I-1.21: Critical analysis of the European Commission’s Green Paper on Audit Policy: a problematic definition of the systemic agent and an illustration of the opposition between regulation and competition.

Tuesday 30 November 2010, by Marie-Anne Frison-Roche, Managing Editor and Director

Summary: The European Commission published a *Green Paper* in September 2010 on *Audit Policy,* in order to give its opinion on the *Lessons from the Crisis.*From a systemic perspective of financial markets' stability, the Commission analyzes the role of the auditor, the internal structure of audit firms, the concentration of the audit market, and the possibility of a European market for auditing. But, what the Commission presents as a neutral description is actually a series of ideological stances, which are tenable, but also debatable. Thus, the Green Paper makes auditing out to be a structural element of financial markets, which shatters auditing's uniqueness, while attributing it a structural and systemic role, which is questionable. It then requires regulatory tools to open the auditing market to more competition, which will, in reality, expose it to the pressures of demand and lower the efficiency of auditing missions. It would be better to reinforce regulatory mechanisms towards security and conflicts of interest, rather than towards competition, which corresponds to the traditional French model of audit regulation.

1.In its *Green Paper on Audit Policy: Lessons from the Crisis,* the Commission explains the methods and goals of its approach, in what it describes as a simple description of the situation.The rest flows from this description, and various questions raised are influenced by the presuppositions of the Commission's perception of reality. It therefore states that we have not sufficiently studied the role of auditing, and its failures, in causing the financial crisis of 2008: banks with properly certified accounts brutally collapsed, even though auditing, in that it is intimately linked with corporate governance, is the "key contributor to financial stability," since it guarantees the veracity of claims of financial health.

2.Only after having "described the context" does the Commission open the discussion on a certain number of subjects.These include the role of the auditor, audit firms, creating an open, single market for auditing. The Commission stresses that the Paper is part of a "holistic approach" towards financial stability and is based on observations made on corporate governance and executive compensation.The Commission says "a differentiated and calibrated approach" is necessary in function of the size and characteristics of audited companies, particularly according to whether or not the company being audited is systemic or not. The Commission concludes its introduction by saying that it is open to any option that promotes financial stability.

3.The Commission states, as though it were a given, that auditing is a key element in providing information on risks on the financial market, even though this is simply the role that professional associations and recent doctrine have thrust upon the certification of corporate accounts. Indeed, if we stick to statute, even if we regret doing so *after the fact,* certification is required by closely-examined statute, doctrine [1] and case law, to certify that the accounts are exact, faithful, and sincere.It does not say that the auditor must also deduce the risks that the audited firm might cause to itself, its employees, its shareholders, its creditors, and to the market. This calculation made based on the "photo-image" of corporate accounts, even if this "photo-image's" clarity is certified, must be made by all of these interested third parties, but the law does not transfer the burden of measuring risk to the auditor.

4.One might be tempted to do so, *de lege ferenda.*Lawmakers are free to exercise their sovereign power. A judge might also create such a responsibility in a case on professional liability, because jurisprudence sets out professional obligations. But *de lege lata,* auditing consists in certifying the veracity of accounts, and not the fair measure of risk.The "machine" that calculates risks is precisely the financial market, and one who takes risks is by definition the investor: the market is defined as an area of risk.This is already true for markets of goods and services. The qualification is particularly true for financial markets, speculative in nature, where each investor must take his own risks.It would be unnatural to transfer such risks to the auditor, who does not bear risk.

5.The Committee continues its reasoning by noting that a better-designed audit profession and a better organized auditing market would lead to better auditing, because of the Commission's assumption that it is linked with financial regulation, this would reduce the systemic cost of bankruptcy, increase confidence, protect the investor, and reduce the cost of capital. Thus, the

Commission draws a close relationship between auditing and the systemic functioning of financial markets. Without doubt this is a commonly held approach, because the French legislature, by passing the Act of 22 October 2010, created the *Conseil de la régulation financière et du risque systémique* [2] (Council on Financial Regulation and Systemic Risk), which includes the Governor of the Bank of France, the President of the French Financial Markets Authority (AMF), and the Presidents of the Autorité des normes comptables (Authority of Accounting Standards), seems to be going in the same direction.

