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TRANSPARENCY WOULD HELP TO ADDRESS THE AUDIT MARKET PROBLEM

**Response to the consultation on the Interim Report of the
Market Participants Group on Choice in the UK Audit Market**

NICOLAS VÉRON

Addressing the Audit Market Problem Requires Audit Network Transparency

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to the consultation on the Interim Report of the Market Participants Group
on Choice in the UK Audit Market

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Mr. Julian Rose
Secretary, Market Participants Group
Financial Reporting Council
5th Floor, 71-91 Aldwych
London, WC2B 4HN

Dear Mr Rose,

This is my personal response to the April 2007 Interim Report of the Market Participants Group, which was established in October 2006 to provide advice to the United Kingdom's Financial Reporting Council (FRC)¹. It follows my response last year to the FRC's consultation on its May 2006 discussion paper on Choice in the UK Audit Market².

The market for audit services to large international companies is dominated by only four international networks, commonly referred to as the 'Big Four'. This situation is unsatisfactory and represents a significant problem for global capital markets and for the accounting industry itself³. Competition among the Big Four is often fierce, but the possibility that the limited number of players have negative consequences on the quality of financial information must be analysed and discussed. The FRC deserves much praise for its leadership in raising this issue and fostering a debate that goes well beyond the United Kingdom.

The Audit Market Problem is Part of a Broader Debate

This response is based on the Interim Report. However, it must be stressed at the outset that discussion of this question can only be envisaged as part of a larger, worldwide debate on the role of audits.

The debate includes several items. One is the definition and assessment of audit quality. Another is the so-called 'expectations gap', i.e. the notion that investors are expecting more from audits than audit firms are willing to deliver. A third one is the liability risk on audit firms or networks, and how this risk can be managed. And a fourth one is the structure of the audit market, to which the Interim Report is devoted.

These items are strongly interrelated. Audit quality is linked to the incentives that apply to audit international networks, national firms, and individual audit partners. The role of incentives has been illustrated in various cases in which low-quality audits resulting in significant investor damage have been linked to features of the auditor's business model, such as high volumes of consulting correlated with the audit work in the well-publicized cases of Waste Management and Enron – even though this is by no means the only dimension of the Enron audit failure. The 'expectations gap', which a document from the

¹ The Interim Report can be downloaded at: <http://www.frc.org.uk/documents/pagemanager/frc/Visio-Choice%20MPG%20Interim%20Report%20web.pdf>

² The response, published by Bruegel in August 2006, can be downloaded at www.bruegel.org/1427

³ The shorthand 'audit market problem' is used in the rest of this text.

six largest worldwide audit networks⁴ describes as relating to '*material fraud and the ability of the auditors to uncover it at reasonable cost*', will inevitably grow larger if audit firms face a reduction in their incentives to discover malpractice, or to report it if discovered. Exposure to liability and reputation risk *de facto* constitutes such an incentive. Also, the small number of global audit networks with a capacity to serve large multinational companies has given rise to fears of regulatory leniency towards them which, if accurate, could also reduce the incentives for audit quality – the so-called 'too few to fail' argument.

The debate is made broader still by the fact that it cannot be restricted to one single country. While the FRC's remit covers the UK, one important reason why there are significant barriers to entry on the market for audit services to large multinational companies is that any new entrant must display an ability to serve clients all around the globe, which is extremely difficult to establish. In fact, I can think of no other service market for which the requirement for a global presence at the outset of an assignment constitutes such a high barrier to entry. Therefore, this particular market cannot be seen as local; on the contrary, it is precisely its global features that create the audit market problem. Audit services to companies other than the large international ones are generally provided by a larger number of audit firms, including non-Big Four ones. In spite of the importance of the UK audit market *per se*, it is unlikely that a market-led or public-policy initiative covering only the UK could make any significant difference unless it can trigger meaningful effects at international level. Therefore, in order to succeed, any action needs to be prepared with a view to the international context.

