Quality of Public Company Audits from a Regulatory Perspective

Welcoming Remarks

Michel PRADA
Chairman of the Technical Committee of IOSCO; AMF Chairman

Good morning, ladies and gentlemen. It is a great pleasure to welcome such a distinguished audience to a one-day roundtable dedicated to audit quality. IOSCO has decided to set up a Chairs’ Committee on Auditing to examine significant issues that impact audit quality, such as audit quality measurement, auditor liability and audit market concentration from the standpoint of securities regulators.

Today’s conference has attracted 200 high-level participants, including securities regulators, members of oversight bodies, representatives of the audit profession and of listed companies. The audience’s geographical balance is also remarkable, with participants from 20 countries situated in all five continents.

The primary role of securities regulators is to protect investors and foster confidence in the capital markets. Investors rely on the financial statements provided by public companies when making investment decisions. Auditors are vested with the essential responsibility of bestowing credibility upon such statements. If they fail to deliver high quality audits, investor confidence may plummet, leading to negative consequences for capital markets and local economies. Corporate fraud and accounting scandals have triggered significant interest in public company audits in recent years. Furthermore, since both listed companies and audit firms are becoming increasingly multinational, audit quality has become a global issue.

The demise of one of the world’s largest accounting firms as a result of criminal indictment has significantly altered the auditing environment. First, the number of major auditing firms dropped to four, reducing the already limited audit choice for large public companies. Second, the ultimate consequences of auditor liability have become a reality. Third, an understanding of the major risks and costs associated with a market exit of a major audit firm began to emerge.

Regulators must explore all possibilities, including the more creative ones, to address these concerns without compromising the quality of financial information. Furthermore, since securities regulators constitute merely one piece of a global puzzle, a more collective action would probably be required. This tremendous challenge was taken up by Roel CAMPOS in his role as the Chair of the IOSCO Chairs’ Committee on Auditing to whom I now give the floor.
Good Morning. Bonjour.

It is a great pleasure and a distinct honor to be here with you today. I am before you today in my capacity as the Vice Chair of the IOSCO Technical Committee and, in particular, I have the great privilege of being chair of a very important task force on behalf of my colleagues on the IOSCO Technical Committee – the Task Force on Audit Services. Along with Michel Prada, I wish to welcome all of you. We have the distinct pleasure today of hosting many of the most senior executives from the major global audit firms today. Thank you for your interest. We also have a good many academics, institutional investors, and, of course, the major part of our audience is the group of securities and banking regulators from around the world. It is the regulators today who wish to explore the issues of audit quality and concentration. I think you will find your time well spent today.

I want to convey a special thanks to Michel Prada and to Sophie Baranger and their excellent team at the AMF for hosting this important event and doing many of the difficult logistics to bring this project together. I also wish to thank members of my own U.S. SEC staff who worked tirelessly to help prepare this event: Susan Koski-Grafer, Len Jui, Estee Levine, Troy Beatty, and Mark Barton.

So, why are we here today? As most of you realize, the International Organization of Securities Commissions (IOSCO), is comprised of the securities regulators of the world. Of course, many of our members, as consolidated regulators, also regulate other parts of the financial services industry in their home countries. The Technical Committee of IOSCO is concerned about the global state of financial reporting. Certainly, the reduction of global firms to four following the demise of the audit firm of Arthur Andersen adds to our concern. While other groups and even regulators like the FRC in the UK have done considerable work in this area, we believe that no organized study of the issues of audit services have been conducted from the unique perspectives of the regulator and investor. Accordingly, today's conference is the first of perhaps several conferences and roundtables to study in depth the best ideas for necessary improvements of financial and audit services.

Consider that the audit industry has evolved principally from the decisions of the governments of the United States and, thereafter, other countries, in the wake of the great stock market crash of 1929. The basic requirement that audited financial statements be filed by public companies is still the fundamental underpinning for the manner in which the audit industry operates today. Consider also that after the Crash the governments of the United States and other countries seriously considered going a completely different way. Instead of requiring an audit from an independent audit firm, serious thought was given to establishing a large group of government auditors who would review and opine on the financial statements of public companies. So to a great extent, the modern audit profession owes its existence to fundamental decisions made by governments, whose rules were developed and implemented by regulators. So it seems rather appropriate that regulators look at what they have wrought - 75 years after these fundamental decisions were made.

