CAU Asia Focus

COUNTRY ANALYSIS UNIT FEDERAL RESERVE BANK OF SAN FRANCISCO APRIL 2012

Accounting Regulatory Architecture in Asia

Accounting regulatory regimes play a critical role in ensuring the reliability of financial data and the credibility of a company, and ultimately in supporting the stability of an economy. For the United States, the collapse of the Enron Corporation and the eruption of other financial statement related scandals a decade ago stand as clear reminders of the importance of reliable audit reviews and adequate regulatory oversight. These scandals led to the passage of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act). This legislation created an independent accounting oversight board to supervise the U.S. accounting industry and instituted a number of new audit-related requirements. Prompted in part by these U.S. actions, many Asian economies have established similar regulatory bodies and standards for their domestic accounting industry.

Recent scandals in Asia highlight the need for continued focus on audit oversight frameworks. In Japan, for example, accounting irregularities were disclosed at Olympus in late 2011 and at AIJ Investment Advisors Co. in early 2012.[1] And since 2010, the U.S. SEC has conducted fraud investigations of numerous Chinese companies listed in the United States.[2] As a result of these investigations, the SEC is suspending securities registration at about three dozen such companies.

This *Asia Focus* report reviews the evolution of accounting regulatory regimes in Asia during the ten years since the passage of the Sarbanes-Oxley Act. The report presents background information about the U.S. experience, provides an overview of current accounting regulatory frameworks in Asia, and highlights the regimes of four economies—Japan, Malaysia, Singapore, and Thailand.

Background: Sarbanes-Oxley Act of 2002

Enron Corporation was founded in Texas initially as a gas pipeline business in 1985, but later expanded its operations through commodities trading and other business diversification in the late 1990s.[3] By 2000, it had become the seventh largest firm in the United States, employing approximately 21,000 staff in over 40 countries.[4] However, most of its recorded assets and profits were inflated by an elaborate scheme that concealed transactions and debts through unconsolidated subsidiaries. The company's troubles began in August 2001 with the abrupt resignation of its chief executive officer and accelerated in October 2001 with the write-down of its shareholders' equity by USD 1.2 billion over undisclosed investment vehicles, which triggered an SEC investigation. In November 2001, the company announced that its income was overstated by USD 591 million for the five-year period starting in 1997. The situation quickly unraveled, and Enron filed for bankruptcy in December 2001.

Enron's collapse had significant repercussions for corporate governance and auditing oversight in the United States. Not only did Enron's executives face legal action, but its external auditor, Arthur Anderson LLP, was forced to surrender its public accounting license after criminal charges were filed against it in connection with mishandling the Enron audits. The accounting firm's independence was one of the main focuses of the SEC investigation, as Enron paid Arthur Andersen more in non-audit (*i.e.*, consulting) fees (USD 27 million) than it paid in audit services fees (USD 25 million).

After Enron's collapse and a series of other highly publicized financial frauds in 2000-2002, the U.S. Congress held a series of hearings to investigate the nature and causes of the problems. Lawmakers cited "inadequate oversight of accountants," "lack of auditor independence," and "inadequate disclosure provisions" as primary factors behind many of the fraudulent activities. Provisions addressing these issues became key sections of the Sarbanes-Oxley Act.

To establish auditing oversight, the Sarbanes-Oxley Act aims to enhance the supervision of audit firms of listed companies—particularly over their audit practices, conduct, and performance—to ensure the reliability of financial statements. The Act created the Public Company Accounting Oversight Board (PCAOB), which is responsible for registering public accounting firms, performing regular inspections of audit quality, and developing and enforcing audit standards in the United States. The legislation also stipulated specific measures relating to auditor independence and attestation to the adequacy of clients' internal controls over financial reporting. These measures continue to evolve as the PCAOB refines auditing standards and practices in the United States.

Accounting Regulatory Regimes in Asia

After global focus on the U.S. accounting scandals of the early 2000s, several Asian economies adopted measures to enhance the integrity of their local accounting professions and to promote the transparency of financial statements issued by local companies. As in the United States, these economies focused on two major types of provisions: the creation of an accounting oversight organization and the tightening of auditor rules.

