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Eddy WYMEERSCH

Third high level FEE conference on key issues in audit regulation in the EU

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Abstract

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Audit regulation: the perspective of the securities regulators

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2007 and even more 2008 have been crucial years in the financial markets. The events of this period are likely to have a profound repercussion on the development of the system of financial regulation and the many other fields that are directly linked to the financial markets. The systemic nature of the risks that have now appeared call for strong action on the part of all players. And, the auditors although they have been well taken care of in the Sarbanes Oxley Act, are likely to be affected in certain respects as well.

Differently from the previous crisis of 2001-2002 and due to Enron and other similar cases, the audit profession has this time not been the prime target of public criticism. That "privilege" is now reserved to the Credit Ratings Agencies, who can expect a serious dose of regulation and oversight. The audit profession has been confronted with the same reaction after the Enron debacle that lead directly to the Sarbanes-Oxley Act and other comparable initiatives in several parts of the world. The fall-out from Sarbanes Oxley is increasingly visible in Europe as well.

In the globalised world of today, incidents happening in one corner, immediately affect the rest of the economies, and regulation also travels globally, albeit at a lower speed. That is the reason why we should follow these trends with vigilant interest.

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A. Mutual recognition

Among the major developments that are going on right now is the increasing willingness of the public authorities on both sides of the Atlantic, to open access to their markets for players from the other side. These discussions mostly referred to as "mutual recognition", and are being followed with great interest from other major economies such as the Australian, Canadian and on the longer tem, Indian and other jurisdictions.

In some fields concrete results have been achieved.

European companies with listings in the US often complained about the heavy US regulation and the accompanying risk of liability. Once registered with the SEC it was virtually impossible to deregister and leave the American regulatory environment: this was often dubbed “Hotel California”, referring to the movie where visitors could check in, but not check out. Since 2007, the SEC changed its approach, and providing certain conditions to be met, allows companies to prove that they have almost no US investors in their shares left, and therefore can apply for deregistration. Underlying is the analysis, that while US investors massively deal in European or foreign shares directly on the foreign home markets, US investors being already massively exposed to these foreign risks, keeping these companies artificially under the US law would only isolate the US markets as the number of applications for listing is likely to drop. Indeed some figures indicate that European markets have attracted more new listing over the last years. As a consequence, numerous companies have deregistered: it is worth noting that approximately 73 out of 240 listed companies have decided to deregister, since June 2007, that is 50% of the companies that actually qualify for deregistration.

The second important movement in the same overall direction is the acceptance of IFRS for non-US investors as equivalent to US GAAP, and this without further restatement or additions. This decision was taken in 15 November of 2007 and will make access to the US markets considerably more easy but also more attractive. One can expect the SEC to follow to same line of reasoning for US issuers, what would technically amount to abandoning US GAAP, even for the smaller issuers. On 27 August 2008 the SEC approved a roadmap that could lead to the use of IFRS by U.S. issuers beginning in 2014. Decisions have however not yet been taken, and are, understandably, opposed on the basis of several considerations, i.a. equal treatment of large and small issuers. At the same time, the consequences for the IASB are visible, as the US and the EU are redrawing the governance model of the IAS Foundation.

Over time, we expect IFRS being applied all over the world. Today, more than 100 countries around the world currently require or permit IFRS reporting. About 85 of those countries require IFRS reporting for all domestic, listed companies.

The EU has the objective of arriving at a common set of worldwide accounting standards for listed issuers. In the meantime, the objective is to eliminate existing reconciliation requirements between the EU and its key trading partners. This concerns the issuers from the US whose GAAP are considered to be equivalent. It also applies, until 2011, to issuers from Japan, Canada, South Korea and China; others (India, Mexico, Taiwan, Argentina and Brazil) may follow. . This approach will allow opening EU markets to issuers from these jurisdictions. Finally, IFRS would be one of the few standards that are applied worldwide, definitely a momentous achievement.

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CESR intends to play an important role in the application of the IFRS. Indeed, the members of CESR as market regulators and supervisors of financial disclosure are on the front line for all difficulties in the application of the IFRS. CESR has introduced procedures to ensure that necessary convergence is achieved in the application of the IFRS. Firms or auditors may submit questions to the national regulator, which can submit the question to a subcommittee of CESR-Fin for further analysis. On the basis of a thorough analysis and discussion by the accounting specialists of the CESR members, a common opinion is reached, then approved by the chair's committee and published on the website. These interpretations cannot be compared with those of IFRIC that have regulatory value. CESR only acts within its competence of supervisor of the financial information to be disclosed by listed companies. It gives practical information with respect to the way it views a certain issue to be solved. Technically, it means that a company that follows the recommendation will not be confronted with a different opinion from any of the CESR members. In that sense the opinion will have a certain external effect: companies and other third parties can rely on the opinion, which being adopted by all EU supervisors, may also gain support from judicial case law. CESR applies a similar approach to many other fields, such as prospectuses, application of the market abuse rules, Mifid rules, and so on. Interpretations in these fields are posted on the CESR Website.