At its most basic level, should regulators continue to support through rules and regulation the current model for offering financial services? Would there be a market solution, for example, if
regulators removed the requirement for audited financials? Some argue that issuers, to maintain investor interest in their stock, would provide audited statements without a regulatory requirement.

It is impossible to provide a full and comprehensive list of issues that our study might explore. A brief mention of a few issues will provide the flavor of what we may encounter: What is the impact of the global economy and the needs of global companies? Do the costs of audits have to be so high and in particular what is the impact of high audit fees on smaller issuers? Do audited financial statements provide or produce the necessary level of confidence for investors to make investment decisions? How does one measure quality in financial reporting? Indeed, what are the specific needs from financial statements that investors need and want? Is there enough choice for issuers among audit firms? Should regulators take some action to encourage further entry into the audit of public companies? Should regulators consider liability caps and other protections?

So we will look at these issues through the prism of regulators and of investors. Let me explain the concern of regulators with a short story.

Fresh out of business school, a young man answered a want ad for an accountant position in Paris. He was being interviewed by a very nervous man who ran a small business that he had started himself.

“I need,” he said, “Someone with an accounting degree, but mainly, I’m looking for someone to do my worrying for me.”

“Excuse me?” the accountant said.

“I worry about a lot of things,” the man said. “But I don’t want to have to worry about money. Your job will be to take all the money worries off my back.”

“I see,” said the accountant. “And how much does the job pay?”

“I’ll start you off at 250,000 Euros.”

“250,000 Euros!” the accountant exclaimed. “How can such a small business afford a sum like that?”

“That,” said the owner, “is your first worry.”

So, somewhat like this Parisian owner, the regulators also do not want to have to worry.

Now let me explain few logistics for today. The First panel is entitled “Audit Quality,” which will be moderated by me. It will be followed by a short break. The second panel is entitled “Impacts of Auditor Liability on Behavior and Quality,” which will be moderated by Jeff Lucy of ASIC. That panel will then be followed by lunch. Lunch will be in a cocktail format, with no sit-down table, in which there will be different stations for food and participants will have the opportunity to mingle and network. After lunch, the third panel will be entitled “Audit Firm Concentration,” and moderated by Michel Prada of the AMF. We will then have a short break and finish with a Concluding Panel, moderated by me.
After each panel, we will leave about 20 – 30 minutes for questions from the audience – we expect good questions with the high professional attendance. There will be forms passed around for written questions.

The conference will be filmed and made available in a few weeks on the IOSCO website. We also will prepare summary books that will be made available to all the participants after the event.

As stated earlier, we intend to study carefully the points made today and to consult seriously with industry and academia and investors, discussing suggestions that are made today. There may be other round tables to discuss specific suggestions. Ultimately, this task force will prepare a paper of conclusions and observations for regulators and investors, which may lead to adoption of broad principles or perhaps recommended practices.

So, let this Round Table on Audit Quality Begin.

Thank you.
Audit Quality: Evaluating External Audits in Today’s Environment

Moderator: Roel CAMPOS
Chair of IOSCO Chairs’ Committee on Auditing; US SEC Commissioner

Panellists:

- Michael COOK (Audit Committee Chair, Retired Chairman and CEO, Deloitte & Touche),
- Alain JOLY (Honorary Chairman of the EALIC; Director of Air Liquide, Lafarge, BNP Paribas),
- Paul KOSTER (Board Member, the Netherlands Authority for Financial Markets; former Executive Vice President of Koninklijke Philips Electronics),
- Lynn TURNER (Director of Research, GlassLew is LLC; former Chief Accountant, US SEC), and
- Edward WAITZER (Chair, Stikeman Elliott)

Roel CAMPOS

The first panel will deal with some of the more fundamental issues concerning audit quality, before entering into the more detailed discussions. As the panel’s moderator, my task is to present questions to our distinguished panellists. I will begin with Lynn TURNER, who is often viewed as the accounting expert of investors. Lynn, why are audits necessary?

