



I-1.27: a hindrance to the development and the emergence of audit firms of international stature?

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« The statutory audit forms part of the way in which stakeholders in companies obtain reliable financial information, thereby contributing to the efficient working of an open economy. In fact, the statutory audit is above all a matter of confidence. By opining on the reliability and the fairness of financial statements, statutory auditors add confidence to for-profit and not-for-profit relationships, and equally throughout the economy and to society in general »^[1].

The audit of the financial statements of multinational groups presents specific difficulties due to their organization, the sources of their financing, and the complex nature of their operations combined with frequent cross-border implications. The audits of these multinational groups are for the most part performed by the four largest global audit networks (see below).

Some people believe that four firms are too few and that it is necessary to create the conditions under which more firms may emerge capable of performing the audit of international companies, whilst ensuring that the current structure of the market does not evolve towards an even smaller number of firms. Such people are in favour of overcoming any barriers which might stand in the way of the entry of an audit firm onto the international audit market. One of these perceived barriers is represented by the qualifications required for a shareholder or a member of general management in an audit firm, including any supervisory body, which is seen as a hindrance to the development thought to be necessary for certain medium-sized audit firms.

European directive 2006/43/CE in respect of the statutory audit of financial statements currently requires audit professionals to hold the majority of voting rights in their firm and to control the board of directors. In France, this directive has been transposed into law as follows:

- Three-quarters of voting rights in statutory audit firms are required to be held by persons holding the qualification of statutory auditor,
- The offices of general manager, chairman of the board of directors or of the management board, president of the supervisory board, and managing director are required to be held by qualified statutory auditors,
- A minimum of three-quarters of the members of the management or directors' boards are required to be qualified statutory auditors,
- All new shareholders and partners are required to obtain the prior approval of the shareholders in general meeting, or of the board of directors, the supervisory board or the general managers, depending on the legal form of the firm.

In October 2010, the European Commission issued a 'Green Paper' concerning the statutory audit of financial statements in the EU^[2]. The avowed intention of this document, as stated by the commissioner Michel Barnier, was to bring about a discussion of the role and the governance of statutory auditors, and the changes which could be made. Another of the views set out by the Commission in the document is that the terms of European directive 2006/43/CE should be reviewed.

The question to be asked is therefore the following: should we introduce deregulation into an area which has been until now strictly bound by law and regulation? Or, in other terms, a) should we allow free access to the ownership of audit firms, and b) would this effectively assist in the entry of new players into the international marketplace?

Until 1998, there were six recognized audit firms with a global reputation: Arthur Andersen, Coopers & Lybrand, Deloitte, Ernst & Young, KPMG, Price Waterhouse. Price Waterhouse and Coopers & Lybrand subsequently merged in 1998. Then in 2002, Arthur Andersen stopped operating in the wake of the Enron scandal. At the present day, this leaves only four such firms, commonly known as the 'Big Four'.

A number of national firms coexist with the Big Four. These have a relatively significant size and stature, but often have a more restricted world-wide network. Most of such firms are already carrying out audits of large international groups headquartered in their respective countries. In France, in descending order of their 2003/04 revenue[3], one may point out Mazars, Salustro-Reydel, BDO Marque et Gendrot, Grant Thornton. Salustro-Reydel and BDO Marque et Gendrot have since merged with KPMG and Deloitte respectively.

This state of affairs has led the Committee of European Securities Regulators (« CESR ») to state: « ... *there are only a few audit networks which are able to operate at a global level and it is the potential risk of a further reduction in their number that makes the situation serious* »[4].

It is currently claimed that certain medium-sized firms (outside the Big Four) will have to make considerable investments over the medium- to long- term if they are to present an alternative at the global level to the Big Four. It is further claimed that such investments would become possible or easier if access to external funding was permitted, in other terms, if the rules of European directive 2006/43/CE were to be repealed for audit firms based in the EU.

During the consultation procedure initiated by the European Commission[5] in 2009, a number of limits to a future deregulation were formulated, in particular:

- The risks related to the absolute requirement to maintain the strict independence of audit firms, as well as their stability and permanence,
- The limits as to the effectiveness of such a measure to effectively meet the objective of assisting the emergence of one or more new players on the global audit stage.

