auditor did not, we will ascertain how he or she failed and ask if such a failure contributed to the difficulty.

A member of the joint committee asked at a previous meeting if sanctions were proposed. Sanctions are proposed in Article 62 of the directive which sets out swingeing penalties for breaches of the regulation. A fine of €5 million is provided for, as is flexibility, whereby a member state can increase it. There is a significant disincentive for those on whom responsibility is thrust to fail to meet their obligations. That may provide Deputy Anthony Lawlor with some solace.

The question has been asked what legislation will be introduced on foot of the measures constituted, on the one hand, as a directive and, on the other, as a regulation. If it is done in the usual way, the directive will be transposed by way of regulations, that is, secondary legislation, under the 1972 Act. I suspect it will be. It may be that the provisions will be implemented by way of amendment or insertions in SI 220 of 2010. The regulation will have direct effect from the day of its implementation, which will be two years from the date on which it is adopted. Where domestic legislation is in conflict with the regulation, we will have to amend it, but where there are lacunae, the regulation will have direct effect and it may be that we will not have to enact our own provisions.

It was suggested it would be desirable to increase the audit exemption thresholds, which are at the maximum permissible under EU legislation of €8.8 million in respect of turnover and €4.4 million in respect of the balance sheet. The good news is that a further increase in the thresholds is proposed in the audit directive up to €10 million and €5 million, respectively. This is being negotiated and likely to be concluded under the Irish Presidency.

Questions were raised about the response of the big four to the Green Paper and their influence on the legislation. The big four are entitled to respond in a consultation process which is open to everybody. There were a record number of 520 responses to the Commission's Green Paper. It was an astronomical figure. Even if the big four had their aunts and uncles responding on their behalf, it would have been difficult for them to reach a majority. Nevertheless, it would be an understatement to use the word "consternation" to describe the reaction of the big four and the audit community to the Commission's proposals. There is no evidence of undue influence on the Commissioner and they are not at all happy. If they sought to influence the outcome by way of responses in the consultation process, the end product demonstrates that they did not succeed.

Joint audits would be a wonderful device if they could be guaranteed to be joint audits of two of the big four companies. In that scenario, one would have the perfect hand-over mechanism whereby one company would come on board at a particular time and subsequently hand the baton to a second. It would be an orderly approach in a situation which was deemed to require a big four audit. There is no indication I have come across of enthusiasm on the part

of the big four to participate in such an arrangement. A Danish colleague talked at a meeting I attended in Brussels about the experience of joint audits in Denmark and I will never forget his summary which was that with joint audit one got one audit for the price of two. Joint audit might also be an impediment to auditor rotation and muddy the waters with too many parties coming on board. A further difficulty is that joint audits are often not really that; there will often be a dominant partner, which would perforce be the case where a big four company was one of auditors. A certain element of an audit would be farmed out to the junior partner, but a senior partner might still not be happy at having to underwrite that element. While joint audits sound attractive, they lose some of their lustre following an in-depth examination. At a minimum, there are complications.

Legitimate concerns were expressed about the risk of the ICAI having undue influence over the IAASA, but that is not the case. A colleague went to a meeting with the IAASA when he was new to the relevant part of the Department and wondered if there was a risk of regulatory capture. The room literally exploded in laughter. There is no such risk or possibility. It will never happen. They contribute to the funding process in the IAASA and the IAASA's powers are set out in law. It is obliged to wield them without fear or influence, which is exactly what it does. All players in the game accept this. The ICAI would be the largest contributor and I have never heard it complain about providing money for the IAASA which, in turn, makes it do things it does not want to. It is a settled system and not one I would want to vary. It works very well. There is a certain degree of minority representation on the board, but those two or three members cannot influence the actions of the IAASA. I was on the board for a number of years and found those members to be very helpful and have contributed greatly to the process of understanding issues. I have seen no difficulties in the past and see no prospect of difficulties arising now. As Mr. O'Toole said more articulately than I can, we are in exceptionally financially inclement circumstances. It is very difficult to get resources or money from anybody and the prospect of switching from a situation where 60% of IAASA funding comes from the bodies to one where the State pays 100% is exceptionally remote to say the least.

