Audit policy in Europe: 2011 – The year of reform?

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As has often been the case throughout the history of corporate reporting, the audit profession finds its function and role as the subjects of debate. We hear of financial scandals on an alarmingly regular basis, with stories written in newspapers and magazines, shown on television and discussed in several books. The financial crisis of 2007 raised many additional questions on corporate governance and the transparency of information for listed companies, especially regarding financial institutions. Public authorities and delegated policy-setting bodies are naturally participating in this discussion, seeking to recover the confidence of savers and professional investors in the accuracy of publicly disclosed information.

In 2010, the European Union launched a green paper, 'Audit policy: Lessons from the crisis', exploring the audit sector to determine what improvements can be made in the public interest, regardless of the specific role, if any, played by the audit profession in the recent global financial crises. Over 38 questions, the green paper covers classic issues in the field: the role of the auditor, communication by auditors to stakeholders, adoption of international standards on auditing (ISAs), governance and independence of audit firms, supervision of auditors, competition in the market of audit services and specific needs for small businesses. The green paper was published on 13 October 2010, seeking views from stakeholders and the broader public and the consultation closed on the 8 December 2010. In all, almost 700 responses (covering 10 000 pages) were received. According to the summary provided by the European Commission

(EC, 2011) at the beginning of February 2011, the responses have come from various stakeholders, including: members of the profession, from small- and medium-size practices to the big four network firms (59 per cent); individual businesses and trade associations (21 per cent); with the remaining portion from supervisors, investors, academics, government authorities and individuals. Although the majority of the responses are from within the European Union (87 per cent, including 42 per cent from Germany), there have been a number of responses from third countries. The analysis of these responses can give a view of the different and sometimes conflicting interests involved. It seems that the major stakeholder in this debate is the accounting and audit profession in Europe. Actually, the tone of the green paper is severe towards the role and the dominance of the Big Four audit firms: the European Commissioner Michel Barnier, in a speech called *Audit 2011 – The Year of Audacity*, warned there would have to be changes in Europe: '[T]he status quo is not going to be an option', he said (Financial Times, 2010). Of course, concerns about the audit role are likewise expressed in other part of the world. For example, James R. Doty (2011), Chairman of the US Public Companies Accounting Oversight Board (PCAOB), said in a recent speech that '[a]s the guardian of a cultural value, the audit is arguably as important as electricity or water. But if it is to retain that lofty status, auditors and the PCAOB need to do our best to make sure the audit is useful'.

The questions presented in the green paper touch upon problems inherent to the financial

audit function since its modern appearance in the business environment. I recall some classic questions (#16 and #17 in the green paper):

#16 – Is there a conflict in the auditor being appointed and remunerated by the audited entity? What alternative arrangements would you recommend in this context?

#17 – Would the appointment by a third party be justified in certain cases?

These questions bring us to a turning point in the modern history of auditing. During the discussion of the 1933 ‘Truth in Securities Act’ in the United States, the issue of audit providers was raised. Should external audits be conducted by a government agency, or a private association of accountants? During that discussion, A. H. Carter, president of the New York State Society of CPAs, confirmed that public accountants audits the controller’s account. He was then asked, ‘Who audits you?’ He answered: ‘Our conscience’ (Carey, 1969, p. 187).

After almost 80 years, the construction of corporate governance and financial reporting is again at a crossroads. As often happens during a crisis, regulators are entering the playing field with new rules meant to prevent the mistakes of the past. The problem, however, is that the mere appearance of change will not be sufficient. The new regulations require cogent interpretation and adequate enforcement; both the spirit and the letter of the law must be followed. To comply with the letter of regulations while ignoring its spirit is a substantial risk to address in corporate governance, reporting and auditing. The audit opinion is key to the trust and protection of millions of investors and the regular functioning of modern financial markets. This is why, from an historical perspective, it is the reverberation of market crises that fosters a redefinition of corporate governance and financial reporting and auditing rules. A critical role in the definition of the regulatory framework is the choice between

a principles-based approach or a rules-based approach. The European answer appears inspired by the first approach (EC, 2002). The rules-based approach is the one taken in the United States, as evidenced by its switch during the 1970s from the Accounting Principles Board to the Financial Accounting Standards Board. The global capital market requires homogeneous audit quality across different geographical areas. An audit report signed in London can be based on large part on audit work done in other countries (with different audit standards) in the case of multinational companies. This in turn stresses the importance of international cooperation on core principles, rather than detailed rules, and to enhance the quality of global audit oversight.