The situation in this respect is more favourable than a year ago. Partly as a consequence of the FRC's initiative, there is more international awareness of the risks posed by the current degree of market concentration. On 17 May 2007, US Treasury Secretary Henry Paulson announced that a high-level group, to be co-chaired by former SEC Chairman Arthur Levitt and former SEC Chief Accountant Donald Nicolaisen, would look at the audit market and at what he called '*legitimate questions about the sustainability of the auditing profession's business model*'.

No Short-Term Fix

The Interim Report rightly acknowledges that there is no apparent way to bring significant improvement to the competitive situation of the market for audit services to large international companies in the short term, apart from a break-up of existing firms which the Interim Report does not recommend. It makes clear that the full effect of its proposed measures can only be envisaged in the long term, with some positive impact being reached in the medium term but not on audit services to the largest international companies.

This time perspective appears correct to me, even though its implications are somewhat disturbing. The audit market problem could give rise to a short-term crisis. If one of the Big Four networks were to unravel – an event that can be sudden, as the demise of Arthur Andersen proved in 2002 – the provisional recommendations of the Interim Report would not be sufficient to solve the significant difficulties of a market situation in which only three global networks would remain. Were such an event to occur, there would perhaps be no other option than a voluntary or forced break-up of one or several of the remaining audit network(s), a development which is sure to be painful, is not presently desired by the audit networks or other market participants, and whose potential impact has not yet (to my knowledge) been assessed in depth by regulators or other parties.

This may provide a strong incentive for audit quality and crisis prevention. Indeed, there seems to be widespread agreement that audit quality has generally increased since 2002. Moreover, capital markets have been buoyant since 2003, thus reducing the risk of major accounting crises. But the fact remains that all available scenarios imply living for a

⁴ 'Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks', November 2006. This text can be downloaded at www.globalpublicpolicysymposium.com.

certain time without any adequate crisis management framework other than the break-up option. And the latter would be a very radical and possibly disruptive or impractical option, for which the case, it seems to me, has not been made convincingly at this point in the debate. Present efforts should be focused on reaching a lasting improvement at global level, not at providing short-term fixes.

A Problem of 'Supply' rather than 'Demand'

In my response last year, I wrote that *'the main obstacle to non-Big Four firms becoming the auditors of large international companies resides in such firms' actual capabilities or lack of them'*. Developments since then do not seem to indicate a significant change in the current situation where the Big Four networks appear to provide superior worldwide coverage and consistency of service compared to other providers.

I agree with the Interim Report's assessment of provisional recommendations (numbered 5 to 7) aiming at reducing the risks associated with selecting a non-Big Four firm as auditor, and with its provisional recommendations (numbered 8 to 10) directed at improving the accountability of boards for their auditor selection decisions. But I doubt that these measures alone can do much to reduce the dominance of the Big Four firms on the market for audit services to large international companies. To use the same words as the Interim Report, the core of the audit market problem is an issue of 'supply' rather than of 'demand'.

Leadership is to be Shown by the Profession

The Interim Report's preference for market-based measures is commendable. Audit is a highly regulated industry, and this may be one of the reasons why market entry barriers for audit services to large international companies are so high. Further regulatory intervention should be seen as a matter of last resort. It would be far preferable for the profession to show leadership in resolving or at least mitigating the audit market problem. However, in the absence of such leadership, regulators may have to consider their own options.

This link was illustrated in the United States by two contrasting developments, at a quarter-century's interval. In 1977, following foreign corruption scandals and the high-profile bankruptcy of Penn Central Railroad, Congress discussed federal regulation of the accounting profession but the American Institute of Certified Public Accountants (AICPA) successfully argued that a self-regulatory system based on careful peer review and an independent Public Oversight Board (POB) would be preferable. In 2002, however, the Enron scandal and the subsequent demise of Arthur Andersen were met with defensive attitudes from the US accounting profession and AICPA. The AICPA's refusal to envisage far-reaching reforms led to the embarrassing resignation of the POB in January 2002, and paved the way for the termination of auditors' self-regulation in the US with the creation of the Public Company Accounting Oversight Board (PCAOB) by the Sarbanes-Oxley Act of July 2002⁵.