**Deputy Anthony Lawlor:** They should make that point.

**Mr. Pat Houlihan:** Yes because there is the requisite level of independence. The IAASA has not been trammelled in any sense. If money can be obtained from external sources in a climate like this, we should continue to avail of it and be happy that it is available from these sources. It is particularly important at a time when it is quite likely that the responsibilities, functions and duties being thrust on the IAASA will increase, as is more than likely arising from the current proposals. In that situation I would be reluctant to mention the word "funding" to the bodies in case they get the bright idea that they should attempt to renegotiate the deal and pay less. The Deputy's point is well founded in principle, but in a practical sense there is no issue with the funding and how it is structured. This is not the best of times to be seeking to change a system that is working when there is no money around to fund it.

**Deputy Áine Collins:** I need to declare an interest. I am a member of one of the professional bodies and was a registered auditor for many years. I am trying to decide whether I am better trusted as a politician than as an auditor. I wonder about my own choices in life. Having been an auditor, I know that auditors take their job very seriously. The amount of regulations brought forward in the past ten or 15 years, even since I trained, has been good and everybody is happy to respond to them. By their nature, auditors and accountants like to be regulated, know that they are doing a good job and make sure there is regulation. We are happy to pay the levies we are paying to bodies such as the IAASA because it reassures us, which is very important.

In respect of the banking issue, we should wait until the report is published before we pass judgment on many people who do good work every day to keep Irish commerce going and around the world because there is so much investment abroad. It is important that we wait and not make the remarks that others here have made.

It is good to have this discussion. A big issue is the rotation of audit firms, which is good. I do not agree with joint audits because auditors would compete with one another which would not be of benefit to the client. There is a code of ethics between auditors and professional firms whereby obtaining information from a previous auditor is never a problem. Most people respect this and all audit firms will co-operate. If there is a need for information gathered or a question arising, an auditor has only to write to the previous auditor who will be more than happy to give the information and clarify the matter. The only issue about which I have concerns and on which I would be open to further discussion is whether eight years is too long. That is a long time in any cycle of commerce.

**Mr. Joe O'Toole:** It went from five years to eight in the discussion and eight years seemed to be the point at which people were drawn into it.

**Deputy Áine Collins:** A little less would be better, but I realise that the IAASA has drawn on its experience and from what others have contributed. That is good and I thank the IAASA for coming to discuss this issue because it is a very important one.

**Ms Karen Erwin:** In response to Deputy Áine Collins's point, we have a statistic about several issues that have arisen over a number of years that might be useful.

**Ms Helen Hall:** By its nature, our job is negative, but it is important to put things in context and not to blacken the entire population of auditors and accountants. There are almost 31,000 accountants and auditors in Ireland who are members of the prescribed bodies that we supervise. We received 22 complaints during the year which amounts to 0.8% of that population. We considered all nine professional bodies and during the year they received 320 complaints. That is a high number and action is required, but it is a little over 1% of the population.

There will be a requirement for hand-over rotation in the audit reform packages and the ESMA will set the standards for what must be put in, which will give us some comfort. There will be a steep learning curve for any new auditor, but at least the law will state what must be handed over. Whether eight years is too long is a very contentious issue and there are pluses and minuses. The current proposal suggests a period six years but another before the legal affairs committee in the parliament is for 25 years. There will be a great deal of discussion at European level on this issue which seem to be firmly on the table at the parliament.

**Mr. Pat Houlihan:** To add to what Ms Hall has said, this is the tie breaker. I listened with interest to what Deputy Áine Collins had to say about the ideal time span. One prophecy I can make that is likely to be fulfilled is that the duration agreed to may not be the most congenial or the one supported by the strongest argument. It will be a huge issue among lobbies and between the Council and the parliament. The compromise period will probably be longer than most prudential people such as the Deputy would consider appropriate. If it does happen, it can be varied.