The roles of Asian accounting oversight bodies are similar to those of the PCAOB in the United States. All oversee the registration of public accounting firms and inspect the quality of audits performed by these firms. The quality of an audit is determined by a number of factors, including an auditor's independence from the firm it reviews and its testing of internal controls. To support audit quality, independence, and accurate financial statements, accounting oversight bodies may mandate a number of requirements, including: (i) auditor rotation, (ii) restrictions on non-audit services, and (iii) attestations by external auditors on the quality of a firm's internal controls over financial reporting.

The regulatory bodies of seven Asian economies—Japan, Malaysia, Singapore, South Korea, Sri Lanka, Taiwan, and Thailand—have joined the International Forum of Independent Audit Regulators (IFIAR), an organization of independent audit regulators through which members share their experience and knowledge about regulatory practices and activities. As of early 2012, IFIAR had 39 member economies, including the United States. Although Hong Kong and China are not IFIAR members, they do have regulatory organizations that perform the audit oversight function of firms operating within their territories.

Table I summarizes the structure of accounting oversight bodies in selected Asian economies and the United States.

Key Audit Roles and Requirements in Four IFIAR-Member Economies

A detailed comparison of the key roles of accounting oversight bodies and related audit requirements is possible based on available information covering four IFIAR economies: Japan, Malaysia, Singapore, and Thailand. These roles and requirements are summarized below, while additional details are summarized in the reference table at the end of the report.

Registration of Auditors and Audit Firms

In audit oversight practices, a designated authority is responsible for registering the auditors and audit firms of relevant companies under their jurisdiction. Typically, this responsibility lies with the appropriate national accounting association or oversight body. The audit registration requirement implies that the designated authority has reviewed and played a role in vetting the quality of the auditor or audit firm in order to approve the registration. The requirement also ensures that auditors and audit firms fall under the oversight of the designated authority.

All four Asian economies require all audit firms to register with their respective audit oversight body or national professional organization. In addition, some Asian economies require firms that audit financial institutions to register separately with the local bank regulator. For example, bank audit firms in Malaysia, Singapore and Thailand must receive approval from their regulatory agency, which is the central bank in these economies. This

Table I: Accounting Oversight Bodies in Asia and the United States

Economy	Accounting Oversight Body	Description
IFIAR Member Economies		
Japan	Certified Public Accountants & Auditing Oversight Board (CPAAOB)	Under the Financial Services Agency (FSA).
Malaysia	Audit Oversight Board (AOB)	Under the Securities Commission (SC).
Singapore	Accounting and Corporate Regulatory Authority (ACRA)	Statutory board under the Ministry of Finance (MOF).
South Korea	Financial Supervisory Service (FSS)	Under the Financial Services Commission (FSC).
Sri Lanka	Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB)	Currently funded by the Parliament. Its governing board is heavily comprised of government officials, including the Director General of the Securities and Exchange Commission.
Taiwan	Financial Supervisory Commission (FSC)	An independent authority under the Executive Yuan (the executive branch of the government). The Accounting and Auditing Supervision Division of the Securities and Futures Bureau under the FSC implements audit regulatory oversight.
Thailand	Securities and Exchange Commission (SEC)	An independent state agency whose board chairman is appointed by the Finance Minister.
United States	Public Company Accounting Oversight Board (PCAOB)	A private-sector, nonprofit corporation under the oversight of the Securities and Exchange Commission (SEC).
Non-IFIAR Economies		
China	Ministry of Finance (MOF)	Acts as the primary audit oversight body, but the Chinese Institute of Certified Public Accountants conducts quality reviews of public accounting firms.[5]
Hong Kong	Hong Kong Institute of Certified Public Accountants (HKICPA)	A professional accounting association responsible for both overseeing auditor registrations and audit quality.[6] The Chief Executive of the Hong Kong Special Administrative Region may appoint four lay persons to its Council.

additional requirement ensures an adequate level of oversight for bank because of their economic importance.