The risks related to the absolute requirement to maintain the strict independence of audit firms, as well as their stability and permanence

Independence in respect of ethics

The notion of independence is of the highest importance in achieving an efficient audit and for the credibility of the role of the audit in maintaining the confidence of players in financial markets. Independence is to be judged both in fact and in appearance under the terms of the Code of ethics of French statutory auditors and of the Code of ethics of IFAC[6]. It may be considered by some that the funding of audit firms from non-professional sources could compromise their independence. We give two examples:

- In the event that an audit firm obtains permanent funding from non-professional sources, its *apparent* independence could be perceived by enterprises and financial markets as becoming altered,
- Assuming that company A is a shareholder in an audit firm, it is difficult to see how company B, a competitor of company A, could conceive of using the audit firm, whatever and irrespective of safeguard measures were put in place. It therefore follows that the number of firms on which company B may call is reduced, which is contrary to the aim of increasing the range of suitable available service providers enterprises may choose among.

The FRC has stated that the risks related to independence and to conflicts of interest already exist, and are covered by controls[7]. The CNCC has indicated that it believes that the costs related to the reinforcing of internal control procedures and protective controls would be out of proportion to the expected benefits, and that their effectiveness could not be fully guaranteed[8]. In addition, the right

of a shareholder to sell its shares at any time – in our example, company A – could result in a situation where the said audit firm would be, in respect of company B, at times independent, then not independent, which would in practice quickly become difficult to manage, both for audit firms and enterprises.

Another category of potential investors, because of their organization and nature, could be the banking institutions. The entry of banks into the capital of audit firms would raise two major concerns. Firstly, it is open to question how the bank regulatory authorities – in France, the ACP ('Autorité de contrôle prudentiel') – would view the independence of an audit firm held by a bank it was responsible for supervising. Secondly, considering that banks represent a systemic risk^[9], their entry into the capital of audit firms would result in this systematic risk being imposed on the firms concerned. At present, audit firms are not subject to systemic risk, as the various firms are by their nature and their creation independent of each other and of all other enterprises whether or not they audit them. They could not therefore enter into a chain reaction, collapse one after the other, and so affect the stability of financial markets. The complete disappearance of one of the global audit firms in 2002 did not, so far as we can tell, have any significant effect on the functioning of financial markets.

Management independence

Any external investor would have an obvious interest that the firm in which it had invested would:

- Set about its commercial development in the most ambitious way possible. However, statutory audit cannot be carried on as a commercial activity with its associated practices, in particular cold-calling. In extreme cases, it cannot be excluded that incentives could be offered to obtain an engagement or to service a particular client, a practice which the professional shareholders could not accept for deontological reasons, and in the best interests of the firm in the long-term.
- Seek to keep its operating costs as low as possible. The CESR insists particularly on the risk of pressure for cost reductions (for example, a cap on technical training and quality control budgets) resulting in lower audit quality^[10]. It may also be questioned whether the search for the lowest possible operating costs is compatible with an auditor's obligation to perform his engagements to certain standards.

Expected return on capital invested

For an external investor in the capital of an audit firm, his investment presents risks and particularities which would appear to justify the expectation of an increased return:

- Rules of professional confidentiality forbid the participation of a non-professional external investor in the preparation of audit programmes, and, more generally, in the performance of engagements. Engagement profitability is also covered by professional confidentiality. In consequence, a non-professional external investor would have to rely entirely on the firm's professional staff for the management of the business.
- Audit firms are subject to numerous, cumulative professional risks of a criminal, civil, disciplinary or administrative characters. Sanctions imposed can range from fines to the temporary or permanent loss of the license to practice. How can a non-professional business entity be expected to assume such a level of responsibility related to a professional practice, when his objective is to make safe and profitable investments? The CNCC believes that a financial player is unable to assume the responsibility inherent in the auditing profession without having any say in its conduct^[11]. The nature of the risks involved would require an investor to claim a higher return.
- French law permits external non-professional investors to hold up to 100 % of an audit firm, on the strict understanding that a minimum of 75 % of the voting rights is held by qualified statutory auditors. An investor who would accept to relinquish such a significant portion of his normal rights as a shareholder, and thereby be unable to have any possibility of control on the strategy or the operating decisions, or on the way in which his investment is used, would in all probability insist on a much higher return.