But there is more to come. The starting point here is the massive presence of US investors in the world markets, including the European markets. Just between 2001 and 2005, US investor holdings of foreign securities of all types nearly doubled, from $2.3 trillion to $4.6 trillion. US investor ownership of foreign equities during this same period increased from $1.6 trillion to $3.3 trillion. Nearly two-thirds of American equity investors are now invested in non-US companies, a 30 percent increase from just five years ago.

And although I have no comprehensive figure for the EU-US direction, there is ample anecdotal evidence that Europe invests massively in US markets. The speed at which the events in the US have manifested themselves all over the world indicates that we are moving to fully globalised markets.

Once it is accepted that the Transatlantic Divide exists in the heads of people but not in their wallets, one should start to look for ways to unlock this tremendous financial potential. Why not officially open the markets on both sides, to our mutual benefit in terms of more efficient financing, better risk spreading and all other benefits deriving from better-integrated markets?

There are several platforms on which this approach would bring great benefit. One could easily see the same investment fund - in the US, a mutual fund – being offered on both sides of the Atlantic, which is not the case today. Generally spoken, as far as investment funds are concerned, one can safely state that investor protection is equally satisfactory in both jurisdictions, so there is no reason not to open the markets, at least for the more traditional products. By the way, European investment funds count among the most successful financial products in large parts of Asia, Africa and South America, but are not on offer in the US.

The same applies to IPO's where frequently investors from the other jurisdiction are excluded because the administrative burdens of registration are too heavy. Exclusion takes place voluntarily, or on the basis of explicit clauses in the offering documents. In the absence of active marketing of the securities in the other jurisdiction, one cannot expect cross border sales to take place. And Takeover bids are in the same position, leading to discrimination against the shareholders the law is intended to protect.

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More controversial but more important is the unlocking of the markets for trading in securities. This is usually referred to as the installation of "trading screens" with the banks and brokers in the other jurisdiction. It means that securities that are regularly traded in one state could be actively offered to investors in the other states. This would imply that the banks and brokers of the first state would be able to offer these securities to investors in the receiving state. Indirectly therefore, it would mean that our European intermediaries would get access to US investors, without having to meet the stringent requirements set by the SEC for registering as a securities broker.

For the investors, the direct advantage would be that US investors would get easier access to a larger number of EU securities, that EU securities would be followed by more financial analysts, and that double fees for executing trades could be avoided. Increasing interest would enhance liquidity, insuring better prices. Issuers could more easily tap the huge US capital market, reducing their cost of capital. And the market for corporate control would become more exposed, leading to higher valuation for investors.

Looking at all those benefits, the question will arise: why has this had to wait until 2008? The answer is mainly that each market had a tendency to protect itself, fearing i.a. that investor protection was insufficient to open it to domestic, retail investors: even recently, leading regulators have warned for the dangers of fraudulent brokers, acting out of some remote European city, soliciting innocent widows and orphans in the US. Looking at the figures mentioned above, investors have obviously not been convinced. The US still considers its capital market the best in the world, although recent events would call for more than a footnote [1].

Therefore opening the markets requires more than a decision on the principles, but a more detailed analysis whether investors will be sufficiently protected if they are exposed to the intricacies of the other market. It is precisely this exercise, which is now being considered between the US SEC and the European Commission, at the political level, and CESR at the technical level.

The present plan consists of proceeding to a detailed analysis of the state of regulation and enforcement of the rules in all the jurisdictions involved – for the European side, the 27 member states - and determine which states can now – or in a later phase – access the regime of mutual recognition. CESR will analyse the equivalence of the national regulations, starting from the EU directive, while determining the extent to which the rules are being effectively applied. In a second stage, in a direct discussion with the member states involved, a determination will be made about that state regulatory and supervisory system. The Commission will be the guardian of this process.

But we have to be careful: the mutual recognition process can not result in having US rules and procedures – e.g. class actions – applied in Europe. The process is based on the acceptance that regulatory and supervisory systems are "largely equivalent" and if specific rules are different, that does not jeopardize the protective strength of the regulatory system.

[1] See on the Website of the US Treasury, the following quote "The United States has the strongest capital markets in the world, and this position is achieved through hard work and smart strategies that keep up with a dynamic, global marketplace."