Inspections of Audit Quality and Audit Firms

Audit inspections play a critical oversight role in ensuring audit quality. In audit inspections, the designated authority reviews the quality of audit firms' work and their internal controls and practices. Depending on the designated authority's scope, the inspection may review compliance with auditing and ethical standards, the quality of individual audit reports, and the potential impact of corporate culture on audit quality.

Audit inspections are typically more rigorous for the Big Four[7] and other major audit firms that employ a large number of auditors or audit a large number of listed clients. Both the United States and the four Asian economies subject these firms to a more frequent inspection cycle ranging from one to four years, as opposed to three to five years for smaller audit firms. Audit inspections target the Big Four because they tend to audit the majority of listed companies in a given economy, ranging from 61 to 88 percent in the selected Asian economies[8] and 98 percent in the United States.[9] As such, the quality of the Big Four's audit performance has a greater potential impact on the integrity and reliability of financial reporting in the market. Indeed, Japan's audit oversight agency (the Certified Public Accountants & Auditing Oversight Board) subjected these firms to a series of special investigations following a spate of accounting scandals in 2005. The investigations resulted in the agency's issuance of a number of recommendations to improve audit quality control at the four accounting firms.[10]

Requirements on Auditor Rotation

Audit rotation requirements mandate that companies periodically change auditors or audit firms to ensure auditor independence. The concern is that if an auditor works with the same client for an indefinite period of time, the auditor may develop too close a relationship with the client that might impair his/her objectivity and professional skepticism. The Enron scandal highlighted the importance of auditor independence, particularly given Arthur Anderson's questionable role in shredding key documents.

Audit rotation requirements may apply to auditors, audit firms, or both. They typically specify the length of the mandatory rotation period and the length of the subsequent "time-out period," during which the auditor or audit firm may not engage in an audit for a particular client. The requirements' strictness varies across Asian economies, with the audit rotation period for key auditors ranging from five to seven years, and the time-out period for key auditors ranging from two to five years, if any. Singapore is the only selected Asian economy that requires mandatory rotation of audit firms; however, this requirement applies only to firms that audit banks. These firms face a five-year rotation period and five-year time-out period.

The United States also does not require the mandatory rotation of audit firms, although PCAOB is seeking public comments on a proposal to do so.[11] During a public hearing in March 2012, the Big Four and many large U.S. corporations expressed opposition to the proposal.[12] They argued that new auditors would not have the institutional knowledge required for an in-depth audit, particularly for complex multinational corporations. They alleged that this lack of familiarity with the client operations would lead to more costly audits because of the time required to fully understand the company's business and accounting system. Opponents also opined that there could be a higher risk of missing potential problematic areas resulting in poor audit quality, and that the mandatory audit partner rotation is sufficient for a "fresh look" at the audit. The PCAOB reportedly expects the debate over mandatory audit firm rotation to extend into 2013.

Restrictions on Providing Non-Audit Services

Audit oversight agencies in both the United States and Asia restrict audit firms from providing non-audit services to promote independence. The importance of non-audit service restrictions is highlighted by Arthur Anderson's non-audit services to Enron in both the nature of the service provided and the magnitude of the fees. Arthur Anderson had provided extensive tax advisory services in structuring many of Enron's special purpose vehicles, which hid the company's off-balance sheet losses. In addition to services that directly affected Enron's financial statements, Arthur Anderson's non-audit fees exceeded its audit fees from Enron and generated a significant conflict of interest in providing an objective audit opinion.

Restrictions on non-audit services vary based on how the audit regulatory body anticipates which activities will impair the auditor's independence. The restrictions may range from a prescriptive list of prohibited services to broad guidance. For example, similar to the United States, Japan explicitly prohibits the same audit firm from providing non-audit services related to the client's financial statements and investment advisory services. However, Singapore allows the same audit firm to provide non-audit services if the resulting threat to auditor independence is at an "acceptable" level. Malaysia is unique in that it provides a quantitative criterion based on audit fees. Specifically, the non-audit fees may not be more than 20 percent of audit fees.