Lynn TURNER

Analysts use the numbers presented in the financial statements of listed companies to provide information to people who influence stock market trade. If this information is inaccurate, it might impact investors’ return on a certain stock. In turn, that stock would have to be repriced, at significant cost to the capital markets.

It is therefore crucial that the numbers presented in financial statements are accurate. Clearly, the analyst community realises that financial statements are merely a snapshot of a certain company at a given moment, and that the economic picture they convey is likely to change over time. The role of auditors is thus to provide a high level of assurance that this snapshot is accurate. If they are unable to offer such assurance, it would significantly change stock pricing and capital allocation activities.
Roel CAMPOS

Since the importance of the audit function is so clear, is it still necessary for regulators to require audited financials or could the market take care of that on its own?

Lynn TURNER

History has shown that regulation is necessary. Before external audits were required, not all companies conducted them, leading to mispricings in the marketplace. As was made clear by scandals of companies such as Enron or WorldCom, the incredible numbers of a few companies can impact the entire market. This impact justifies the requirement of regulators that an independent third party examine the numbers to ensure they are credible.

Roel CAMPOS

Ed, do you agree that the essential function of audits is to establish confidence and trust in the system?

Edward WAITZER

Clearly, the historical objective of the audit function was to ensure the credibility of financial information. It is also clear that the regulatory activities conducted over the past five years have led to improved accountability and audit performance. However, I believe we should also consider whether that regulatory approach has not been pushed to extremes, leading to an increasing imbalance between the relevance and reliability of information.

There has been much discussion on the metrics that are relevant for investors today. I believe one of the reasons little progress was made in developing such metrics is that they are inherently judgemental and qualitative, and therefore do not lend themselves to an environment where a primary focus is to avoid liability. Thus, performance indicators tend to be chosen for ease of measurement and control, rather than for relevance or accuracy. However, I believe that the use of indicators that are, at best, mere surrogates for the real economic indicators, might actually widen the trust gap that increased regulation tries to breach.

A second difficulty is that in such an environment, the natural inclination of the auditing profession is to mitigate investor expectations, rather than to align them. While the official goal is to improve accountability to the public, many of the actual requirements are focused on improving accountability to regulators and legal standards. The central control focus these requirements impose might be inconsistent with building public trust. Thus, the risk is that in the quest to achieve the ‘holy grail’ of extreme accountability and transparency, we will build an unhealthy culture of suspicion, low morale, and ultimately a degree of professional cynicism.

Roel CAMPOS

Michael, from your perspective, is the auditing objective of building confidence being met today?
Michael COOK

I believe that in order to properly serve the investor community, we should focus on financial reporting, of which auditing is merely one component. I believe it is irrefutable that audit quality has significantly improved over the past years. Following the financial debacles, there has been a pronounced cultural shift within the financial reporting community, from ‘make the numbers’ to ‘do it right’. Other factors, such as Sarbanes-Oxley, and whistleblowing, have also contributed to the enhancement of audit quality over that period. The SEC has also made a significant contribution by emphasising the role of audit committees, and the PCAOB provided helpful support through its guidance and its inspection programmes.

I thus believe the accounting profession has done an admirable job in responding to the changing culture. Some people feel that the large number of material weaknesses and restatements indicate the auditing system is not working well. However, I would argue it is actually a proof that the system is working properly, since people are making significant changes in their reporting systems.

To use a sports analogy, the ‘defence’ part of financial reporting has grown stronger. This part includes all the factors designed to protect the reliability and credibility of financial information, such as internal control, auditing, certification, and whistleblowing. However, the reason our defence is currently very strong, is that we have played nothing but defence for a long time. As a result, I believe the value, relevance, and usefulness of the financial information that we are working so hard to protect is rapidly declining.

Companies are making increasing efforts to provide financial information that does make a real difference to the marketplace. However, most of this information is being delivered outside the basic, regulated, financial reporting system. Thus, while the need for such information continues to grow, our ability to respond to these needs from within the ‘defence’ system continues to decline.

