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CHOICE IN THE UK AUDIT MARKET

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Response by Nicolas Véron to the Financial Reporting Council's Discussion Paper on Choice in the UK Audit Market

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Brussels, 4 August 2006

Dear Sir,

In May 2006, The Financial Reporting Council (FRC) issued a discussion paper on "Choice in the UK Audit Market"[1], following the study it had jointly commissioned with the United Kingdom's Department of Trade and Industry (DTI)[2]. It is my pleasure to hereby respond to the FRC's consultation on its discussion paper.

The introductory development and answers to the FRC's questions, enclosed in this letter, are my own personal views. This document should not be seen as reflecting in any way the views of Bruegel as an institution nor of Bruegel's members.

An Unusual Competition Issue of Major Importance

The current state of concentration of the market of audit services for large international companies, with only four networks of firms[3] covering almost the entire market, has been a source of international concern ever since the fall of Arthur Andersen in early 2002. It was called "a national problem" by the former Chairman of the US Securities & Exchange Commission (SEC), William Donaldson[4]. Among other similar expressions of unease, the Accounting and Auditing Practices Committee of the International Corporate Governance Network issued a "Statement of Concern" in 2005, which depicted the current state of affairs regarding the structure of the audit market as "deeply unsatisfactory"[5].

This is not a competition issue in the usual sense, because the relationship between an issuer and an auditor cannot be reduced to its commercial component. On the auditor-client relationship, the DTI-FRC document and previous publications, most notably a report of the US Government Accountability Office (GAO) in July 2003[6], have highlighted the absence of evidence of broad anti-competitive behavior[7] and

[1] Available at http://www.frc.org.uk/press/pub1104.html.
[2] "Competition and Choice in the UK Audit Market", report prepared by Oxera Consulting Ltd for DTI and FRC, April 2006; available at http://www.frc.org.uk/press/pub1083.html.
[3] Universally known as the "Big Four": Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers.
[4] Quoted in "The Big Four: Too Few to Fail?", *BusinessWeek*, 1 September 2003.
[5] http://www.icgn.org/organisation/documents/aap/audit_market_structure.php. I am a member of the ICGN's Accounting and Auditing Practices Committee.
[6] US Government Accountability Office (GAO), "Public Accounting Firms: Mandated Study on Consolidation and Competition", report pursuant to Section 701 of the Sarbanes-Oxley Act, July 2003; available on http://www.gao.gov/new.items/d03864.pdf.
[7] Evidence of significant anti-competitive behavior by the Big Four firms was found in 2000 in Italy, but this could be linked to country-specific regulatory features and it does not seem that the practices identified in that case have

of any direct negative consequences for clients, such as unduly high prices or low quality of client service, of the concentration of the market. They also established that the issue of choice is essentially limited to the market for audit services to large international companies: on most other segments of the broader audit market, non-Big Four firms are present and compete with the Big Four firms.

However, the same reports have also firmly established that in the current regulatory environment, market forces alone are unlikely to modify the structure of the market for audit services to large international companies and specifically to increase the level of choice in this market. This goes to the central issue of this debate, which is the relationship between choice, audit quality, and the resulting quality of public financial information disclosed by large international companies.

The auditor works not only for the issuer which is its client, but also for shareholders and other financial partners and stakeholders, which all have an interest in the quality of the issuer's public financial reporting. And even beyond this already wide constituency, the auditor's job is also part of the general framework of trust that supports the financial system, and whose disappearance could have severe consequences on financial markets and on the economy. Therefore, audit services have a major collective-interest component besides the commercial one, which explains why the audit profession is regulated in most countries. As a corollary, the main concern about the degree of concentration of the market for audit services to large international companies is about its impact on audit quality, not on price or other commercial features of the service provided by audit firms to issuers.

Whether the issue of choice is currently serious enough to call for specific measures is a debated question. One aspect is whether there are cases in which the combination between the limited number of firms and the rules limiting the range of services that one firm can offer to an audit client results in the undue limitation or outright absence of choice. Beyond the DTI-FRC report, more comprehensive research would help knowing the extent of such situations, including outside the UK. Another aspect of the choice issue is whether the limited number of firms leads to a weakening of incentives for audit quality. I share what appears to be a wide consensus among market participants, that a market structure in which the number of firms able to audit large international companies would have decreased from four to three would be undesirable. To avoid such an outcome, there can be a suspicion that in the event of a failure of audit quality that could call into question the reputation of one of the Big Four firms, regulators and other players would not subject that firm to the same vigorous oversight as would have been the case otherwise. This is the so-called too-few-to-fail argument.