· The need for non-professional external investors to obtain a high return on the capital that they might invest would result in the risk that an audit firm could be faced in time with default due to the high cost of its capital and of the permanent pressure to achieve a level of profitability sufficient to service the return expected by investors.

An over-riding need for permanence and stability

The CESR notes that it is not rare for financial markets and investors to take a short-term approach^[12]. There is, however, an over-riding need to ensure the permanence, constancy and stability of the statutory audit function and its engagement procedures.

· **Permanence:** it is clear that the aim is that the number of audit firms does not decline in the future. It follows that over and above their compliance with professional and deontological rules, firms must control with due care and prudence the risks related to the acceptance, continuation and the conduct of audit engagements.

· **Stability:** all investors have the right to dispose of their shares at any time. In addition to the impact on the independence of the firms concerned, discussed above, the possibility of repeated changes in shareholders is likely to destabilize to some extent their culture and operational strategy. The absence of changes in its shareholders is therefore crucial for the security and the permanence of audit firms, as well as for the maintenance of the direction it has set out for its performance compatible with its long-term interests, its culture and, last but not least, the interests of financial markets. This also raises the above-mentioned risk from changes to the independence of an audit firm arising from the circumstances and identity of its shareholders as they enter and exit from the list of its shareholders. At the present day, the independence of audit firms is an established fact, and the continued compliance with this principle is entirely in the hands of the firms themselves. Is this not the most healthy state of affairs possible to ensure that auditors play their part effectively in the proper functioning of capital markets?

· **Constancy:** the procedures applied in relation to the performance of the statutory audit profession and of statutory audit engagements in general should be coherent and unchanging over time, without varying as a function of management decisions taken other than in compliance with professional and ethical rules.

Statutory auditors are personally responsible for the work they perform, which also results in the concomitant responsibility of their audit firm. This responsibility is particularly heavy and far-reaching (see above), and it is easy to understand why they consider it preferable, even necessary, to retain the control and entire power over the way they in which they fulfill and discharge their professional duties, particularly in respect of quality, professional training, and the procedures and methods related to the performance of the audit activity. The organizational structure of firms helps to ensure the allocation of profits and risks, and to implement in effect the quality, the responsibility and the independence of audit firms.

Could the proposed changes be effective in pursuing the aim of helping the arrival of one or more new global audit firms?

It should be noted that the current model does not include any inherent obstacles to the development of more global audit firms, at least within the current framework set for auditing in France. The French authorities have pointed out that several medium-sized firms have, in the past, succeeded in entering the French market under the current legislation (see above)^[13]. The CNCC has published the information that 700 different audit firms hold audit appointments in public interest entities in France^[14]. It is also remarkable that there is at present a firm, not one of the Big Four, which has more audit appointments among CAC 40 companies than some of the Big Four.

Nevertheless, removing the barriers on shareholdings cannot alone guarantee that new global audit firms will come into being, for the following principal reasons:

· Deregulating the rules on shareholdings could make it easier to bring about further concentration, the opposite of what is sought,

· The players themselves need to have taken the strategic decisions to develop, to enter the international audit market, and to be prepared to assume the professional risks inherent to such audits,

· Assuming that an audit firm obtains funding from a non-professional source, its *apparent* independence could be perceived by enterprises and the market as having been compromised, which could deter the future use of their services,

· The French authorities wonder whether such an option would not have the paradoxical effect, contrary to what is sought, of encouraging the major firms which, more profitable and better known, would be the best placed to attract any help from external investors. The change could therefore reinforce the present situation[15],

· International enterprises use other criteria than size to judge whether a firm is capable of taking on and carrying out the audit of their organization, such as its reputation, its public image, the quality of its services. The presence of new players would not imply that enterprises would consider them a suitable alternative of taking on the audit of their financial statements. The FRC notes that it has not yet been proved that enterprises are particularly desirous of choosing a medium-sized audit firm.