6.The Green Paper goes on to note that audit is a statutory profession, its "social role" supposes that auditors must be independent, and this is a fundamental rule for all auditors.But, the business climate must allow for such independence. However, some have raised doubts as to the possibility of independence in the current climate, and point out that corporate accounts have been certified as solid, whereas they were, in reality, financially unstable.

7.There is said to be expectation gap between auditors' technical mission and the market's expectations from the profession, which would oblige us rethink the goal of the audit and the adequacy of the audit profession in relation to these goals. Perhaps, but is it appropriate to consider that the market's "expectations" are equivalent to the market's "law"?Indeed, assuming that in an extremely subjective perception, we impute intentions to the financial market, or define it as an ensemble of intersubjective relationships, capable of "expecting" information on risk, which prevents investors from having to do their own research.

8.It is not certain that the passivity of a reasonable investor, different from a risk-taking investor who acts without having all the information at his disposal, corresponds to the "law" of the financial market in a Schumpeterian conception of economics.On a financial market, information about risk is able to be sought out, but is not delivered. In any case, if information were to be delivered, it would be up to the issuer to deliver it under corporate law, and not up to the auditor, whose obligations only bear upon the exactitude, sincerity, and fidelity of the accounts.

9.The Green Paper therefore begins with a major and explicit assumption: to the European Commission's mind, the issue of auditing is part of a larger, structural perspective concerning the structure of the financial market, of which the audit is part, and the structure of the audit market in and of itself.Indeed, the audit market has a direct impact on how the profession of auditor is carried out. Or, to quote the words of the Commisssion, the market belongs to "a handful of large, global firms that have all attained systemic proportions."As with any institution in the financial industry, no single player should contain such systemic risks. It must therefore be avoided that any company become so important that moral hazard comes into play, or we must decide to adopt a practice analogous to living wills for banks. Indeed, we must avoid any interruption in the services provided by audit firms to large corporations, which a bankruptcy would provoke. We must therefore try to increase the size of smaller audit firms, combat barriers to entry and increase market fluidity by creating a European market. Additionally, the overall market must be supervised independently of the profession.

10.But all these assertions, which are presented one after another as facts and realities that must be corrected and combatted, are in reality, opinions. This is not to say that these opinions are inherently illegitimate. But, we might think that a regulator, independent from the profession, would be a guarantee against conflicts of interest, which continue to cause problems since an audit requires impartiality, because auditors must pronounce a judgment even though they are paid by the companies whose books they have to certify. But on other points, the opinion is less justified. Nonetheless, the Green Paper's point-by-point analysis articulates everything as though it were describing the facts before the debate, whereas it is actually this description that must be debated.

11The very subject of this study must be debated. It is not acceptable for the Commission to express a great number of fundamental affirmations and then to state that, "given the context" (we will see in the commentary that this is not a description, but rather an implicit opinion), it is necessary to "open a debate". To do so is to shut down the debate before it even begins. So, let us open it.

12.The Commission has one slogan: financial stability.In this, the audit is a structural tool for regulating financial markets. The Commission takes this for granted, since the Paper starts by deploring that the role of the audit in the financial crisis has not been sufficiently studied. This is why it will regulate the audit market, because it implies that the concentration of this market had a role in the crisis, and between the lines, we can read that this is targeting conflicts of interest. Even before we discuss the method that the Commission has chosen, even before opening the debate, to regulate the audit market, let us examine this first description, which is in reality an opinion. This will allow us to then examine the Commission's proposed regulatory system for the audit market, and we will notice that the Commission contradicts istelf, because it defines the audit as a profession that has been internalized in the financial market, which would require systemic-risk-oriented regulation (I), whereas the Commission has decided to regulate the audit market by imposing full competition, a contradictory affirmation (II).We must return to a definitive form of regulation (and we find some elements in this direction in the Green Paper) that prevents the conflicts of interest that prevent the auditor from doing his job of impartially verifying that accounts are exact, sincere, and faithful (III).

