III-3.12: Vers quelle régulation de l'audit faut-il aller ? (How Should the Audit Be Regulated?)

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Translated Article PDF

Accounting standardAlternative financialAuditAudit CommetteeAudit MarketBankBankruptcyBig fourCertificationColloquiumCompetitionConcentrationConfidenceConflict of interestsCooperationCostCredit rating agencyCrucial operatorDefinitionDeontologyDeregulated marketEfficiencyEuropean CommissionEuropean single marketExpectative gapFinancial crisisFinancial marketFinancial stabilityFutureGlobal marketGoalGreen paper on auditIncentiveIncumbentIndependenceInformation asymmetryInternational audit forumItalyJoin auditLiabilityManagerMandatory votationMarket expectationMicro economyMoral hazardOpacityOpinionPerimeterPriceProfitPublic goodPublic interestPublic serviceQualityReal economyRisk reportingskepticismSocial responsibilitySystemic riskTeleological reasoningTrustUnited Kingdom

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MAIN INFORMATION

On May 20, 2011, a colloquium was held in Paris on the question of How should the Audit be regulated?, organized by The Journal of Regulation, l'Ecole de droit de la Sorbonne, and KPMG France, one of the Journal's privileged partners. The participants were Jean-Luc Decornoy, Nathalie de Basaldua, Alain Couret, Marie-Anne Frison-Roche, Christine Thin, Stephen Haddrill, Claude Cazes, Etienne Wasmer, and Mara Cameran. The reflections and discussions bore upon the European Commission's Green Paper on Audit Policy. The colloquium's ambition was to discuss the methodological links that must guide the future of the Audit, both in relation to financial regulation and competition, and also to analyze what the inspirations for audit reform should be, especially by using the available economic studies. Each participant agreed that the most important goal was to ensure that the audit is of very high quality, and everything ought to converge towards this goal.

CONTEXT AND SUMMARY

Jean-Luc Decornoy, President of KPMG France, opened the event by introducing the **general question** in two points. First of all, he asked whether auditors played a role in the onset of the financial crisis.

Secondly, he asked whether the concentration observed in the audit market bore risks for financial markets and investors. He believes that, certainly, the auditors of the banks that went bankrupt and brought the markets down with them did not properly alert others of the situation, but that this is not their role, because auditors are not regulators' eyes and ears.

Accounting standards setters must also take into consideration the question of what the role of the audit is, and must realize that the audit only concerns one company, and not an entire industry. As concerns the apparent concentration of the audit market, the orator pointed out that the size of the 4 major players on the audit market has not prevented many small audit firms from auditing listed corporations in France.

If such small players do not exist on the European or global market, this is due to other factors, such as the necessity of making large investments to create an international network, or to the need for acquiring a reputation that is naturally linked to size. The question therefore is whether or not this necessity must be carried out by regulation, or by small audit firms themselves.

Furthermore, Jean-Luc Decornoy insisted on the fact that auditing requires independent auditors who have the means to carry out a high-quality audit and who are capable of exercising and developing their professional judgment. Yet, it is difficult to apply the rules of competition to the audit because of its general interest imperatives, such as quality and security.

Furthermore, competition lowers costs, including the cost of the audit, but must not reduce the audit's quality. Since it is broadly accepted that high-quality audits are essential to the financial market, the orator believes that the audit must be made more secure, rather than weaken it by competition.

After this general introduction, **Nathalie de Basaldua**, Head of the *Audit Policy* unit within the European Commission's Directorate General for the Internal Market and Services, explained the **Green Paper's dynamic** by repeating the European Commission's conclusions, and of course did not engage the Commission with her neutral contribution. She explained that the Green Paper's goal was to open a debate, rather than provide answers.

The first question regards the role of the auditor, since the markets expect them to provide a more substantial analysis of the audited company's situation than in years past. Furthermore, reading the reactions to the Paper, it seems that auditors must concomitantly be closer and more distant from corporate managers, through the English notion of an obligation of skepticism concerning the reports that are presented to them.

A second issue concerns auditors' independence, since they carry out a mission in the public interest, but are paid by the audited company, which has the potential to create a conflict of interest. Solutions such as the prohibition of providing consulting services or the limitation of the percent any single company makes up in an auditing firms' annual revenue are potential solutions to this problem. Capital requirements should also be imposed on audit firms in order to guarantee their independence.

A third question concerns the audit market, its lack of competition, its potential systemic risks, and the fear of moral hazard; possible solutions would be to create mandatory rotation, joint audits, prohibiting "only big four" clauses, or creating 'living wills' in case an audit firm goes bankrupt. A fourth questions concerns the creation of an European audit market, which can only be created by breaking down the barriers to auditors' trans-border mobility.