Attestation of Internal Controls

Auditor attestation of internal controls over financial reporting is a relatively new development in Asia. Under this requirement, the external auditor must issue a statement that opines on the effectiveness of the internal controls over financial reporting. This statement effectively ensures that the auditor thoroughly assess internal controls as part of the external audit. Auditor attestation requirements have been partially driven by accounting scandals, which by nature imply a breakdown of internal control. This breakdown of internal control at management levels was exemplified in the Enron scandal in the United States and in Japan by the Livedoor and Nikko Cordial scandals in 2006 and 2007, respectively.

In 2011 and 2012, Japan and China implemented auditor attestation requirements similar to those of the United States.[13] These are the only two economies to have issued such requirements. Notably, both economies have experienced a number of accounting scandals in recent years. Indeed, the high-profile Kanebo scandal in 2005 was one of the catalysts that prompted audit oversight reforms in Japan. China goes beyond requiring the review of internal controls over financial reporting by including non-financial reporting objectives.[14]

Conclusion

Over the last decade, regulators in Asia have acknowledged the need for continual improvement in audit regulatory oversight. High-quality external audits are crucial to ensuring the integrity of financial statements and bolstering market confidence. During critical times, market stress may add pressure on corporate management to meet performance targets and expectations, and manage cash flow and ongoing operations. Indeed, recent accounting scandals in some Asian economies reinforce the importance of audit oversight. Given the increasing complexity of business transactions and the opportunity for "creative" accounting practices, the continual development of audit oversight by Asian economies is highly encouraging and should contribute to supporting market confidence and stability.

Endnotes:

1. In October 2011, Olympus executives were found to have hidden USD 1.7 billion in losses from investments in the 1990s. While Japan's Securities and Exchange Surveillance Commission ended its investigation on March 28, 2012, the Olympus scandal is still unfolding. In February 2012, the Financial Services Agency (FSA) announced that AIJ Investment Advisors Co. cannot account for USD 2.3 billion in pension-fund assets under management.
2. Most of these companies are Chinese companies that listed in the United States through reverse mergers, which bypasses the SEC filing requirements for initial public offerings. In one of the latest accounting scandals, the SEC charged the executives of Puda Coal for fraud, which will cost U.S. investors about USD 100 million.
3. Congressional Joint Committee on Taxation, "Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations," February 2003, www.jct.gov/s-3-03-vol1.pdf (last accessed April 13, 2012).
4. 2001 Fortune 500, CNN Money, http://money.cnn.com/magazines/fortune/fortune500_archive/full/2001/index.html (last accessed March 21, 2012).
5. World Bank, "Report on the Observance of Standards and Codes (ROSC) – Accounting and Auditing: People's Republic of China," October 2009.
6. Hong Kong Institute of Certified Public Accountants, "Information Sheet," December 2011.
7. The Big Four include Deloitte & Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers.
8. As reported by IFIAR from 2010 to 2011, the Big Four account for about 70 percent of market capitalization in Japan, 88 percent in Malaysia, 61 percent in Singapore, and 70 percent in Thailand.
9. Emily Chasan, "A Good Auditor Is Hard to Find," CFO Report, March 20, 2012
10. The CPAAOB investigated the Big Four audit firms (KPMG AZSA & Co., Deloitte Touche Tohmatsu, Ernst & Young ShinNihon, and ChuoAoyama PricewaterhouseCoopers) from October 2005 to June 2006 after various accounting scandals, particularly the high-profile Kanebo scandal. It issued recommendations to improve audit quality control management in its June 2006 findings, and followed up in June 2007.
11. Public Company Accounting Oversight Board, "PCAOB Rulemaking Docket Matter No. 37/PCAOB Release No. 2011-006: Concept Release on Auditor Independence and Audit Firm Rotation," August 16, 2011.
12. "Top watchdog, U.S. Chamber clash on auditor rotation," Reuters, March 22, 2012.
13. China issued auditor attestation requirements under the Basic Standard for Enterprise Internal Control, dated May 22, 2008.
14. PricewaterhouseCoopers, "Opportunities to improve financial reporting and internal controls in China: CAS and C-SOX," May 2011.
15. The precise definition and composition of public interest entities (PIEs) varies across economies. Conceptually, a PIE is an entity of significant interest to the public because of its size, business nature, and range of stakeholders. Listed companies typically fall under the classification as a PIE.