Although there is no evidence that regulators have been unduly lenient, some developments which all happened after the demise of Arthur Andersen do not appear to contradict the too-few-to-fail argument. When the SEC tried KPMG in January 2003 on past fraud in the accounts of Xerox, one SEC spokesperson felt appropriate to state that "no one here wants to see KPMG disappear"[8]. Similar concerns were heard in connection with Parmalat in 2003 and 2004, when nobody wanted Deloitte to collapse in spite of its name being associated with a very serious fraud case. And as several partners of KPMG were found to be involved in unlawful tax-shelter schemes in 2005, senior U.S. Justice Department officials expressed concern, as did the United Kingdom's financial Services Authority[9]. In this context, the FRC's effort to explore possible avenues for increasing choice is legitimate and welcome.

Exploring Possible Future Steps

Given the previously expressed concerns about the structure of the market, there are two main ways to look at possible future steps to increase choice.

- The first approach focuses on the number of firms. It primarily aims to increase the count of audit firms that are active in the market, so as to restore sufficient choice as arguably existed as late as the mid-1990s. The idea here is that once a situation is created where, say, at least six or seven networks are able to audit large international companies instead of the current four, then it can be ensured that this number does not later decrease back to four. This "firm-count" approach calls for a one-off move to increase the number of market participants and for careful oversight in the following period.

extended beyond the Italian market. See the press release of Italy's Competition Authority (Autorità Garante della Concorrenza e del Mercato), 21 February 2000.

[8] Quoted in The Economist, 1 February 2003.

[9] "Ex-KPMG Execs Could Face Crime Charges," in the online journal *CFO.com*, August 3, 2005, and "European Regulators Express Concern on Possible US Prosecution of KPMG," *Financial Times*, July 11, 2005.

- The second approach focuses on making the market contestable and opening its access to new entrants. It aims to remove or significantly lower the permanent barriers that hamper the entry of new firms into the market for audit services to large international companies – the many obstacles identified by the GAO and DTI-FRC studies. This "open-access" approach calls for deeper structural changes than the previous one, most notably in legislation and regulation, and can therefore be considered more ambitious. The "firm-count" approach essentially aims to restore the competitive pressure to what it was in the 1980s; by contrast, ensuring conditions for open access would create a situation that has arguably not existed since the First World War, since which there has been no durable new entrant into the market for audit services to large international companies[10].

Whether the priority would be on firm count or open access determines different choices as to the steps to be taken.

- The firm-count approach would lead to creating new players, drawing or resources either from the Big Four firms or from non-Big Four firms or from a mix of the Big Four and non-Big Four or otherwise. How this could be practically achieved, so that the resulting firms have at least the same capability to conduct high-quality audits as the current Big Four firms, is a matter for discussion. I know of no in-depth analysis of this question.
- By contrast, the open-access approach would lead to changing the regulatory framework, because the current regulatory framework, as is firmly established by the GAO and DTI-FRC studies, does not ensure contestability. Specifically, it would need to create the conditions for the very significant investment – in skills and experience, training, IT and knowledge-management systems, brands, and other items whose buildup requires significant effort, time, and money – that would allow a new entrant to credibly offer audit services to large international companies with a level of quality at least equivalent to the one provided by the current Big Four firms. The capital requirement for such investment, if it were to be made by a new firm, is practically incompatible with the notion that audit firms should be majority-owned by individual chartered auditors, which is a major feature of current auditing regulations in most countries. Providing practical possibilities to mobilize significant capital for investment would be the key to open market access to new entrants.

Firm Structure and Audit Quality

To evaluate the different possible future steps, it is necessary to better understand the relationship between the structure of audit firms and the quality of audits.

Currently, the Big Four are international networks of national firms. The exact structure of the international network varies from one brand to another, but it is always designed to ensure the legal autonomy of each constituent national firm, so that it is not affected by legal risks in other countries – most crucially, that the non-US national firms are not subject to US litigation risk. At the same time, the network structure has to be strong enough to ensure (i) a minimum level of quality in each national firm and (ii) sufficient coordination and economies of scale between the national firms.

The national firms are subject to national legislation and their structure and legal status therefore varies from one country to another, e.g. partnerships or commercial entities. Almost invariably, they are owned by individual partners who share the liability of the firm. In some countries, such as Germany or Spain, this liability is limited or can be limited by contractual arrangements with clients; in some others, such as France, the UK or the US, no such "liability cap" currently exists. (The issue of liability cap mechanisms is further developed in my answer to question Q6 below.)

The individual liability of each partner is determined both by national legislation and by firm-specific arrangements and insurance mechanisms.

The relationship between international network structure, national firm structure, individual partner liability mechanisms on the one hand, and audit quality on the other hand, is a generally poorly understood one. This is partly because so little is known about the former items.