There are parallels to the present situation. The accounting profession has taken leadership in acknowledging that it needed to look beyond its immediate clients' desires and reach out to its ultimate stakeholders, the users of financial information and, most prominent among them, the investor community. This was illustrated by the Global Public Policy Symposium, a joint initiative of the Big Four together and two other international audit networks (BDO and Grant Thornton), which held its first meeting in November 2006 with a strong emphasis on dialogue with investors.

By contrast, there is some risk in the accounting profession's current advocacy of limiting the liability of auditors. The argument is that a single large liability could bring the downfall of a Big Four audit firm, with harmful consequences for the marketplace, and

⁵ See the March 2002 congressional hearing of Charles Bowsher, last chairman of the POB, available at http://banking.senate.gov/02_03hr/031902/bowsher.htm.

that liabilities should therefore be limited or capped. But this line of advocacy can also be described as an endorsement of the 'too-few-to-fail' argument, i.e. that the willingness to preserve the current market structure leads to more leniency towards the audit firms' possible failings.

Liability limitation may in any case not suffice to avert the risk of disappearance of one of the Big Four. Indeed, no authoritative case has been made that Arthur Andersen could have survived if it had not been indicted in the Enron case. Many observers think Andersen was condemned to go down anyway because of collapse of client trust, especially after the WorldCom scandal proved that what underlay its crisis was more than just 'a few bad apples' in the Houston office. Even the hands-on involvement of Paul Volcker, one of the most respected individuals in the international financial community, did not prevent Andersen from collapse. Market pressure, rather than liability issues or regulatory action, also played a key role when Misuzu (affiliated with PwC) exited the Japanese audit market earlier this year.

This is not to deny the seriousness of the liability issue. It cannot be excluded that liability issues might endanger one or several of the Big Four firms. The corresponding risks create difficulties for the firms to recruit and retain the best minds as partners, which is no good thing in terms of audit quality. And if the risks materialise, it could prove brutally unfair to many people, as was the case when the collapse of Andersen destroyed the wealth of many partners of Andersen US who had done nothing wrong. But this does not mean that these risks justify a *de facto* promise of bail-out in the form of public protection against legal liability.

By giving the appearance of pushing hard for a reform that may be depicted as self-serving and reducing the incentives for audit quality, there is a risk of diminishing public trust in audits and of increasing the 'expectations gap' that the audit profession otherwise rightly wants to reduce. Rather than insisting on a quick legislative change on this issue, the profession should focus first on making its case to the investment community and other users of financial information. If liability reform were to diminish users' trust in audits, the accounting profession would have scored an own goal against its long-term interest.

Greater Transparency is Needed for Reform

Transparency is an area in which the accounting profession could show a lot of leadership, and in which regulators might eventually intervene if no change comes from the profession itself. I see transparency in the international networks' financials and governance as a prerequisite for reform of other important matters such as audit liability and the structure of the audit market.

Some countries, including the United Kingdom, have already introduced a framework that requires audit firms to disclose audited financial statements and elements of their corporate governance arrangements, thus shedding light on their business model, incentives, and economic constraints. The so-called 8th European Directive will force an improvement in audit firm transparency across the EU, starting in 2008.

But even taking into account planned changes under the 8th Directive, too little will be publicly known about the international audit networks to inform the debate on audit reform. The enormously important role of these networks in maintaining public trust in capital markets justifies that they be submitted to a level of disclosure that allows the public to understand their business model and incentives. Therefore, steps towards more disclosure must be envisaged, preferably as an initiative of the networks themselves. Some audit firms, such as Mazars, have already expressed such leadership by publishing internationally consolidated or combined audited financial statements. The Big Four must move in that direction. As Colin Sharman, then KPMG's International Chairman, urged as early as 2000: "*How can secrecy be justified? How can professional partnerships aspire to be real business advisors if their own businesses are closed books? I urge you to open*

*your books before regulatory pressures insist, before clients insist, before shareholder organisations insist*⁶.

This disclosure should not be restricted to the national level. The demise of Arthur Andersen has shown the somewhat illusory character of a description of those networks as a collection of legally independent national firms. When Andersen US collapsed, its sister firms in other countries followed and each of them was eventually absorbed by another of the Big Four, even though the vast majority had no large liability or even reputation risk in the Enron case. Therefore, any understanding of the business model and incentives of the international audit networks should include transparency in their financials and governance.