It is useful to repeat that the activity of audit cannot be said to be highly capital intensive. A combination of other characteristics is needed to provide the stimulus for the emergence of new players. The fact that today there are only four major players is the result of a process, not a starting point. The need to comply with regulatory provisions has led some audit firms to come together to reach the required critical mass to be able to assume in full the audit of international companies. These firms have long made the strategic choice of developing a certain number of methods and procedures to ensure that they are capable of fulfilling the role on an international level, which has therefore brought about the conditions for their growth.

One thing is sure, a global player cannot be created out of nothing and overnight. It would certainly be possible to produce a large firm quickly by merger, which would require the approval of regulatory fair trading agencies, but as we have seen, size alone does not necessarily result in a firm which is recognized throughout the financial markets. Enterprises have other criteria to satisfy in the selection of their auditor. The French authorities have indicated that any medium-sized French audit firm which decided to enter the market of listed company audits would be immediately confronted with the problem of their lesser reputation and capabilities which would lead enterprises not to choose them[16]. In addition, to bring about a change in the public image of these firms would in all likelihood take some time to achieve when we consider the definition of image as the net result of the interaction of all the experiences, impressions and beliefs which individuals possess with respect to a company[17].

Removing the barriers to entry to the capital and to the exercise of voting rights in audit firms in the EU through changes to the provisions of directive 2006/43/CE may seem to be an interesting option in furthering the entry of new players to the global audit market. However, the nature of such a decision would encourage important new risks to arise for the security and the serenity of financial markets, as well as for the firms themselves, without any certainty that the proposed changes are appropriate or that they would work in practice.

Finally, the global dimension of what is at stake has to be considered, as the audits of companies with international activities extend beyond the EU, and the financial markets are now interdependent and related.

[1] Compagnie nationale des commissaires aux comptes (« CNCC », the French institute of statutory auditors), June 2009, « le Commissariat aux comptes, l'essentiel » ; translated by the author

- [2] Green Paper on auditing, European Commission, October 2010
- [3] La Profession comptable, n°266 March 2005, Classement de la profession comptable libérale en France
- [4] CESR, 1 June 2009, response to consultation on control structures in audit firms
- [5] European Commission, 18/11/2008, Consultation regarding control structures in audit firms and their consequences for the audit market
- [6] International Federation of Accountants (« IFAC »), Code of Ethics for professional accountants, article 290-6
- [7] Financial Reporting Council ("FRC"), United Kingdom, 9 March 2009, Response to consultation on control structures in audit firms
- [8] CNCC, Compagnie Nationale des Commissaires aux Comptes, 27 February 2009, réponse à la consultation de la commission européenne sur les structures de contrôle dans les cabinets d'audit
- [9] FRISON-ROCHE, Marie-Anne, Les 100 mots de la régulation, PUF, 2011, p.118.
- [10] CESR, 1 June 2009, response to consultation regarding control structures in audit firms
- [11] CNCC, Compagnie Nationale des Commissaires aux Comptes, 27 February 2009, réponse à la consultation de la commission européenne sur les structures de contrôle dans les cabinets d'audit
- [12] CESR, 1 June 2009, response to consultation regarding control structures in audit firms
- [13] Ministère de la Justice, 2009, Observations de la délégation française sur la consultation de la Commission européenne portant sur les structures de contrôle dans les cabinets d'audit
- [14] Source : Compagnie nationale des commissaires aux comptes, 2010
- [15] Ministère de la Justice, 2009, Observations de la délégation française sur la consultation de la Commission européenne portant sur les structures de contrôle dans les cabinets d'audit
- [16] Ministère de la Justice, 2009, Observations de la délégation française sur la consultation portant sur les structures de contrôle dans les cabinets d'audit
- [17] R.M. Worcester, (1997) "Managing the image of your bank: the glue that binds", International Journal of Bank Marketing, Vol. 15 Issue: 5, pp.146 – 152