Several years ago, the CEO of a cookie firm jokingly offered his shareholders to receive either the annual reports or a box of cookies, and the vast majority opted for the latter. Similarly, I believe that currently the majority of the investor community would prefer to receive the information produced outside the regulated reporting system, since it is more useful and relevant. Such ‘offensive’ information would include business performance matrices, and non-GAAP net income information, and I believe it could enhance the utility and relevance of financial reporting in a broader sense.

Roel CAMPOS

How about audit quality? How should regulators examine it?

Michael COOK

I believe the reliability of the information should remain the starting point for measuring the quality of the auditing process. Later, we should also examine the usefulness and relevance of the information provided for the investor decision-making process.
Roel CAMPOS

Let me now turn to Paul KOSTER. Do you believe the quality of the information provided in the financial statements can be relied upon?

Paul KOSTER

Fortunately, I believe it is. The European Commission has made great efforts, within the Financial Services Action Plan, to improve the reliability of financial statements. Many directives have been introduced, such as the Transparency Directive, the forthcoming Eighth Directive, and the introduction of the IFRS standards in Europe.

However, I agree that the information contained in them is not always very useful. A recent survey published by CESR on the communication of auditors with the public demonstrates that it might be useful if auditors provided a more detailed explanation of their work in the financial statements. They could explain what actions they have taken to ensure their independence, and the audit’s specific risks and focal points of attention. There are times when the margins of a certain company are rising, while those of most companies in the same sector are declining. In such cases, investors would like the auditors to explain their actions, in order to be reassured that the numbers are correct.

I thus believe financial statements should include an accountant’s discussion and analysis. Such information would also help the auditing profession make a better impression on the financial markets, by communicating how well they are performing their tasks.

Roel CAMPOS

I would now like to ask Alain JOLY to provide us with the perspective of a business CEO on financial statements.

Alain JOLY

I agree that over the past few years, we have seen a dramatic improvement in the reliability of the numbers being produced. At the same time, to be a bit provocative, I believe we are seeing an increasing number of ‘disclaimers’ by auditors. This is a cause for concern, since shareholders must ultimately rely on the judgement of the auditors. This judgement must therefore be clear.

I would therefore disagree with Paul KOSTER’s suggestion that auditors describe their work in more detail. This would lead to 500-page annual reports, which would become unreadable. At the end of the day, auditors should stick their necks out, and clearly state whether, to the best of their knowledge and understanding, they believe the company’s statements to be fair and honest. We must take care not to become a litigation society, where everyone is running for cover.

Roel CAMPOS

Michael, could you describe the ‘offence’ information that could improve financial statements, and respond to Alain JOLY’s concern about providing too much information?
Michael COOK

Convergence would top my list of ‘offence’ activities. We should strive to establish global financial reporting communications that are as consistent as possible.

Second, we should also ensure simplicity, transparency and the effectiveness of communication. I agree that in part, as annual reports keep expanding, people are discouraged from trying to read and absorb them. However, the notion of simplicity also relates to the content and the understanding of what is included within financial reporting.

In the debate between ‘rules’ versus ‘principle’ based systems, I would certainly lean towards the principle side. I believe that although some rules are necessary, they tend to lead to compliance, and thereby to standardisation, which do not meet the true needs of financial reporting.

I believe we need more value-based information, particularly with respect to asset and liabilities valuations. While some existing indicators, such as receivables and cash, are useful and relevant, many others are not.

I believe investors should be supplied with information that is typically discussed at investor meetings, but is not included in financial statements, such as who is buying the company’s products, or the success level of its research efforts. Including business performance matrices will enable us to create a financial reporting ‘package’, rather than a mere ‘statement’. However, I believe the defence and control mechanisms should be applied to this information as well. Often, that is not the case today. Thus, the most relevant information the investor community needs is not controlled by the auditing efforts, while the auditing information is becoming, in my judgement, increasingly less useful.

Roel CAMPOS

Lynn, do you agree that the balance sheet is becoming irrelevant? And would investors appreciate receiving business performance matrices, like the ones used by analysts?