Trust between regulators is essential in cross border matters, along with a clear understanding of the differences in the political and social context in which the rules are put at work.

All market participants should also have clarity about the consequences of mutual recognition for the position of the companies, their directors and employees: here the rule should be that action that has not been undertaken in the US, is not subject to legal or regulatory procedures in the US. As we witness from recent events, this opinion is not shared by US courts, nor by US regulatory authorities. If no solution can be achieved, the problem should at least be clearly spelled out and market participants should be clearly informed.

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B- Auditor choice

Let me now turn to an important issue directly affecting the audit profession. It is often referred to, with some euphemism, as “auditor choice”. This issue is often approached in terms of diversity, or of competition. I would like to broaden the approach to a more general consideration that is of prime importance to the supervisory community.

The recent market events have illustrated the vulnerability of our financial system to risks occurring in one or several players: the CRAs are the most recent example. With the auditors, credit rating agencies are important gatekeepers.

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In the field of auditing, which is the subject of today's conference, systemic risk has since several years been recognized: events with systemic consequences could occur if one of the remaining four largest auditing firms would cease its activities. Ceasing activities may be due to many factors, but as we have learned from Arthur Andersen in the Enron case, government action disqualifying a firm in a criminal action is not the most unlikely. Liability suits, conflicts among the leading partners, mergers among firms, may all lead to the disappearance of one of the remaining four major auditing firms. A recent US report has identified several occasions, even recent ones, where this risk actually – almost - materialized.

The sudden disappearance of one of these firms would not only affect that firm and the reputation of the auditing business in general, it would place a very considerable number of large companies before a conundrum: being obliged to replace their auditor, they would have to appoint another firm, lest their activities would not be effectively supervised. This would almost inevitably drive them to one of the three remaining firms, leading to an even higher concentration in the auditing business. The issue is therefore firstly one of competition. If the number of companies affected would be very high – which is not unlikely as will be shown from the figures cited below -, and if the difficulty to find an adequate replacement could not be solved within a reasonable but short time frame, the issue may take on systemic proportions, casting doubts on the reliability of the financial statements of many large companies. One knows how disruptive a confidence crisis can become. The Financial Stability Forum, regrouping all supervisory organizations in the world, in its recent statement on financial stability has repeatedly referred to the crucial role of auditing for maintaining confidence and financial stability.

But there are other aspects to this state of affairs: financial supervisors have serious concerns about the degree of concentration, and reports on this point have been published in the EU, the UK, the US, France and others. In case of grave violations or deficiencies, supervisors would feel hampered to impose sanctions on one of the remaining firms, as this may trigger the collapse of the firm. Remember Andersen and Enron. This situation might result in some kind of immunity of these firms. On the other hand, supervisors could only impose fines, letting the firm subsist. As these fines have to be proportional to the violation, they would be exceptionally high, affecting the activity and development of the firm, without taking the necessary step, which would be its elimination. The high degree of concentration therefore leads to a curtailed supervisory system. This too is not desirable.

The situation today is quite unbalanced.

In June 2008, the Big Four stood for 92% of listed companies in the largest economies, up 1% from March 2007. These figures reflect an average, as it reached more percentages above 95 in Canada (98%) Italy (98%) Japan (98%) UK (97%) and US (96%). In France only 69% listed companies called on one of the Gig Four firms, and in Germany 88%. That means that the other firms acted only for less than 5% of the markets, France and Germany excepted. The Oxera report made similar findings[2]. The relative position of individual audit firms indicates that these sometimes audit one third of the total number of listed companies. The disappearance of that firm would have grave consequences in terms of trust in the financials and might destabilize the trading in securities of these issuers. The US study also mentions that smaller companies are more and more calling on one of the Big Four.

This situation therefore should not be taken lightly and is not developing in the sense of more diversity. There also is awareness that the situation is not likely to be turned around quite rapidly. Quite a lot of thinking has been going on as to the remedies. It is clear that there is not one single remedy and that any change will not achieve results overnight.

Before briefly analysing the different remedies proposed, it is useful to reflect about the underlying motives for this strong and increasing degree of concentration.
Several explanations are advanced. The most frequently cited is the complexity of today's business and of related financial reporting, taking into account its increasingly international character. Investment in advanced methods of analysis requires more and more investments which smaller firms may not be able to expend. Human capital being of paramount importance, smaller firms offer less attractive work and career environments, what will lead to weaker networks for those leaving the firm. Auditing networks will often be smaller, hampering auditing in a global context.

