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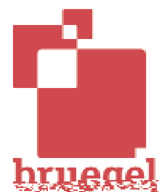
TRANSPARENCY WOULD HELP TO ADDRESS THE AUDIT MARKET PROBLEM

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

NICOLAS VÉRON



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

6 July 2007

Mr. Julian Rose
Secretary, Market Participants Group
Financial Reporting Council
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Dear Mr Rose,

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 2002[5].

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_03hrg/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

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.

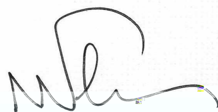
The same need for evidence favours waiting for more financial transparency from international audit networks before taking any significant regulatory action. This applies to auditors' liability. The 'fear of God' that has gripped audit networks following the collapse of Arthur Andersen appears to have 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,



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