Lynn TURNER

I believe the fundamental financial statements are still extremely useful. Furthermore, we are not concerned about 500-page reports, since we do not read them. 24 hours after a company files its financial statements, they can be downloaded into our computer systems, which automatically upload all the information into our computer models. The computer then automatically picks up key ratios and informs us of significant changes in the company’s disclosures. We believe the historical financials that are provided today are extremely useful, since they enable us to determine whether the company’s management is really being accountable for its actions and accomplishments.

However, I agree that including additional key measures of performance, which every successful management team tracks, could be equally useful for investors. To the credit of Commissioner CAMPOS, a couple of years ago the SEC recommended in a formal release that companies disclose that information in the context of their annual reports and quarterly filings to investors. Unfortunately, very few companies have implemented that recommendation so far. We
should strive to a point where the auditor reports are more descriptive, and provide useful information in a narrative format to investors.

Alain JOLY

I agree, but I believe we must be extremely careful not to mix the past, present and future. I am thus rather concerned about the current trends in international accounting standards, with both the IASB and FASB shifting towards a full fair value approach. While historical accounting has its limits, it is still based on facts. Thus, I believe historical accounting supplemented by some asset impairment considerations and fair value treatments for some specific instruments, is the optimal solution. If we shift to full fair value, we will absolutely destroy the separation of the past and the future, since a number of judgements on the balance sheet will be based on fancy forecasts, rather than facts. I believe this presents a significant risk, and regulators should definitively have a strong stance on this issue.

I agree that providing additional information about the company in the annual reports could be useful. However, we should be aware that nowadays people regard statements which appear in the annual reports as facts, and therefore there is significant risk in adding statements that relate to future estimates.

Michael COOK

I would like to clarify that I do not suggest that the business matrices necessarily be included in the financial statements, but perhaps in the financial reporting package in a broader sense.

Roel CAMPOS

How would discipline be imposed on such industry analytics?

Michael COOK

Clearly, the process should be supervised to ensure consistency, and to prevent the elimination of information that does not reflect favourably on the company’s performance. I believe in identifying the most relevant business matrices, and examining whether they are currently being communicated consistently and efficiently within the financial reporting system. If they are not, I believe the audit community should assume a broader responsibility for financial communications, to include the information provided to the analyst and credit evaluation communities.

Audit Committee members should ensure some discipline is exercised in the preparation of such communications and particularly in that of earning releases. They should review these numbers with the company’s management as well as with external auditors.

Roel CAMPOS

What should regulators do to promote such a strategy?

Lynn TURNER

I believe that initially, regulators should not intervene. Companies should provide such information voluntarily, as part of good governance. Grant Thornton has recently launched a useful initiative to
encourage audit committee chairs to ask their investors what additional information they would like to receive, and ensure that the company provide them with this information. I believe that is the correct approach. By talking directly to the analysts of a particular company, Audit Committee chairs could ensure that the information provided is better targeted and more relevant than the one provided through a broad general regulation. However, if companies are unwilling to adopt such an approach, it might be necessary for regulators to intervene.

Roel CAMPOS

Alain JOLY, do you feel companies should choose by themselves what information to supply, or should regulators intervene?

Alain JOLY

First, I believe the business matrices provided by the company should be based on the segment reporting the company is using, which is based on the segments used to manage the business. I believe the company’s management should choose these business matrices itself. However, auditors and audit committees should ensure that the matrices are not changed every year and that they are indeed the ones used internally by the company.

I. Fraud

Roel CAMPOS

Investors often inform the SEC that they are concerned about fraud. Do you feel anything should be done in that regard with respect to auditing?

Lynn TURNER

First, we must realise that we would never detect and capture all fraud. However, I do believe the auditors can make significant progress in that respect. Today, auditors are still not using certain procedures that are used by other professionals, such as hedge fund analysts, to greatly enhance the possibility of detecting fraud. Such procedures enable to better assess the tone at the top. Consequently, it is not unusual that an analyst manages to detect fraud where an auditor failed, although the latter has access to the company records. In Enron’s case, two large hedge funds managed to detect that the company’s books were cooked, while Arthur Andersen did not.