The Green Paper has received more than 700 responses, of which 40% come from Germany, and which substantially differ in their content. Nevertheless, it seems that the auditor's role must be clarified, auditors must be made more independent, they must be supervised on the European level, and must benefit from a sort of European professional passport. The theme of the industry's concentration remains quite controversial. In its ongoing work, the European Commission will proceed with a cost/benefit analysis, in collaboration with the concerned parties, and the Commission's propositions will be emitted in Autumn 2011.

After these two general contributions, the first portion of the colloquium was consecrated to determining the **links governing the future of the audit.**

On this subject, **Alain Couret**, professor at the *Ecole de droit de la Sorbonne* and director of *Sorbonne Finance* (IRJS - Institut Tunc), analyzed the **links between the future of the audit and the future of financial markets**.

He observed that financial markets seemed to be headed towards more competition, transparency, confidence, and oversight. The audit is perceived as a pillar of financial stability, which shifts the debate, because the audit is more of a banking problem than a question regarding financial markets. This puts the role of the audit in bank failures into doubt, but financial regulation plays a major role in such failures.

Up to now, no reports on the financial crisis had evoked the role of auditors in the onset of the crisis. The Green Paper therefore takes on a completely different perspective, by affirming that if the role of the auditor were transformed, the efficiency of financial markets and the amelioration of financial stability could be obtained, and might even promote corporate social responsibility.

Thereby, auditors would be responsible for expressing opinions on potential future performance using not-exclusively financial data, rather than certifying the sincerity of past situations. Should the future of the audit be so tightly correlated with the future of financial markets? Of course, the financial markets have caused the audit to be so important because it participates in market confidence: information is the market and the auditor is the guarantor of its sincerity.

This is why the European Commission considers the audit as a sort of sub-system of the financial markets that is responsible for guaranteeing financial stability. The Green Paper therefore concludes that the auditor is a "systemic agent," but the orator reminds the audience that it has been demonstrated that this qualification is inappropriate. Rather, it is important to affirm that auditors help manage systemic risk by providing the market with essential information.

Furthermore, the Green Paper observes that the audit is a market that must function efficiently. But efficiency and competition are not always the same thing, because there is no observable relationship between competition and the provision of objective information. On the other hand, oversight of auditors must be improved, especially if they are to provide opinions. Furthermore, the Green Paper shows the extent of the market's "expectations."

In order for confidence to remain strong, the audit must be independent, and the fight against conflicts of interest, be they caused by the way audit firms are remunerated or by market concentration, must remain a priority. Furthermore, the Green Paper wants to create a European market for the audit, which would protect the general interest, since investors themselves are requesting the provision of information beyond the strictly financial.

The orator therefore foresees a future for the audit beyond and outside the abstract entity that is the financial market. If its role must go beyond the certification of accounts, its liability and organization must be rethought: joint audits, because they confront independent and potentially contradictory opinions, doubtlessly is a good way to achieve this new model. Furthermore, if the auditor is to be responsible for providing and independent and not-exclusively-financial information, what is to become of their firms' business models?

These models must readapt themselves to provide the non-financial information that investors want to be provided by a trustworthy source. This must lead us to rethink the role of the audit in a "post-MiFID market". The speaker insists that the Green Paper does not take into consideration this fact, and only envisages regulated markets, whereas the fragmentation of alternative markets makes the certification of information even more vital.

It makes no sense to increase auditors' obligations if they are simply a sub-system of deregulated and opaque financial markets. Similarly, a less abstract vision should lead us to better distinguish between audits performed on large, listed corporations, and those performed on SMEs.

Pursuing the analysis of the Green Paper in its relationship to law, in relationship to which it establishes logical relationships with what the future of the audit should be, **Marie-Anne Frison-Roche** describes the **logical links between the future of audit and competition**.

She goes back to the origin of the construction of the European Union, which was intended to create a single market, and which today requires a unified financial market that can only be achieved by the creation of a European market for the audit. In this instrumental and teleological approach, the speaker reminded the audience of competition's rules as confronted with the imperative of financial stability, adopting the same approach as the Green Paper.

Indeed, competition law dictates behaviors rather than market structures: this is why concentration is not punished in and of itself, dominance is controlled by regulatory law, and not by competition law: therefore, we must carefully distinguish between these two branches of law. Financial markets, which are the markets taken into consideration by the Commission's analysis, are regulated.