This should include both consolidated financial statements of national firms, and combined financial statements of each international network, using a generally accepted set of accounting norms such as International Financial Reporting Standards (IFRS). These financial statements should evidently be audited, as the UK example proves is possible in spite of the competition. Some oversight of this financial disclosure by national public oversight bodies (such as the FRC in the UK or PCAOB in the US) should probably be envisaged as well to enhance the credibility of the process. For the combined accounts of the international networks, the public oversight body of the country in which the main international partnership of the network is legally registered could play a coordinating role, with exchanges of practices within the recently created International Forum of Independent Audit Regulators (IFIAR).

Disclosure should also include more details about the networks' and national firms' governance, taking into account their current legal form as partnerships. Because of this, the reference standards of disclosure, which could be applied using the 'comply or explain' approach, may be different from those in use for publicly listed firms, such as the UK Combined Code which the Interim Report refers to (provisional recommendation 14). Standards of disclosure should aim to clarify the incentives at network, firm, office, and partner level, thus allowing a better assessment of the context that may favour optimal audit quality. To what extent such disclosures might include individual senior partner remuneration remains open to discussion. Preferably, these standards of disclosure should be prepared by the profession itself, based on an in-depth consultation of its stakeholder base and especially of the user community. If no momentum comes from the profession, their preparation could be envisaged by international groups of regulators such as IFIAR and the International Organisation of Securities Commissions (IOSCO), building on the existing basis including the 8th European Directive. The OECD guidelines for multinational enterprises⁷ could serve as a useful reference.

Such transparency would be essential for both the debate on auditor liability and that on the structure of the audit market:

- Financial transparency would help the public understand the true stakes in audit liability and the cost of audit risk; the national level of disclosure is especially important in this respect. This public understanding is indispensable to forming a consensus on which legislative provisions governing audit firm liability might be appropriate.
- Financial transparency would shed light on the international audit networks' business model, provided segment information is of high quality and includes separate income statements for audit (and immediately related) services. This would allow the public and potential investors to understand both the prospects for successful new entry onto their market, and possible obstacles to it. Potential new entrants, outside the narrow circle of today's international audit networks, currently have no way of reliably assessing market potential given the lack of reliable public data.

⁶ Speech to the Institute of Chartered Accountants of Ireland, June 2000.

⁷ [http://www.oilis.oecd.org/oilis/2000doc.nsf/LinkTo/daffe-ime-wpg\(2000\)9](http://www.oilis.oecd.org/oilis/2000doc.nsf/LinkTo/daffe-ime-wpg(2000)9). See item 3 on page 12 for the scope of application, in which my understanding is that the Big Four audit networks can be included.

Some might argue that transparency should be provided only to regulators and public oversight bodies, rather than to the general public. But research (as well as experience) shows that public disclosure can be more efficient than mere disclosure to regulators, because regulators are not always best placed to detect problems or act on them⁸. Therefore, there should be both public disclosure on essential items such as those mentioned above, and more in-depth disclosure to public oversight bodies, as exists in the banking sector, at least for the majority of banks which are publicly listed.

Ownership Reform Opens Promising Prospects of Improvement

One of the Interim Report's key insights is the recognition that audit firms' ownership rules, initially designed to ensure appropriate incentives and protect auditors' independence, may have become an obstacle to the adaptation of the accounting profession to current challenges. Audit services to large international companies are now a heavily knowledge- and capital-intensive business, and the limitations on the ownership of firms that deliver it are likely to hamper the possibility of investment by new entrants. I therefore wholeheartedly approve provisional recommendation 1 of the Interim Report, which encourages the FRC to '*promote wider understanding of the possible effects on audit choice of changes to audit firm ownership rules*'.

Expectations of such effects, though, should be cautiously managed. While ownership reform offers promising prospects for the audit market, it is unlikely to resolve the audit market problem at a stroke, and the possible downsides must also be analysed.