For progress to be made, a helpful input would be more detailed information than is currently available from the audit firms and networks, including the Big Four firms, on their own governance and financials at national and international level. This could include information about insurance costs and contingent liabilities, as well as information about the firms' processes to detect and to punish malpractice. In

[10] The respective dates of creation were: 1845 for Deloitte; 1849 for Price (Price Waterhouse in 1874); 1854 for Coopers and 1898 for Lybrand (merged in 1957); 1890 for Deutsche Treuhandgesellschaft, subsequently merged with Peat (est. 1867) and Marwick (est. 1887); 1894 for Arthur Young & Co; 1899 for Touche Ross; 1903 for Ernst & Ernst; and 1913 for Arthur Andersen.

effect, the nature of incentives and constraints applying to audit partners and firms in most countries is currently shrouded in opaqueness. Absent regulatory requirements (which are already stronger in the UK than in most other countries), the public information provided by audit firms and networks is generally kept at a level which makes it difficult to make an informed judgment, especially regarding the effects of the market's structure. Therefore, by improving their level of disclosure audit firms and networks would have much to bring to the public debate on auditing.

Such insight would be crucial to assess whether the legal limitations that currently exist on audit firm ownership and access to external capital are effectively conducive to audit quality. As previously said, providing the possibility of access to external capital could be a key element in enabling new entrants to offer audit services to large international companies. However, this should obviously not come at the price of lower audit quality.

Conclusions

The FRC is right to emphasize the issue of choice in the audit market. It is an important issue. It is not self-solving in the current regulatory environment. It is also an international issue. The UK, being the birthplace of modern audit firms and a vibrant financial centre, can take leadership in the international debate but non-UK players, including the SEC and the European Commission, should vigorously commit themselves to this debate as well.

Too little is still publicly known about the mechanics of the audit market for concrete steps to be recommended yet. The FRC should encourage international audit networks to disclose more about their internal governance and liability arrangements and their financial data at international level, so that the public debate on the audit market can be informed on facts rather than assumptions. It should foster a better public understanding of the relationship between the structure of international public networks, the ownership structure of individual audit firms (in the UK and elsewhere), the liability and incentive mechanisms at firm level and at partner level, and audit quality. And it should encourage debate on which option would be most productive between the "firm-count" and "open-access" approaches as described above, if choice is to be increased. Such efforts should be undertaken as soon as possible.

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Q1. Do you agree that the focus of the debate should be on the degree of choice in the market for audit services to large public companies, rather than other features of this market?

Yes. Specifically, the focus should be on the relation between choice and audit quality. While the price of audit services is a legitimate concern for issuers, it does not currently appear to be a cause of major concern from a public-interest point of view. Furthermore, price increases can be as much linked to regulatory changes, such as the Sarbanes-Oxley Act in the US, as to the particular features of the market structure.

Q2. What do you regard as the most important criteria for evaluating any opportunities for mitigating risks arising from the level of choice in the audit market?

The primary aim of any new steps should be to increase the confidence of the public and of market participants in the quality of audited corporate reporting. Audit firms play a central role in promoting the quality of corporate reporting, both by their participation in the financial reporting standard-setting process and by their role in enforcing financial reporting standards and promoting a high quality of disclosure.

Q3. We invite views on how different groups, acting individually or collectively, could increase the propensity of non-Big Four or new firms to seek to be major players in the market for audits of large companies […].

Making credible inroads into the market now dominated by the Big Four firms would entail a very significant investment for any non-Big Four new entrant. Therefore, the question here is how sufficient resources could be mobilized in a credible way for such investment. This applies both to existing firms which haven't entered the market of audit services to large international companies, and to possible new firms that would enter this market.

One key consideration is whether the current constraints on audit firms' ownership by individuals, including those set out by the European Union's eighth directive on Statutory Audit, are indispensable to guarantee audit quality. There are two aspects to this question:

- Are the rules on firms' ownership efficient in ensuring their stated aims of independence and integrity, including in the Big Four worldwide networks, with their current structure of incentives and mutual insurance mechanisms?
- What alternative mechanisms could ensure sufficient independence and integrity of audit service providers, supposing a partial or total exemption of the rules on partners' ownership and liability?

These questions, as outlined earlier in this memorandum, require more public debate than has been the case until now.

It may be noted here that the "joint audit" system, by which large companies are required to have their financial statements audited by two separate firms (as is the case in France), has allowed a number of non-Big Four firms to thrive, but does not provide an answer to the question asked by the FRC. Joint audit allows non-Big Four firms to be involved in the audit of large companies but apparently not to the extent that they could compete with Big Four firms for the full extent of their services. This is evidenced by the fact that while a number of large French companies have a non-Big Four firm as joint auditor alongside a Big Four firm, very few (and ever fewer) have two non-Big Four firms as joint auditors. Furthermore, I know of no comprehensive assessment of the positive or negative impact of the joint audit system on audit quality.