Thereby, banks are regulated economic agents because they benefit from information asymmetry, which allows them to be tempted by moral hazard, and are in charge of stimulating the real economy and bear systemic risks because the failure of one can bring about the downfall of the entire financial market. Audit firms certainly have a determining role in the financial market, since auditors certify information, but they are not systemic, since their failure would not cause systemic catastrophe: auditors are "crucial operators," which is a different notion than that of "systemic operator."

However, the Commission confuses the two, which leads it to make a baseless analogy between auditors and banks. Why should we be so concerned with the concentration in an industry that is not systemic? Marie-Anne Frison-Roche continues by reminding the audience that competition supposes the opposition of interests between economic agents that contract with one another, which produces the economic equilibrium of exchange.

The competitive model is desired by the Green Paper, even though it is inapplicable to the audit since the audit must be overseen. Rather than reasoning via competition, we should apply the notion of general interest to the audit. The speaker is so critical towards the European Commission's linking of competition and audit because she believes that the audit should be regulated rather than subjected to more competition.

On the other hand, Marie-Anne Frison-Roche agrees that it is necessary to create a European audit market, which is an integral part of the European financial market. In order to do this, securities regulators and professional organizations must be in close contact with one another, and international regulatory networks must be reinforced. Furthermore, a European passport for auditors must be created. Thereby, the future of the audit would be in accordance with the original goal of European Community law: the construction of an internal market in order for Europe to exist as an international entity.

Christine Thin, the president of the *Haut Conseil du Commissariat aux comptes*, then discussed the **links between the international future of the audit and the future of national audit organizations**. The speaker pointed out that in order to give an opinion on the quality of the information provided on the consolidated accounts of global firms, auditors must have been able to perform audits on a global scale. This imperative can be satisfied either when an audit firm has foreign affiliates, or when it has international and mobile employees.

Furthermore, Christine thin insists on the fact that, despite the diversity of national organizations and rules, they all share one same, constant rule: auditors must always be able to effectively oversee corporate accounts, highlighting that many companies only accept such oversight when it is in their interest.

The quality of the audit is not unfavorable to the audited firm, and investors must be able to have trust in the system, whether it be a company or the financial market. An international audit forum was held in 2006 and was attended by 38 audit regulators, which promotes convergence in oversight rules and addresses international issues. This forum is a perfect setting for discussion with international audit networks. International and European structures for the audit already exist.

The substantial rules that may be considered to be universal do not hinder the creation of a European audit area using purely European directives, using corporate law and account certification. Thereby, the Eighth Directive is the pillar for the audit in Europe, and the speaker points out that this piece of legislation created the principle of cooperation between national supervisory bodies. Effective links were thereby created between the various levels of oversight, and the group of experts within the European Commission also plays a major role.

The national level is also essential to create a true European and international dimension, even if it is only in order to safeguard national particularities. The debate is enriched by this diversity. The speaker developed upon the example of more or less limited regulation of "public interest" corporations in each country, and France has proposed a debate on this subject, believing that regulation need not necessarily be limited to this category. The internationalization of the audit has reached a scale to which national regulations may participate, but they must respect the same rhythm and steps in order to achieve this.

After these enlightening contributions, the second part of the colloquium was devoted to the **analyses guiding the future of the audit**.

Stephen Haddrill, Chief Executive of the Financial Reporting Council, demonstrated the **role of national policies in audit regulation**. He thereby explained the role of the Financial Reporting Council in Great Britain, which is in charge of accounting quality in order to encourage investment.

This regulator is an accounting standards setting body that ensures investors benefit from the trustworthy information that allows them to have confidence in the financial markets. Efforts to improve governance, accounting, and audit participate in this mission and are essential for the European economy. Auditors have a central role to play on the financial markets. The speaker affirmed that he did not think that auditors had made technical mistakes that caused the financial crisis, but affirmed that nonetheless auditors could have done a better job.

This has led the FRC to take into account the expectation gap between the currently defined goals for the audit and those that the market needs. A working document was published on the subject: Effective Company Stewardship, which proposes a broader role for the audit, especially as concerns risk.

Thereby, according to the speaker, the audit committee should better reveal the areas to which corporate officers must pay attention, and their reports should better reflect the discussions between management and the committee, without affecting the quality of their mission. Auditors should then guarantee that audit committees have correctly carried out their tasks, which diminishes the aforementioned gap.

The FRRRP, a panel within the FRC, is more particularly focusing on the pertinence of risk reporting, since some companies simply generate imprecise and very general reports, even though, as the speaker points out, proper risk reporting is the keystone to corporate longevity. Confidence and investor engagement are essential, and this is why he believes that they should be better implicated in the way auditors are chosen, as they should be in issues concerning the audit more generally: this is why the FCR has published a Code that plans for commitments to be made in this direction between institutional investors and large corporations.