**Chairman:** I gather there is concern about the evolving definition of the PIEs.

**Ms Helen Hall:** I will answer that question first and others might like to add to it. The proposals on the table will expand the current definition. As soon as an entity is expanded within



that definition, it will come under our direct supervision. In some cases this may have unintended consequences, for example, we estimate that if we were to take over the quality assurance of auditors of public interest entities immediately, there would be eight firms involved. That is the basis on which we would have submitted our plan to Mr. Houlihan. If, for example, credit unions were deemed to be public interest entities, one could add at least another 100 firms. That was the figure I received when I last spoke to people in the Central Bank about credit unions. That is one example of how the scope of our work will change. Do we risk the unintended consequences of perhaps applying a higher level of regulation to firms that in Ireland are perhaps not of public interest? The other interesting part of the proposals is that in the current eighth directive there is an option to add to it, which is very important for each jurisdiction. In our jurisdiction we might be concerned about an entity on which we want to impose regulation but that option is no more. The question being debated in the European Union is whether we should leave member states with the ability to add public interest entities.

**Chairman:** Would anyone like to add to what has been said?

**Mr. Pat Houlihan:** The Commission's decision to move forward with a directive and a regulation is symptomatic of other actions it has taken in international market areas and so on. It has picked this blueprint and will stick with it. The crucial issue is that mentioned by Ms Hall, namely, the discretion for member states to decide matters themselves. The previous Eighth Directive included a core definition for public interest entities, to which members states could add if they so wished. What is happening now is that there is an enormous expansion in the core list and member states can do nothing about it. As stated by Ms Hall, it would be reasonable to provide for a smaller core list to which members states can add, depending on the importance of the entity in their jurisdiction. Unfortunately, the Commission, on a point of principle, believes that the previous eighth directive was not uniformly implemented throughout the Community and wants to eliminate, as much as possible, discrepancies in how this is done. Unfortunately, Ireland as of now may be the victim of that particular philosophical approach by the Commission. It is a serious issue for us in terms of the consequences for IAASA - that is, a plethora of work that is not really necessary but which somebody has to pay for, and a jeopardising of those public interest entities that do not need to be described or treated as such in terms of their competitiveness in the marketplace. As I said earlier, only a handful of member states have a concentration of these firms. Unfortunately, unless something else happens, Ireland may suffer. As I mentioned earlier, we are making a submission to the Commission on the justification for their inclusion. We are doing our best to address this issue.

**Ms Helen Hall:** It is important to remember that the audit reform proposals do not affect only regulatory authorities such as IAASA or auditors; they also affect the entities themselves. The current list of public interest entities includes investment funds, of which we have many in this jurisdiction, captive insurance companies and reinsurance, which are tiny but will now be required to have an audit committee and non-executive directors, the cost of which will be enormous. As mentioned earlier by Mr. Houlihan, the jurisdictions most concerned are, unsurprisingly, Ireland, Luxembourg and the UK, because of the markets in which we operate. Although we term these proposals audit reform, there are impacts therein for entities, companies and investment funds.

**Chairman:** We can follow up on that issue.

**Deputy Áine Collins:** Will companies limited by guarantee be audit-exempt and, if so, from when?

**Mr. Pat Houlihan:** The measure to which I referred in my introductory remarks will be, as I understand it, provided for in the consolidated companies Bill, which it is hoped will be published before the end of the year. I understand the issue is being dealt with in that context.

**Deputy Áine Collins:** It will probably be the end of next year before it comes in.

**Mr. Pat Houlihan:** Yes. Consideration is currently under way of creative ways through which the Legislature can process the measure. We would welcome members' ideas.

**Deputy Áine Collins:** Mr. Houlihan might regret that.

**Mr. Joe O'Toole:** Deputy Collins should be aware that a consolidated companies Bill was expected at the end of 2007, 2008, 2009, 2010, 2011 and 2012. I was promised by three different Ministers that it would be published at the end of a particular year.

**Deputy Áine Collins:** I am sure the current Minister will deliver.

**Chairman:** I thank the witnesses for attending. I note the proposed changes to IAASA's board and wish the organisation luck with them. The committee has further work to do on this issue. We will try to engage further with IAASA over the next couple of months.