Boards appointing the auditor may be sensitive to the reputation point: as a board member would you not vote for the best guarantee you can find in the market in terms of protection against liability suits? The Big Four are generally presented as the optimum in terms of quality of service, justified or not. The markets, and especially the underwriters and other gatekeepers will feel more comfortable when one of the Big Four having signed, considering that they risk less liability.

But also auditing firms may be hesitant to enter the market for large company audits: competition may be quite stiff, and fees not necessarily more attractive than for auditing smaller firms. Providing non-audit services – often more lucrative - may not be in the firm's regular offer. Liability, especially in the US, is a considerable deterrent to act for large companies, not only for auditors but for the firm's directors and other actors as well. Taking on the audit of a large company may lead to temporarily overburdening the audit firm, to the detriment of its other clients.

It will be striking that very few of the arguments mentioned pro and con are linked to regulation. The unbalanced structure of the market is due to market drivers, which are very difficult to modify. Indirect action may not be very efficient, and produce side effects that are wholly unexpected. Regulators generally are therefore very loath to intervene in this matter, as it would be seen steering the market. Only upon certain exceptional decisions – e.g. a

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[2] Oxera, Ownership rules of audit firms and their consequences for audit market concentration, October 2007.

merger of one of the remaining audit firms – could action be undertaken on competition grounds. In the most recent important merger, the EU competition authority did not raise objections, what might not necessarily have been the most inspired outcome[3].

Should one intervene in terms of regulation? Most reports prefer a market led solution. However, they recognise that the remedies proposed are not very effective and that results cannot be expected in the near future. Whether regulation is needed will also depend on the nature of the remedies adopted.

There are different lines of reasoning that have been developed. Most of these amounts to strengthen the "smaller" audit firms to allow them compete more effectively with the bigger ones. These "second league" firms, being the firms that are sufficiently large to accept mandates from listed companies, but at present are mainly active in the unlisted sector, are only a handful of firms. These firms would have the potential to act in lieu of one of the Big Four, in case if the disappearance of one of them. The proposals usually do not address the position of the smaller, local audit firms.

According to a first approach, the financial position of these firms should be strengthened, allowing them to keep pace with the investments needed to join the first league. This could be achieved by allowing them to call on outside investors, even to the point that their shares may be traded publicly. Calling on outside investors requires however a change in the governance, as most audit firms are modelled on a partnership structure. The main objection against involving outside financiers is based on arguments of independence of the audit firm, undoubtedly the cornerstone of their legal and social position. Therefore countervailing measures likely to protect the firm's independence are proposed. More fundamentally, the question arises whether more generous financing would solve the concentration problem: it presupposes that these "second league" audit firms are constrained by lack of capital to serve their clients as efficiently as their bigger brethren, which of course would also upgrade their financial strength. The Oxera report analysed the case of additional investment, whether or not in a partnership structure and concluded:

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[3] The merger between Price Waterhouse and Coopers & Lybrand in 1998. The Commission accepted arguments at the time of the merger of Price Waterhouse and Coopers & Lybrand that consolidation would pose no problem as smaller players would grow in size and reputation to pick up market share.

"Assuming that either the actual impact on independence and quality of the existing restrictions is low, or that alternative measure are available that would compensate for any change in ownership and management structures, firms could be presented with the possibility of access to cheaper capital and greater incentives to invest. However, the impact of this move on market structure would still depend on whether improved access to capital is sufficient to change the current market dynamics. Nevertheless, as noted above, it would clearly create an opportunity and the incentive for firms to explore alternative market structures."

The argument gives answers to some questions, but does not address the importance of human capital. The Oxera report investigated these lines of reasoning in great detail and concluded "the form of ownership might have an impact on the decision to invest, provided that human capital can be retained under the alternative ownership structure with external investors".

In any case, decisions to allow firms to increase the financial means of auditing firms should be taken only by the firm concerned, taking into account the specific aspects of its business. The regulator can only enable firms to adopt more flexible financing instruments and should remain particularly vigilant with respect to the independence issue.

A second line of reasoning is based on the appointment procedures of the listed companies. It appears that most audit firms are appointed for a very long period of time, hence creating bias and proximity risks. Rotation is now a widely accepted, however with the reservation that except in very few jurisdictions, rotation is not on a firm basis, but merely leads to a change of the partner in charge. It is questionable whether this type of rotation does offer sufficient guarantees in terms of independence, but it certainly does not contribute to the opening up of the market for auditing services.