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Reference Chart: Summary of Auditing Oversight Bodies' Roles and Audit Oversight Requirements

Oversight Body / Legislation	Roles of Auditing Oversight Bodies	
	Registration of Public Accounting Firms	**Audit Quality Inspection**
USA		
Public Company Accounting Oversight Board (PCAOB) *Sarbanes-Oxley Act, 2002, last amended 2010*	• Audit firms of publicly listed companies must register with the PCAOB. • The PCAOB is responsible for registering "issuers, brokers, and dealers" as defined under the PCAOB Rules and Securities Exchange Act of 1934.	• PCAOB conducts annual inspections annually for firms that regularly provide audit reports for more than 100 audited companies. • It conducts inspections, at least triennially, for firms that regularly provide audit reports for 100 or fewer companies.
Japan		
Certified Public Accountants & Auditing Oversight Board (CPAAOB) *CPA Law, 2004, last amended 2007*	• All CPAs must register with the Japanese Institute of Certified Public Accountants (JICPA). • JIPCA's Center for Listed Company Audit Firms is responsible for registering audit firms engaged in the audit of listed companies to reduce the burden on the CPAAOB and place more emphasis on self-regulatory mechanisms.	• JICPA's Quality Control Review Team reviews auditors and CPAs every three years on the audit of financial statements, particularly the audit process, of listed companies, certain large companies and other entities that must have audited financial statements. Notably, JICPA tries to review the big audit firms every other year. • CPAAOB's Office of Monitoring and Inspection oversees JICPA's quality control reviews, and will conduct on-site inspections of the audit firm, JICPA, and related sites, if necessary.
Malaysia		
Audit Oversight Board (AOB) *Part IIIA of the Securities Commission Act, 2010, last amended 2011*	• The AOB registers auditors of public interest entities. • All audit firms must register with the Malaysian Institute of Accountants (MIA), which is under the Ministry of Finance. • Bank Negara Malaysia must approve a bank's appointment of its external auditor on an annual basis.	• The AOB conducts inspections and monitoring programs to ascertain compliance with auditing and ethical standards. It selects audit firms to inspect on a risk-based approach. • Section 31V of the Securities Commission Act only calls for inspections "from time to time" and does not provide a specific inspection cycle. In its 2010 annual report, the AOB stated its goal to inspect audit firms with more than 10 auditors and that audit more than 40 public interest entities (PIEs)[15] on an annual basis. It will inspect other firms on an unspecified, "pre-determined cycle."
Singapore		
Accounting and Corporate Regulatory Authority (ACRA) *Accounting and Corporate Regulatory Authority Act, 2004*	• ACRA's Public Accountants Oversight Committee (PAOC) is responsible for registering all public accountants and audit firms. • For banks, the Monetary Authority of Singapore (MAS) must approve the bank's auditor. • For listed companies, the Singapore Exchange Limited (SGX) requires that auditors are registered with ACRA, amongst other alternatives.	• Singapore divides the responsibilities for audit quality inspections between its audit oversight body and professional accounting association based on the whether the company is a PIE. • Under ACRA's Practice Monitoring Program (PMP), ACRA directly reviews audit firms that audit public interest entities (PIEs), and the Institute of Certified Public Accountants of Singapore (ICPAS) reviews firms that look at non-PIEs. • The average inspection cycle is two years for the Big Four audit firms, three to four years for firms that audit PIEs, and four to five years for firms that do not audit PIEs.
Thailand		
Securities and Exchange Commission (SEC) *Securities and Exchange Act (1992), last amended 2008*	• All accountants and auditors must be Federation of Accounting Professions (FAP) members and all audit firms must register with the FAP. • The Securities and Exchange Commission (SEC) must approve the auditors of listed companies, securities issuers and other market intermediaries (SEC-regulated entities). The FAP's Quality Screening Committee reviews the auditors of SEC-regulated entities prior to SEC approval. • The auditors of financial institutions must also receive BOT approval.	• Thailand divides the responsibilities for audit quality inspections between its audit oversight body and professional accounting association, largely based on whether the company is listed. • The FAP is responsible for reviewing auditors' work quality. • The SEC inspects audit firms for reliable quality assurance systems, and approved auditors must be part of the approved audit firms. • The inspection cycle is every year for the Big Four firms and at least every three years for small and medium audit firms. • While these measures were issued in September 2010 and will take full effect as of January 2013, the SEC began the inspections as of October 2010.