I. .AUDIT DESIGNED AS AN INFORMATION INTERMEDIARY FOR THE FINANCIAL MARKETS

13.Indeed, the audit as designed by the French Act of July 21, 1966, is a method of impartially verifying corporate accounts in order to enable shareholders and third parties to be sure that the information they receive from the company's accounts about solidity and performance is truthful. At that time, just as the listing of shares was only seen as one particular method of corporate finance, the audit was already seen as benefiting three different audiences: managers, shareholders, and third parties, but the notion of the market was not yet pertinent.

14.Gradually, as the distinction between the listed company and unlisted company has become a *summa divisio,* based on the primary importance of the stock market, auditing has begun to follow this de facto separation, and some claim that the audit practices should distinguish between listed and unlisted companies.At the very least, in such cases, the auditor knows his audience, which becomes the market itself. Only then can we envisage the effects that auditing might have on financial markets, because the affirmation that the accounts are veracious is a piece of information all to itself, and is actually the most precious information, because of the trust placed in the auditor who is entrusted with a public service. This is why the Commission des opérations de bourse was able to condemn an auditor who had certified a document whose contents were proven to be inexact for disseminating false information on the markets (Paris, March 7, 2000, *KPMG).*

15.Thus, the European Commission, concerned over the stability of financial markets, and seeking to draw "lessons from the crisis" is imposing an "audit policy" because it believes that financial market regulation will come through audit market regulation and by defining the profession of auditor.

16.We understand the Commission's argument (not description). Simply, the Commission erases the traditional conception of the audit, as it appeared in France in 1966, which did not link the audit with the financial market. The Committee has implicitly adopted the *summa divisio* between audit of listed companies, or at least companies that emit financial instruments on markets, and which assumes that an audit is synonymous with systemic risk, which increases whenever the audited company is systemic itself, and audit of unlisted companies, or companies that do not emit financial instruments.

17. Although it is true that auditors provide the financial markets with information, it has never been proven that this makes them systemic (the concentration of the audit market is not sufficient proof of this), and that the bankruptcy of an audit firm would have a domino effect on the markets, a perspective which justifies forcing the market open to new audit firms.

18. However, to the Commission, the auditors are themselves market institutions that have become internalized and systemic because the audit market is too concentrated for the important role they play in financial markets. This sort of information intermediation provided by the audit is what makes it an impartial market operator, which explains why the Commission draws analogies between its analysis of the banking sector and its analysis of the audit.

19.Is this a reason to consider implementing solutions designed for financial institutions, such as living wills, to audit firms?Indeed, the notion of "systemic operator" is twofold: it has a negative meaning but also a positive meaning.In the negative sense, this means that the operator's bankruptcy would cause the entire sector to fail. Banks, because of the crisis in confidence, are all systemic. Some industrial companies, because of their great size, strategic or social importance, are systemic, because their bankruptcy would bring a devastation greater than the direct consequences of their bankruptcy.

20. But audit firms are not systemic in this sense. Indeed, if one fails, its cases will be transferred to a competitor: even if the market is concentrated, competition and the fact that certification is annual mean that there will be no panic. Auditing firms are systemic operators in the positive sense, in that they provide markets with crucial information, such as a certification that corporate accounts are sincere, exact, and faithful. In this, they are necessary information intermediaries. This is why the French Council of State's jurisprudence has traditionally ruled that auditors are in charge of a public service. But there is no reason to submit these firms to prudential supervision or a regime of greater competition (see below), which are all attached to the negative sense of systemic operator. By using the term, the Green Paper is correct in its characterization in the positive sense, but wrong because it applies the rules applicable to the negative sense of the concept.