From the side of the company, the procedures deserve to be clarified and strengthened, as part of the corporate governance rules detailing the role of the audit committee. Systematic reappointment should be avoided, while procedures for appointment should be pre-announced and based on pre-formulated key criteria. The selection procedure should be dealt with at board level, be transparent, free from any real or apparent conflict of interest, and the outcome disclosed ex post. Public bidding should be the rule, as is already the case in many companies. All candidates should be treated on a strict equal footing, avoiding the larger firms to outbid the smaller ones in a subsequent procedure. The appointment should not be based exclusively on price, as this would weaken the audit quality, but on a series of mostly verifiable criteria fixed in advance. Public disclosure of the audit committee report is advisable, while the procedure should be extensively documented and open for inspection to the Audit Oversight Board.

A third approach is the one mainly followed in France: this is the only country where the second league auditing firms have been able to maintain a considerable part of the market: 31% As a consequence some important auditing firms have been able to expand their business even in the largest listed companies, some with a have a widespread international presence. The French approach is laid down in the 1966 Companies Act and is based on the "joint audit": firms have to appoint at least two auditors who, applying the "four eyes principle", will jointly undertake all the audit work, resulting in a common signature. Very often issuers call on a local firm as the second auditor. Both auditors act on a joint basis, leading to allow access to information and expertise also for the second auditor. There is no information as to the consequence of the system on the overall cost to the firms, but in principle, this should not trigger a significant price increase.

The advantages of the joint audit are essentially described in terms of audit quality: strengthening of the firms' independence, reducing the familiarity risk, introducing a certain level of competition between the firms leading to more objective and verifiable decision making. For the issuers, the presence of two auditors allows them to rely on double expertise, and compare opinions. However, there are also some drawbacks: if the second tier firm is designated along a Big Four, the second tier firm often is regarded as the junior partner in the joint team, without effective decision making. After a while, the lead might be entirely taken over by the senior partner.

Which way forward?

The present situation is quite menacing: any failure will lead to an at least temporary disruption in the provision of auditing services. This should be avoided. There are however no easy solutions: a mandatory split up of the existing auditing firms is likely to weaken the existing framework. Nurturing the "second tier" firms to enter the fray for the larger market share therefore seems a more effective approach. Here again not one single solution will do. The three main lines of reasoning outlined above may be put to work simultaneously, but with a clear preference for the corporate governance measures (second strand of proposals: strengthening the selection and appointment procedures). As a large part of the issue discussed here lies in the hand of the issuers, not with the auditing firms, action should be addressed to the issuers and their governance procedures. "Good corporate governance practices" are being advocated in the Corporate Governance Codes: a firm recommendation about the selection procedure could be introduced on a voluntary, "comply and explain" basis, with some form of external oversight in case of refusal. This may not directly lead to allowing second league firms to be appointed but would at least make boards publicly accountable in case a second league firm has proposed a more competitive offer. Activist investors would certainly look into these matters with sharp eyes.

Whether other, especially legislative measures are needed, is a decision that is up to each individual state, taking into account the individual characteristics of its home market. Opening up the firms to outside interests may not be acceptable in all jurisdictions, taking into account also the position of the smaller firms. Finally, joint auditorship, the French solution, would amount to impose regulatory measures with a view of its side effects on the development of second league firms. Its success in France remains limited to 31% of the market. One would prefer to see the phenomenon addressed straight on, not by indirect methods, the outcome of which is unpredictable.

Market concentration statistics

Table shows percentages unless otherwise stated

AUDITOR	**FTSE 100**		**FTSE 250**		**FTSE SMALL CAP / FLEDGLING**		**AIM**	
	FEB 08	NOV 06	FEB 08	NOV **06**	FEB **08**	NOV **06**	FEB 08	NOV 06
NUMBER OF COMPANIES	*100*	*100*	*250*	*250*	*522*	*542*	*1390*	*1132*
PRICEWATERHOUSECOOPERS	39	42	29.2	31.2	22.2	23.1	11.1	9.8
KPMG	23	22	**19.6**	22.7	19.9	19.7	13.4	13.3
DELOITTE	21	18	**28.9**	24.3	17.2	18.1	9.9	9.6
ERNST & YOUNG	16	17	**18.5**	18.6	21.3	19.9	9.1	7.2
BDO STOY HAYWARD			**2.0**	2.0	2.9	3.3	10.5	11.8
GRANT THORNTON			**2.0**	0.4	8.2	2.6	16.0	13.8
PKF					1.7	1.3	3.7	4.1
BAKER TILLY					1.1	2.2	7.9	8.7
ROBSON RHODES					0.0	5.4	0.0	3.4
OTHERS				0.8	5.2	4.4	18.4	18.3
NON BIG 4 SHARE	*0%*	*0%*	*4%*	*3.2%*	*19.2%*	*19.2%*	*56.6%*	*60.1%*

Source: Financial Reporting Council, Choice in the UK audit market. Progress report and future consultation, May 2008

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