The speaker points out that it is not surprising that the European Commission has become concerned with the way the profession is regulated. In the British perspective, Stephen Haddrill says that he is satisfied that the debate exists. Because he is concerned with European coherency, he is favorable towards the creation of a new European authority to deal with the audit. His principal preoccupation is whether the Commission has clearly expressed the goal it is trying to achieve, and whether the appropriate public policy tools exist to achieve them.

The discussion is principally axed around the question of concentration on the audit market. The FCR has intervened to stimulate competition in the industry, and the speaker believes that competition promotes innovation and increases the quality of the audit, which is the central goal. Therefore, measures that increase competition but reduce quality must be rejected.

According to the speaker, the joint audit is one such measure, because it increases the cost of performing an audit, such as mandatory rotation, which it would seem increases concentration in the industry. However, mandating a change in auditor every ten years could be a good idea. More generally, the speaker believes that competition authorities are better equipped to deal with this question than audit regulatory bodies. This is why he is glad that the *Office of Fair Trading* in Great Britain has opened an investigation into the practices on the audit market.

This is a proper division of labor, so to speak, because the FRC should only have to worry about the quality of the audit, while the competition authority deals with issues relating to competition, relying on the expertise of the industry regulator as needed. This is why the regulator has asked the British competition authority to pay particular attention to banks' use of audit firms' consulting services, as well as capital ownership rules regarding audit firms, and "Big Four Only" clauses.

Keeping with this distinction between competition and regulation, the speaker believes that living wills should be drawn up in case an audit firm should go bankrupt, and should be established between financial, audit, and competition regulators on the European and British level.

According to him, what is essential is that bankruptcy does not lead to a market dominated by only three players. Stephen Haddrill concludes by saying that imperatives of professionalism and confidence justify the United Kingdom's support of the idea of an Audit Firms Governance Code. It is the quality of auditors' tools, experience, and judgments that directly impact financial markets and allow investors to continue placing their trust in them.

Following this presentation, **Claude Cazes**, President of the *Compagnie Nationale des Commissaires aux comptes*, described **the impact of professional organizations on auditors behavior in regulating the audit**. Preliminarily, he highlighted the difficulties that still exist in defining regulation, especially in the way it differs from rule making, and whether governments use the term "regulation" to interfere in the economy.

It is important not to increase the system's complexity by creating new rules that attempt to solve true problems. The speaker then discussed the European Commission's Green Paper. He wondered about the goals pursued by the document, which are not always clearly laid out, and believes that it is not true that auditors played a central role in banks' failure.

According to him, the main issue is the correlation between what the markets expect and the future definition of auditors' mission. Indeed, the crisis of the audit is not a question of independence or quality, but the very definition of the audit itself. He believes that perhaps a more prospective conception of the audit's goals would have changed things.

This is why the speaker insists on the fat that the only valid question is that of the goals of the audit and its perimeter, and not the way that the audit market is organized. He believes that French law already corresponds to the demands made by the Green Paper since it has already strictly separated the audit from consulting services, and has established double oversight by the professional regulator and the securities regulator.

And yet, the speaker is in disagreement with the Green Paper's conclusions. In his opinion, the Commission's competition-based approach is not a panacea: it is not the number of audit firms that caused the crisis, since the main point is the quality of the audit, for the audit is a service and not a product. Furthermore, the speaker insists that we must remain in a free-market perspective, and the Commission's suggestions accord the State an overly broad role, since an omnipresent State is in contradiction with the desire for increased competition.

Claude Cazes believes the first priority ought to be the definition of what a quality audit is and determining why audits are carried out, because it is essential to reduce the *expectation gap* that separates the audit from the markets, which is a goal shared by the CNCC and the European Commission.

This is why the speaker believes that professional organizations as the leaders of a new form of regulation. He believes that these bodies must take the double opportunity offered by this regulatory imperative, and must affirm that the audit exists in the general interest in order to allow corporate profits to create micro-economic and macro-economic benefits.

Professional organizations must contribute to this by setting clear and stable standards on the international level that will supervise the profession using the discipline needed to create a credible deontology. Professional organizations cannot exercise without the cooperation of the H3C and the securities regulator, in France, for regulation cannot be decreed.

Etienne Wasmer, a professor of Economics at Sciences Po, analyzed the audit using the triptych of **Audit, Asymmetry of Information, and Competition**. First of all, he highlighted the fact that since financial markets are characterized by asymmetries of information, the audit is a public good that helps them to function better, audited companies to better understand themselves and to make better decisions (internal efficiency), and reinforces redistributive efficiency to investors' benefit (external efficiency).