21. Nevertheless, the Commission considers that the audit must be conceived as an internalized instrument of financial markets. This is not self-evident : it is an opinion.It is remarkable that this is not subject to debate, because the goal of financial stability is universally held. This could logically result in splitting the audit market by considering that audits of listed companies are a sub-market. Must we go further in analyzing the institutional consequences this would have?

22. Specifically, this is a second point of our commentary, the European Commission believes that the structure of the audit market is not satisfactory. Rather than blaming the dysfunctions in auditing that played a role in setting off the financial crisis, such as fraud and mismanaged conflicts of interest, the Commission blames the concentration of the market as being the audit industry's responsability in the financial crisis.

II.THE IMPLICIT AND CONTRADICTORY OPINION IN FAVOR OF TRANSITORY REGULATION TO IMPLEMENT A COMPETITIVE AUDIT MARKET

23. The European Commission concludes that the market must be opened to more competition. We find ourselves in a classic liberalization scheme that has existed in Europe for the last 20

years in monopolistic network industries. We can identify all of the techniques that were, and continue to be, used to diminish "dominance", meaning that new entrants are systematically favored over incumbents, an impartial regulator is established, who must be exogenous to the industry in order to favor potential competitors.

2. Here we identify the European Commission's idea of regulation:it is the way towards competition when competition cannot spontaneously occur because of the power of existing players, either because they are statutory monopolies or de facto highly concentrated.Thus, by breaking down the existing companies, either from the inside by causing them to split up into smaller companies, or from the outside, by favoring new companies, competition will be beneficial and avoid connivance between large corporations and large audit firms, who share the information rent, despite the fact that the auditor's role is to fight the former's rent, not to share it with him.

25. We can feel the influence of English thought. Indeed, in June 2010, projects to reform UK financial regulation have consisted in promoting competition between banks, using the same methods, and by giving regulatory powers, formerly held by the Financial Markets Authority, back to the Bank of England so that it can be a harsher disciplinarian and favor small market actors. Competition is supposed to favor better financial regulation, serve as a pillar of improved confidence, and promote improved financial stability.

26. Again, this is not a description, but an opinion. Indeed, regulation is an *ex ante* organization of industries incapable of arriving at equilibria by themselves.One can only implement transitory regulation for industries that are conjecturally unbalanced by the power of certain agents (monopolies or concentrations) in order to force competition to grow, and only remove the regulatory regime once competitive maturity has been attained.

27. Yet, the Commission intends to implement this sort of simple, temporary regulation, because its goal is competition and regulation is the means to implement competition amongst audit firms, by diminishing the market power of existing players. But it is a mistake to confuse the liberalization process of monopolistic industries (the goal being competition) and the regulation of crucial sectors, whose goal is, as explicitly stated by the Commission, financial stability, meaning the prevention of systemic risk, which explains why audit firms are seen as being analogous to banks, in that they are both intermediaries on financial markets!

28. If the European Commission is successful in implementing the sort of regulation it intends to implement, meaning there is more competition on a restructured audit market thanks to a regulatory regime that breaks down barriers to entry, the law will be more competition between all operators in charge of a public service. However, since the European Commission has understood audit through the prism of financial markets and the need for stability, auditing becomes a means for preventing systemic risk, and the audit market must be preserved from such risk. The regulatory system therefore required is a permanent regulation that targets, like banking and financial regulation, systemic risk.

29. If the Commission implements regulation aimed at competition, by definition temporary, it contradicts itself. Indeed, the law of a competitive market is that suppliers' only goal is to be chosen over other suppliers. In order to accomplish this, supply will meet demand and vice-versa, this double elasticity allowing the market to reveal an equilibrium price. But if the Commission encourages competition, we will simultaneously have to regulate behavior.