Finding measures to improve this cooperation is among the objectives of the green paper. According to a recent Eurobarometer survey, as reported by European Central Bank (2011, p. 88), less than one in ten European Union citizens consider their national government to be the right agent when it comes to the regulation and reform of global financial markets, and instead put more trust in international and European organizations to address these tasks. However, the mission is not simple. For example, the principle of auditor independence is interpreted differently in different European countries. Language only has meaning when placed in a meaningful context, and the European Union intends to create a substantial common meaning, regardless of locale or language. Therefore, the additional problem in the European context of the 27 member States is that sometimes the simple translation of directives and recommendations does not bypass different cultures and, as a consequence, different implementation of the same directive. However, this is a problem common to every international rule, including International Financial Reporting Standards and International Standards on Auditing.

As a consequence of the consultation process on the green paper, a proposal is expected by the end of 2011. Among the suggestions under

consideration are the French system of joint audits and the German system of long-form report. Meanwhile, in the United States, the PCAOB is expected to issue a concept release that 'may result in the first substantial changes to the [audit] reporting model in more than half a century. The release will explore various possibilities and seek specific feedback' (Doty, 2011).

Another debated theme is related to the 'too big to fail' firms or, in this case, 'too few to fail' (Nocera, 2005). This issue is treated in the green paper with potential direct impact in the market of the audit services. The view proposed is that

The market for audits of listed companies is, in the main, covered by the so called Big Four audit firms. In terms of the revenues or fees received, the total market share of Big Four audit firms for listed companies exceeds 90 per cent in a vast majority of EU member states. Entry into this top-tier section of the audit market has proven very difficult for many mid tier audit firms despite their capacity to work in the international audit market. Such concentration might entail an accumulation of systemic risk and the collapse of a 'systemic firm' or a firm that has reached 'systemic proportions' could disrupt the whole market ... in view of the systemic risk represented by the large, global firms, the Commission would also welcome views on whether the consolidation of the past decades should be reversed (EC, 2010, pp. 15, 17).

This approach to address the market of audit services and its players is counterbalanced by PCAOB Chairman James R. Doty (2011):

I question how directly these proposals advance the public's call for more relevant information, including 'early warnings,' from auditors. I do not believe that the global audit firm networks themselves pose systemic risk to our economy. But initiatives to shrink the global firms

would likely further weaken their ability to audit the large, multi-national companies that may themselves be systemically important. The global audit firm is not too big to fail: it is too important to leave unregulated. To protect investors, governments should regulate such firms, not cripple them. There's no reason to think that if there were more major firms they'd be more likely to stand up to their clients. Audit firms today compete fiercely on the basis of price and client service. They don't compete on the basis of investor protection, and they question whether their corporate clients value audit quality. This position offers no support for anti-competitive, price-fixing practices. But competition issues are the bailiwick of competition authorities. And I would be concerned about measures to promote competition proposed in name of audit reform and expressed in the rhetoric of market transparency that would, in application, have a negative effect on audit quality.

These positions are concerned with the supply side of the market of audit services, with an implicit reference to a consumer and a producer. However, this scheme is not easily applied to the audit market. If we agree that the auditor's actual clients are the users of audited financial statements and not only management or the board of directors, the buyer (in substance) is not the one signing (in form) the contract. Moreover, there is a risk that auditors in a capitalist environment can forget their societal mandate and become simply businessmen trying to sell a commodity.

In this context, it is important to stress that auditors have an important role to play and are entrusted by law to conduct statutory audits. This entrustment responds to the fulfillment of a societal role in offering an opinion on the truth and fairness of the financial statements of audited entities. The independence of auditors should thus

be the bedrock of the audit environment. It is time to probe into the true fulfillment of this societal mandate. (EC, 2010, p. 3)

These arguments explain why the organization of the peculiar market of audit services is a matter of politics, sometime linked to philosophical assumptions and cultural values that are antecedent to economic reasoning. This means that although regulations can be changed, cultural internalization of the public interest role of the auditor is more challenging. In any case, every decision should pass a cost/benefit analysis. Moreover, the fundamental premise of any audit quality reform is the quality of people acting in the business environment as auditors, so, in theory, the system contains the seeds of its own recovery.

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