Credit rating agencies are examples of players which have built a reputation for independence in the examination and processing of financial information, without being subject to specific ownership rules. Among critics of credit rating agencies, of which there are many, few argue that they should be transformed into partnerships. But apart from the obvious fact that credit rating and audit are two very different businesses, this example shows that the absence of ownership limitation is no guarantee of bringing more players into the market. In fact, the largest three credit rating agencies have consistently purchased emerging new entrants for decades, so that their collective dominance of the credit rating market has remained unchallenged.

The media sector is another point of comparison. It shows both that powerful and indispensable information intermediaries can operate with no specific ownership rules (in many countries at least), and simultaneously that the independence of such actors under private ownership in concentrated markets can never be taken for granted, even though this market does not entail the same barriers to entry as the market for audit services to large international companies.

Increased transparency on audit networks' business model and financials would increase the chances of success of ownership rules reform by informing potential investors of the possible economic rewards of entry into the audit market. As argued earlier, this can have meaningful consequences only if implemented at international level and not just in the UK. Similarly, changes in ownership rules should be discussed at international level to have any chance of impact.

Wrap-Up

Not enough attention was devoted to the audit market problem at the time of widespread corporate scandals and financial reform in 2001-02, and the magnitude of the problem now calls for action. However, any action must be based on strong evidence and preferably be market-based, which calls for strong leadership from the accounting profession itself, and by the investor community, which includes the most prominent users of financial information.

⁸ See Alexander Dyck, Adair Morse, and Luigi Zingales, "Who Blows the Whistle on Corporate Fraud?", NBER Working Paper No. 12882, February 2007.

Because we need more evidence before action, short-term attention should be given as a priority to more transparency from the international audit networks about their financials and governance arrangements. This should go further than the Interim Reports' provisional recommendation 2 by covering the networks' international activity and mandating the use of generally accepted accounting norms such as IFRS for national consolidated financials and international combined financials. Transparency about governance should also go beyond the requirements of existing national legislation and the 8th European Directive, in order to give the public a meaningful picture of the networks' international and national business model, incentives, and financial strength.

The same need for evidence favours waiting for more financial transparency from international audit networks before taking any significant regulatory action. This applies to auditors' liability. The 'fear of God' that has gripped audit networks following the collapse of Arthur Andersen appears to have served capital markets well, with most observers acknowledging an improvement in audit quality since 2002. Regulators should make sure they do not lower the incentives for audit quality, especially as the possibility of less favourable market conditions in the near future may increase the level of audit risk.

Evidence should also be sought on issues that have a significant bearing on the audit debate, and on which the current level of public understanding is insufficient. Two items are of particular significance. First, given the huge impact of Andersen's collapse in 2002, we need a shared analysis on why it happened instead of the current divergence of opinions. Second, we need a diagnosis of the current competition situation at European and at global level, of the same level of quality as the 2003 Government Accountability Office report on the US audit market, and the 2006 Oxera study (jointly commissioned by the Department of Trade and Industry and the FRC) on the UK audit market. The initiative for such evidence-gathering could come from market participants (including the accounting profession), or public institutions (at national, EU, or international level), or both.

Reform of the ownership rules applying to audit firms holds the promise of lowering some of the barriers to market entry for audit services to large international companies. While no panacea, such reform is a very welcome prospect, which the FRC should further elaborate on, and champion internationally. It too would be enhanced by more transparency on the part of existing audit networks, as the information provided may help potential external investors to assess the economic attraction of investing in the audit sector.

I hope these elements prove useful for the FRC's reflections.

Yours sincerely,



Nicolas Véron

Research Fellow, Bruegel

Contact: phone +32 473 815 372, email n.veron@bruegel.org

Copy to:

- *Mr Pierre Delsaux, Director for Free Movement of Capital, Company Law and Corporate Governance, Directorate-General for the Internal Market, European Commission*
- *Mr Jeffrey Lucy, Chairman, International Forum of Independent Audit Regulators*
- *Mr Philippe Richard, Secretary General, International Organisation of Securities Commissions*
- *Mr Ethiopis Tafara, Head of International Affairs, US Securities and Exchange Commission*