Q4. We invite views on how the propensity of companies and their audit committees to purchase audit services from non-Big Four firms could be increased […].

My view is 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. Therefore, while companies should certainly be encouraged to give a chance to new entrants, it is doubtful that this encouragement alone can have any material impact on the structure of the market for audit services. In other words, the focus of attention in the choice debate should remain on the "supply side" rather than the "demand side".

Q5. We invite views on: (a) the combination of steps that would be most likely to lead to increased choice; (b) whether these steps could be taken forward by market participants, or whether existing laws and regulations may constrain or prevent this; (c) the costs of the steps relative to the risks arising from the existing or potential degree of concentration in the market.

There is no denying the importance of the problem of choice in the audit market. However, it is difficult for me at this stage to firmly recommend any specify policy steps to alleviate it. Several questions would need addressing before such a recommendation can be made, especially those listed in the first part of this memorandum on auditors' and audit firms' liability, audit firms' ownership rules, the desirable changes in the audit market's long-term structure, and the requirements on the internal organization of international networks of national audit firms to foster audit quality.

Q6. We invite views on steps that could be taken to mitigate the risk of unnecessary withdrawal of a firm from the market […].

It is not clear what should be considered an "unnecessary" withdrawal of a firm from the market. Mergers such as the one between Price Waterhouse and Coopers & Lybrand in 1998 were driven by market forces and have not been stopped at the time by regulators. To my knowledge there is currently no talk of such voluntary combination among the Big Four firms.

It is highly debatable whether the disappearance of Arthur Andersen in 2002 was "unnecessary". Beyond the firm's involvement in high-profile cases such as Waste Management, WorldCom and of course Enron, several studies have highlighted the degradation of the quality of its internal controls and of its collective ethics in the years preceding its demise. That even Paul Volcker was not able to save Arthur Andersen is an indication that it was a difficult case indeed.

Generally speaking, it is not self-evident that significant public or collective efforts should be made to preserve audit firms which do not meet high standards of integrity.

Audit firms have advocated publicly enforced caps on their liability or the possibility to limit it by agreement with audit clients, reflecting provisions that currently exist in several countries including Belgium, Germany and Spain. This proposal has been relayed by the US Chamber of Commerce in a recent paper[11]. However, there is no obvious argument, other than the desire to preserve existing entities, which would justify that the legal incentives and checks that apply to audit firms should be different from those that apply to other market participants. Furthermore, a contractual limitation of liability agreed between an auditor and a corporate client could bear the risk of having a negative overall impact on the quality of financial information, by diminishing the incentives for audit quality. In any case, it is far from obvious that a liability cap mechanism would have been sufficient to save Arthur Andersen in 2002, or would potentially save any of the current Big Four firms from a future crisis. One of the main assets of large audit firms is their reputation for integrity and should remain so. It remains to be seen how new legislation to create liability cap mechanisms would contribute to this reputation.

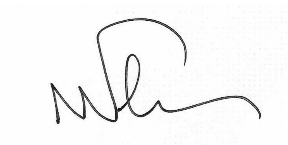
A different risk is that of a Big Four audit firm voluntarily leaving the assurance market. Evaluating the likelihood of such an event would require information on the firms' governance, liability risks and financial structure, at international and not only UK level. As mentioned previously, the Big Four networks would make a significant contribution to the public debate by providing more disclosure on their own governance arrangements and financials in major markets and at international level.

Q7. We invite views on steps that could be taken to mitigate the effects of a voluntary or involuntary withdrawal of a firm from the audit market […].

In the previously mentioned paper of the US Chamber of Commerce, former PCAOB Chairman William McDonough is quoted as having said, "none of us [regulators] has a clue what to do if one of the Big Four failed".

The disappearance of one of the Big Four would compound the difficulties already inherent in the current market structure and would arguably create a rapidly unsustainable situation. In such an event, there would probably be short-term pressure for regulators to quickly re-establish a more diverse supply, possibly by means of a mandatory break-up of the remaining Big Three.

Yours sincerely,



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***Bruegel** (www.bruegel.org) is a European think tank devoted to international economics, which started operations in Brussels in 2005 with the support of European governments and international corporations. Bruegel aims to contribute to the quality of economic policymaking in Europe through open, fact-based and policy-relevant research, analysis and discussion.*

11 "Auditing: A Profession at Risk", US Chamber of Commerce, January 2006.