There are two options open to the committee in respect of this issue - namely, to report to the Minister, or to make a direct contribution on it to the EU Commission. I propose that we take the second option. Is that agreed? Agreed.

#### **Irish Auditing and Accounting Supervisory Authority: Discussion with Chairman Designate**

**Chairman:** The purpose of this meeting is to discuss with the chairman designate of IAASA, Mr. Brendan Walsh, the approach he will take in his new role and his views on the challenges facing the authority. Members will be aware of the Government decision of May 2011 which put in place new arrangements for the appointment of persons to State boards and bodies. The committee welcomes the opportunity to meet with the chairman designate in public session to hear his views and trusts this provides greater transparency to the process of appointment to our State boards and bodies.

On behalf of the committee, I welcome Mr. Walsh and invite him to make his presentation.

**Mr. Brendan Walsh:** I thank the committee for the opportunity to make this presentation. I am honoured to be considered for the position of chairman of IAASA. I have learned a great deal about the authority since 1.30 p.m. Needless to say, as an outsider to the authority and accounting profession, I am not that familiar with the work of the authority.

I understand the authority has an important role to play in rebuilding the public's confidence in the processes of financial reporting and statutory auditing and is doing so in the context of major changes in the European regulatory framework and supervisory structures following the establishment of the European Securities and Markets Authority and publication by the EU Commission of a Green Paper on reforms of the audit market, which were discussed at some length earlier by the committee.

As discussed, the authority is also facing a major expansion of its functions as it assumes

responsibility for quality assurance of certain firms. These demands are on top of the authority's existing role of supervising the financial reporting of equity issuers and the regulatory and disciplinary activities of the prescribed accounting bodies. As mentioned during the earlier part of this meeting, this increase in the authority's workload comes at a time when resources available to public bodies are shrinking. Securing adequate resources commensurate with the increased responsibilities will be crucial to the authority's success in performing its expanding role. The statement of the outgoing chairman and review of the outgoing chief executive underline the commitment and professionalism of the authority's staff and provide me with great reassurance that IAASA will be able to meet the challenges it faces in effectively supervising the Irish financial reporting system. I believe it will receive the support of the Oireachtas in discharging this duty.

As I said, I come to the role of chairman as an outsider to the accounting and audit profession but as one who has had a lengthy involvement with this profession as a customer, particularly in the context of pensions funds and fund management industries where the role of auditing is crucial. It is equally important in the very turbulent financial period since 2008. The expectations gap that was mentioned in the previous debate became very apparent to me as a member of a number of boards dealing with very large sums of money that suddenly became smaller in the course of 2008 and 2009 with grave implications for investors, members of pension funds and people looking forward to a retirement with some financial security. The debate that took place here was enlightening to me in regard to the expectations gap not just between the general public and the profession but also in regard to directors of companies, who rely on auditors to give them comfort and assurance that the accounts have been kept honestly in accordance with the law. Directors of companies can take reassurance from this. The expectations gap, as mentioned by Deputy Tóibín among others, is that we as directors cannot rely on this to discharge ourselves of responsibility for prudence and for the decisions that ultimately determine the performance of pension and investment funds.

I have an appreciation of the key role played by the auditing profession in maintaining confidence in the stability of the financial system, but I also have an awareness of the limitations that are placed on that by the way in which the systems in the accounting and the auditing profession operate. I am conscious of the need to strive for maximum transparency in areas that are often highly technical and obscure to the general public. It is also vital to maintain public confidence in the integrity and independence of the regulatory and disciplinary process. We had an extensive discussion in this regard earlier this afternoon and I have certainly obtained great clarification of the role of the authority with regard to indirect supervision but also with regard to direct supervision, as was clarified by some of the contributions.

The present system of self-regulation in the accounting and auditing profession gives increased significance to the supervisory role of IAASA. I am coming to this as an economist. Some people say that accountants are economists who could not stand the excitement and retired to the accounting profession. I am doing it the other way around. I thought of this in the context of the professional insights an economist should bring to the role of the supervisory authority. I am happy to say that most of the ideas I would suggest were mentioned in the previous discussion.