Reference Chart: Summary of Auditing Oversight Bodies' Roles and Audit Oversight Requirements (continued)

Audit Oversight Requirements		
Auditor Independence: Auditor Rotation	**Auditor Independence:** Non-Audit Services	**Auditor's Attestation on Internal Controls**
USA		
• Every five years for lead and concurring partners and a five-year time-out period; for other significant audit partners a seven-year rotation period and a two-year time-out period. • Seeking proposal on mandatory rotation of audit firms.	• Section 201 prohibits audit firms from providing nine non-audit services, and allows the provision of other non-audit services, including tax services, with the approval of the company's audit committee.	• Section 404 requires public companies to report on the responsibilities of management for establishing and maintaining adequate internal controls over the company's financial reporting process, as well as management's assessments of the effectiveness of those controls. • The company's external auditor then opines on the effectiveness of the internal controls over financial reporting as part of the external audit.
Japan		
• Under the Amended CPA Act, engagement audit partners must rotate every seven years with a two-year time-out period. • Large audit firms that audit 100 or more listed companies in Japan have a five-year rotation rule with a five-year time-out period for the lead engagement partners and engagement quality control review partners.	• Article 34-11 of the Amended CPA Act prohibits audit firms, auditors, and spouses of auditors from providing non-audit services related to the company's financial documents. • A supplemental Cabinet Ordinance lists eight prohibited non-audit services, which also includes investment advisory services.	• On March 30, 2011, the FSA's Business Accounting Council released standards on the "Management Assessment and Audit concerning Internal Control over Financial Reporting," which requires external auditors to release an "Audit Report on Internal Control Assessment." These standards are effective as of April 1, 2011.
Malaysia		
• Under MIA *By-Laws on Professional Ethics, Conduct and Practice* (MIA By-Laws), the key audit partner must rotate every seven years. • For public interest entities, the rotation period is five years and the time-out period is two years. • For banks, Bank Negara requires a five-year rotation period and a five-year time-out period for the engagement partner.	• Article B-1.4 of the MIA By-Laws prohibits audit firms and auditors from providing certain non-audit services that would be a significant threat to auditor independence, integrity or objectiveness. • The article lists seven categories of prohibited non-audit service. Notably, the last category is a quantitative criterion under which the non-audit fees may not be 20 percent or more of the audit firm's total annual fees for two or more consecutive periods or an individual auditor's revenue.	• Auditor's opinion refers to but does not attest for the company's internal control.
Singapore		
• For listed companies, SGX requires a five-year rotation period and two-year time-out period for the audit engagement partner. • Singapore's *Statement of Auditing Practice 25 on the Audit of Listed Companies* also reiterates the five-year rotation period for the auditor-in-charge, but does not mention the time-out period. • Furthermore, the ACRA *Code of Professional Conduct and Ethics* (ACRA Code of Ethics) provides for a rotation period of "normally no more than seven years" and a subsequent two-year time-out period for listed companies. • For banks, MAS requires a five-year rotation period and a five-year time-out period of the audit firm.	• Section 290 of ACRA's Code of Ethics allows for the provision of non-audit services if its threat to auditor independence is at an "acceptable" level. It describes potential threats to and safeguards for independence.	• Auditor's opinion refers to but does not attest for the company's internal control.
Thailand		
• The SEC and BOT require the auditor who signs the audit opinion to rotate every five years for listed companies and banks, respectively.	• Thai SEC *Notification Kor Jor 16/2548* requires companies to disclose the audit fees and non-audit services fees paid to auditors.	• None