30. For example, if an auditor continues to be chosen by a corporate officer, agency theory shows that the principal has no interest that his agent correctly execute his mission, and will prefer a less costly and less effective service, which, far from being a problem for him, will be a boon. So, the virtues of competition become vicious. Thus, if the competitive model is chosen, we must dissociate the body that runs the company from the body that chooses the auditor, and avoid that either one be captured by the other.

31. Similarly, to break down barriers to entry, the Commission examines the habitual modes of *partnership* in auditing firms.Indeed, whoever wants to become a partner must pay a substantial sum to acquire shares. This constitutes a barrier to entry. The European Commission, committed to the size and virtue of newcomers, calls these practices into question. But if we take the rules of classical capitalism, as formulated by the French Act of 1872, if the person taking an action (the auditor) risks his own invested money, he will naturally be prudent and diligent in the execution of his task. Yet, the competitive market is by nature an area where risks are taken. Auditing should not be this kind of area.

32. The audit should be an area of safety, allowing the auditor to be impartial. In this, the auditor is not like a part of the corporation, but a judge of the corporation. We must therefore regulate

the audit market and organize the profession in such a way that auditors have the means to afford the necessary luxury of impartiality.

III. PERMANENT REGULATION TO PROVIDE THE NECESSARY LUXURY OF THE AUDIT'S IMPARTIALITY

33. Impartiality is a quality that can be defined both subjectively and objectively. Subjectively, the impartial person is one who has no personal interest in the task he or she accomplishes. The clearest example is a person who is not corrupt. From an objective point of view, the impartial person is a person who is in a position to be free of prejudice.

34. In regulated systems, when one organization controls another, the risk is that the former will be captured by the latter, especially when the former has more information at its disposal than does the latter. The auditor is in the difficult position of easily being captured, either by information asymmetry, or by connivance, or by anticipating future advantages.

35. Indeed, the auditor is structurally in conflict of interest because, as in the days of the spice trade, he is paid by the person who he could potentially harm, which might diminish his ardor. The inconsistency of his situation has led to very radical proposals, like that made in the USA after the *Enron* case to nationalize the audit, since the State is supposed to be less easy to capture because it is not structurally in conflict of interest.

36. In this perspective, the Green Paper opens two possibilities for further thought. We could go towards a reform of corporate law, which leads to transferring the power to nominate auditors by other people than corporate officers, supposing that the capture problem does not follow this change, like a faithful friend, since usually all of the company's organs are dominated by corporate officers. So, the question of who would appoint the auditor remains difficult, and resembles the eternal question of who should guard the guardians.

37. In a more satisfactory way, the Green Paper discusses techniques of regulation, in the broad sense, meaning techniques that settle power struggles by themselves, which makes an added level of external supervision superfluous : this is the example of the joint audit.This has existed in French law for a long time, and allows for a sharing of tasks and reciprocal surveillance, guided by shared liability. This

38. Finally, the audit market must both remain between the hands of powerful companies, especially because of the burden of the responsibility of dealing with systemic actors on financial markets, whose accounts' quality promotes financial market stability (an analysis shared by the Green Paper), according to the aforementioned definition of a systemic agent. However, as rightly pointed out the Green Book, a profession menaced and structured by conflicts of interest cannot self-regulate. What the financial crisis has unveiled is the inanity of business ethics, as embodied by professional deontology that does not, at least partly, rely upon a governmental structure, and whose effectiveness is not only guaranteed by the desire of well-bred people to do good, but by disciplinary procedures carried out by the State.

39. In this, the European Commission is naturally moving towards a regulatory system for the audit, similar to the system already in place for financial and banking regulation.

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[1] PASQUALINI, François, *Le principe de l'image fidèle en droit comptable,* préface d'Emmanuel du Pontavice*,* Litec, Paris, 1992, n° 31, p. 26 s.

[2] Frison-Roche, Marie-Anne, *La nature hybride du Conseil de régulation financière et du risque systémique*, *D.* 2010, point de vue, p.2712-2714.