One of the areas in which economists have been sceptical about regulation and regulatory authorities is with regard to the concept, mentioned by Mr. Pat Houlihan, of regulatory capture - the idea that a regulator provides an opportunity for the people being regulated to enforce structures and rules that they themselves favour rather than acting as a genuinely independent

supervisor of the profession. Regulatory capture has been a big concept in economics and a Nobel prize was awarded to the person who threw this idea out in the United States. It has given rise to a certain scepticism about supervisory and regulatory authorities. I have taken consolation from the earlier remarks that the way in which IAASA works has avoided any taint of regulatory capture. It is my ambition that this should continue to be the case during the years I am associated with it.

What an economist can bring to any role such as this is the opportunity to consider the incentives that people in the profession face. Economists believe that people are ultimately driven by the incentives and the rewards they can reap from certain types of behaviour. It is important in the medical profession that the providers of medical care are driven by concern for their patients rather than by a concern for increasing the size of the profession or increasing their own incomes. In the same way, in this area, it is important that the incentives faced by auditors and accountants in regard to the firms in which they have an audit role are not tainted by any other incentives in regard to the firms with which they are dealing. The existence of a secondary motivation for going along with practices in a firm because of another relationship the auditor has with the firm is perilous and must be avoided at all costs. The incentives facing the profession have to be such as to minimise any conflict of interest that could arise, such as a conflict between the interests of the auditing bodies and the interests of the public and the shareholders of the companies.

A final concern that economists have in this regard - which needs to be mentioned, not just in the Irish context but also in the European context - is the question of cost. Excessive regulation, intervention and burdens of compliance on firms, including audit requirements, do ultimately make firms less competitive with jurisdictions in which these regulations and requirements are less onerous. This is an issue faced by Europe as a whole and to some extent by the United States in the wake of the crisis we have come through. We must be conscious that at the end of the day, firms are in business in order to meet consumers' wants. They must do this in a transparent and honest manner. They must comply with accounting regulations and with the law in this area but they also should not be burdened with excessive costs. I think there is a balancing act to be performed between the goals we have been emphasising - transparency, credit and trust and confidence in the auditing function - on the one hand and the danger, on the other hand, that firms will become choked by regulations that are onerous and costly.

**Senator Mary M. White:** Go raibh maith agat. I welcome Professor Walsh and wish him the best of luck in his new role. I was privileged to study national economics under Professor Walsh, because prior to his return in 1980 the standard was not brilliant.

The ordinary man and woman cannot believe the state the country is in, and the austerity programme that has resulted from this is a consequence of the behaviour of the banks. Many people, including me, find it difficult to accept that auditors could charge large fees to the then Anglo Irish Bank. How will we recreate credibility in companies?

In the United States, Enron, a company that was audited by Arthur Andersen, is an example of accountability. I know the legislation in the United States is different from Irish law. We must look at this. In the United States people are accountable. The system is transparent and one can finger a person and say that he or she did not do his or her work properly. I know there are investigations and that we must be circumspect. Day in, day out, the question is asked: why has no banker been held to account for what happened to the country? Our recession is far more complex than that of any other country. What are we going to do? The witness mentioned that the council is in the process of financial reporting and statutory auditing and regulation. How is

that going to be enforced? We appear to be useless in that regard. We are great at making laws - that is what I have learned here - but useless at implementing them. What will the witness do?