The public nature of this good does not necessarily mean that it ought to be a public service. The first question that the speaker asked was whether more competition was desirable in such a configuration, since it reduces profits and brings prices closer to their marginal costs, whih benefits companies whose costs are reduced, and temporarily benefits investors. But, Etienne Wasmer also remarked that the "quality of the accounts" is private information, and earns the auditor "informational profits."

Therefore, in order to ensure the auditor does his job well, his "good will" must be counted on, unless incentives are provided, since the concept of "good will" does not exist in economics. The auditor is expected to behave like any other ordinary economic agent, selfish and rational.

The speaker therefore examined the correct structure of incentives. Increased competition can be dangerous because it reduces costs, and might reduce the quality of the audit in the long run. Playing on the auditor's reputation (increasing quality) is a more efficient incentive, as long as profits are high. Etienne Wasmer refers to economic studies performed on credit rating agencies, which are transposable to auditors.

They show that it is in auditors' interest to please the audited company, which suggests an inverse and negative relationship between profit and quality: there should be a separation between the carrying out of the audit and the preliminary selection of the auditor, the key notion being potential conflict of interest.

The solution proposed for credit rating agencies (platform pays) might be transposable to the audit. The speaker continues his analysis of the pertinence of analogies in incentives as regards banks. He doubts that audit firms are systemic, even though banks clearly are, because they are subject to moral hazard, whereas audit firms are not. He does, however, admit that the phrase "institutions close to insolvency gamble for resurrection" applies to both cases.

The speaker concludes by pointing out that the proposal to create a single European market for the audit is attractive, can only be created by adopting common practices, and not a European passport. Furthermore, harmonization between each State's rules in the United States was one of the factors in the systemic crisis, and we should keep this in mind in Europe.

The event ended with a presentation by **Mara Cameran**, who used the Italian example to speak about **The diagnostic performed by the economic analysis of legislation on the mandatory rotation of audit firms.** The speaker described the results of an economic study carried out under her direction at the University Bocconi. Italian law had created the obligatory rotation of audit firms. The ambition of the study was to measure whether this rule led to less concentration on the audit market by comparing the Italian situation with that of other countries.

The various images projected by the speaker showed that in comparison with other countries, the Italian audit market is more concentrated in favor of the Big Four and enjoys less competition. The speaker showed images concerning various countries. We observed that in the United Kingdom, listed companies are much larger than Italian listed companies, and this is why they more systematically choose an auditor belonging to the Big Four. In Belgium, even though there is no obligatory rotation, the Big Four only have about a 50% market share.

Mara Cameran concludes that the rule does not help increase competition and does not favor incumbents, since the analyses show that rather it seems to reduce competition. Mara Cameran observes that, on the other hand, mandatory rotation seems to have positively impacted the quality of the audit. She bases this affirmation on the fact that in Italy, there have been less suspensions for deontological failings since the rule was adopted, except for the first year the auditor carries out an audit in a company, since he does not yet know the audited firm and might make mistakes because of this.

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BRIEF COMMENTARY

This event occurred "in media res," since even though the Green Paper was published in October 2010 and the Commission organized its own colloquium in February 2011, it was held before the propositions that the European Commission will make in Autumn 2011. Therefore, it clearly shows the state of the debate, with its convergences and divergences. The points of agreement were the prevalence of the quality of the audit, everything else only being means to an end. Therefore, the controversial questions of market concentration and rotation concerned the pertinence of these instruments, which are secondary, rather than primary, from a methodological point of view. Secondly, another point of agreement was made evident: the ultimate goal is the quality of the financial market, of which everyone agreed that the auditor is an integral part. All speakers agreed that the financial markets can only flourish in soil irrigated with information and confidence: it is the audit's job to carry out this public interest mission. The points of disaccord concerned the rules capable of making the foregoing reality, and the divergences were very strong between the various speakers. The primary disagreement was whether or not it was necessary to counter the concentration of audit firms on the market. Each rule proposed by a speaker was recused by another, and everyone's arguments were contradicted by another's arguments. Beyond the question of whether or not concentration is undesirable, and which was analyzed in very different fashions, the other disagreements concerned the joint audit, the rule of rotation, and the role of audit committees. Not only was the event an opportunity to shed light on these convergences and divergences, but it also showed the question that remains crucial and unanswered: what is the relationship between the auditor's mission and the revelation of risks to the market? Should this information be provided by the auditor or by another body, such as credit rating agencies or market regulators?