**Mr. Brendan Walsh:** It would be premature to comment on what the outcome of the investigations and the steps that have been taken about the audit role in our particular mess will be. There was a discussion on that issue earlier where it was stated that there are proceedings that are not yet complete and it would be premature for the Irish Auditing and Accounting Supervisory Authority to comment on them. Some of these have shifted into the area of possible criminal prosecutions and one cannot prejudice those. Going back to the Senator's broader question, I think these things go in cycles to a certain extent. Just like the bubble in the housing market or in the stock market there tends to be a crash after which there is a period of soul searching and rebuilding of confidence slowly, perhaps, for five or ten years, and gradually the lessons of the past are forgotten and the same pressures build up again. To some extent, in this area, there were periods when standards were lax and crises developed that should have been averted and they have been followed by periods of reform. For example, in the US in the 1930s an immense amount of legislation was introduced, some of which was gradually relaxed in respect of ordinary banks getting involved in investment activity. After a while the lessons and the pain of the 1920s or early 1930s wore off, and some of the regulations were relaxed, the same tragedy was reiterated and we got into another crisis in the 1990s and the last decade partly through having forgotten what was learned during the previous crisis. To some extent there is a cycle and I think I know where we are in regard to that in this situation.

We have come through the worst financial crisis in our history as an independent country. We are still suffering the consequences of that in economic terms in terms of austerity, hardship and budgetary pain and we are desperately trying to prevent a recurrence. We are aided by the EU measures that have been discussed in which we will play an important role in trying to implement during the Irish Presidency. I see ourselves as moving back into a more cautious reformist period in regard to the substance of what this authority deals with. As outlined in the presentation by the outgoing-----

**Senator Mary M. White:** Yes.

**Mr. Brendan Walsh:** There was a discussion on what is direct and indirect supervision. It is clear that the authority is involved in both and, from my reading of the situation, it will become more involved in direct supervision as time goes by and that there will be a reform period which, I hope, will bear fruit and will not be short lived.

**Senator Mary M. White:** What about the big fees which the auditing companies receive and the information they are given by, say, the financial institution? What will change there?

**Mr. Brendan Walsh:** I think what will change there is that the regulation and the supervisory role will be much more alert and much more hands-on. A reassuring statistic was given about how few of the 30,000 plus professionals in the field have had complaints made against them over the years. The problem may have been that some of the outrageous faults were in very prominent companies and in very prominent situations. They also involved a certain amount of innovation on the part of the people involved which probably took regulators and the general public unawares. There is need for continuing vigilance on behalf of financial positions in companies to innovate to their own benefit and to the detriment of the public good and of the shareholders in the company. That is a very general statement but I have confidence in the professionalism of the body and its vigilance. It is a co-operative venture between the prescribed accounting bodies and this authority - the authority making sure that the prescribed



accounting bodies are following their procedures as stated - the authority also having powers to vet, comment and, if necessary, to change the rules of those prescribed accounting bodies. I see it as a process that will bear fruit over the difficult period that we are going through and that this authority has come through.

**Deputy Peadar Tóibín:** I wish Mr. Brendan Walsh the best of luck in his new role. As he has worked as a professor in national economics for many years he would have witnessed some of the peaks and troughs in the past. That is why I was anxious to get the point across that we need to use an institution that is structured to ensure the next trough is reduced. He made the point that most of this has happened previously. While this is probably the biggest financial crisis in almost 100 years the main determinants are not all that new. It is the lack of institutional memory that is available to the system which is at fault. From my perspective one of the major problems was the clear over-exposure of the property market and the over-exposure of access of cheap credit which led to the weaknesses within these institutions and that was not captured as such at the time. The Regling Watson report said this was a homemade disaster and a disaster which focused on the weakness in supervision.

For citizens this is the biggest catastrophe that has happened to their generation. We are a number of years away from it now. I understand six years is the statutory time span for individuals to be brought before the courts. We are clear on the generalities of the problem but not on the specific issues of who did wrong and what exactly they did wrong. It is a major concern for Irish society that four years on we are still in that position. How can we use the system as a tool to prevent this happening again? How can we create an institutional memory, if that is possible? How can we identify expeditiously the individuals and the actions they did or did not take as soon as possible?

**Mr. Brendan Walsh:** I thank the Deputy for his questions. To some extent he has echoed the issues raised by Senator Mary White. I will make one comment. There is a certain danger in seeking to identify particular individuals who acted recklessly or even in a criminal manner. Unfortunately, these crises recur with depressing regularity but, in fact, we have had relatively few of them in Ireland. However, it is clear from the history of financial institutions in the past 200 years that housing bubbles followed by reinforced by banking bubbles have recurred, perhaps, every ten or 15 years across the world and as the title of one recent authoritative study put it, *This Time is Different*. In each of these crises there are journalists, professionals, economists who give reasons. They said Ireland was different because it had a young and dynamic growing population and an inflow of foreign direct investment, it needed all this extra housing and it was justified to advance loans on very small margins because of the buoyancy of the economy. That was the particular argument in Ireland. In America it was about sub-prime mortgages being extended to tranches of the population that could not otherwise afford housing. There was a certain dressing this up as if it was altruism to bring lower income people into the housing market.

There will always be some rationalisation and some specious argument put forward on which to a certain extent it is the duty of the sceptical economist and journalist to throw cold water. It is difficult to do that. The Honohan report places a fair amount of emphasis on the psychology that develops, the psychological momentum behind these bubbles and how difficult it is for any one individual to buck the trend, to stand out and say the emperor has no clothes, that these arguments are invalid, that this time it is not different and that it will all end in tears the way it has the previous 120 times. It is difficult to do that.

I am not answering the Deputy's question immediately but digressing to say we must be

aware that unfortunately there are forces in complex capitalist economies like ours that lead to these disasters periodically and we must try to restrain them in every way we can. Laws, such as the Glass-Steagall Act, were introduced in the United States to try to put the reins on investment banking but when things had settled down and people said profit opportunities could be availed of if the Act was relaxed, it was abolished and we know the consequences of that were disastrous. We must frame good laws for our banking structures to make sure that even though we operate within a European framework we still have some autonomy in regard to, for instance, the margins in which mortgages are advanced. We could have acted in that area earlier and more decisively than we did. I would emphasise the putting in place of institutional legislative constraints rather than necessarily identifying the people who were culprits. There were people who acted possibly illegally and I hope they will be brought to book, but I step back a little from that and point to there being a psychology here, a momentum that builds up and we must try to build institutions, which is not necessarily the role of the supervisory authority rather it is the role of the Oireachtas generally in terms of the framework within which the financial system and the banking system operate.

I think we have learned lessons. At European level, the move last week towards a European system of banking supervision is a very important step in that direction. Hopefully we will have learned lessons from this Irish and Europe-wide catastrophe that has hit us and we will be able to postpone the next crisis beyond the ten year cycle that, unfortunately, has been the pattern in many countries in the past.

**Chairman:** Do Senator White or Deputy Tóibín have any concluding comments?

**Deputy Peadar Tóibín:** Basically Mr. Walsh is saying that it is more of a cultural problem and individuals are part of that culture and to separate them from the culture would not be useful in the long run.

**Mr. Brendan Walsh:** It is a mixture. Obviously when the supervisory framework is lax and there is light touch regulation, there are people who will jump in and avail of that in a reckless way and perhaps in a criminal way. It is a mixture of keeping an eye on them but also, probably even more importantly, making sure the opportunities they have to act in that manner are closed off.

**Deputy Peadar Tóibín:** Would it be possible for us as a committee to have regular meetings with the authority to discuss how things are proceeding, etc., and to have annual reports as well?

**Chairman:** I will invite in the new chairman of the authority and his staff as often as I can. As the chairman will have noted, one could get a good few jobs if one comes in here and one might not have only the one job to do. We want to cover many more topics as well.

Unless Mr. Walsh wants to make any concluding comments, I would point out that it is important in terms of process that we agree that the committee will inform the Minister for Jobs, Enterprise and Innovation, Deputy Richard Bruton, that have we concluded our discussion with Mr. Walsh and that we will forward a copy of the transcript of this meeting to him for his information. Is that agreed? Agreed.

I thank Mr. Walsh for coming in today and I wish him well in his role. I understand he will take over as chairman of the authority on 2 January. I also wish his predecessor well in other developments.

The joint committee adjourned at 4.05 p.m. until 1.30 p.m. on Tuesday, 15 January 2013.