However, although I believe a better fraud standard should be adopted in the context of a regular audit, I do not believe we should conduct separate forensic audits.

Edward WAITZER

I agree that including some fraud testing within the normal audit process makes a lot of sense. I believe such tests should not relate merely to quantitative elements, but also to the company’s culture. Ultimately, all significant frauds were largely due to taking the ‘enlightened’ element out of self interest. Rather, new social norms have transformed self interest into an almost Darwinian concept in the business system.
Michael COOK

I support the improvement of fraud detection procedures within the context of the existing auditing process. However, I must admit I am very troubled by the notion of forensic auditing. Some study of accounting firms suggested a year ago that holding regular forensic audits could help narrow the expectation gap with respect to fraud detection. They even honestly admitted these forensic investigations would be conducted in ‘police style’, and include subpoena power.

I believe this idea is extremely misguided. The problem of companies such as Enron and Tyco was not that their auditors did not identify the problems, but that they did not know what to do with the information. Thus, the expectation gap created by those scandals was performance related, and not the result of some basic deficiency in the auditors’ ability to identify fraud. I thus find the idea of imposing such investigations, which would also entail huge costs, on a generally honest and upright financial community incomprehensible.

Paul KOSTER

I agree that the forensic approach is not an appropriate solution. However, I believe the audit profession is most vulnerable in the fraud area, since investors will not accept another significant fraud case. Thus, dealing with the market’s expectation gap with respect to fraud is of critical importance.

II.  Cooperation with Internal Auditors

Roel CAMPOS

Paul, I know you have some interesting views on internal audit.

Paul KOSTER

I believe that several developments over the past few years have laid the groundwork for the examination of a closer relationship between external and internal auditors. First, following Sarbanes-Oxley, companies have invested huge amounts in improving their internal control environment. Second, companies are becoming increasingly complex, particularly in certain sectors, such as the pharmaceutics industry. This gives rise to the question of whether external auditors can fully understand the company. Third, shareholders clearly demand more transparency and accountability. Fourth, the demise of Arthur Andersen has highlighted the risks associated with the dominance of the big four in the audit market.

I believe that closer cooperation would enable to address some of the current difficulties of audit firms, in the areas of staffing, industry expertise, and cultural gaps. External auditors often do not know what questions should be asked in areas of complicated production process. They could therefore greatly benefit from tapping the huge resources available within the companies.

Naturally, my suggestion relates primarily to large international companies, which tend to have good audit departments. The independence of such departments has also increased significantly, since today much of their reporting is made directly to the Audit Committee. A recent study
indicated that such cooperation would also significantly reduce external audit costs. It could also alleviate some of the staffing problems within firms, thereby enabling smaller firms to provide worldwide services.

Needless to say, it would be necessary to ensure some conditions. First, the independence of internal auditors must be secured through direct reporting to the audit committee. Second, quality standards should be ensured, and we should probably license some internal auditors. Third, regulators could consider performing some oversight on internal auditing as well.

Roel CAMPOS

Lynn, do you feel investors will be comfortable with enhanced internal auditor participation?

Lynn TURNER

Investors greatly support the work of internal auditors. I believe it is extremely useful to have an internal auditor present around the clock, and their support can be particularly important in the area of the whistleblower programs, since they can offer a quicker and more efficient response to such situations than external auditors. I thus believe we should strive to enhance this function.

Edward WAITZER

It is true that auditors access an extraordinary amount of information during the audit process and that one of their major challenges is to identify the relevant parts. I thus agree that there is a role for internal auditors, particularly in larger public companies.

Alain JOLY

I would also agree that tighter cooperation between internal and external auditors could be useful, particularly as the internal audit function has increased in competency and numbers. I also feel we should strive to find the proper balance with respect to the rotation of auditors. On one hand, auditors tend to become complaisant with time. On the other, new auditors do not know the company well, and their competence generally increases after several years.

III. Question and Answer Session

Roel CAMPOS

We have received an overwhelming number of questions from the audience. Unfortunately, we will not be able to do justice to all of them. I would therefore ask each panellist to select out a couple of questions and comment on them.

- What is your view on the extensive amount of management representations auditors request with respect to technical issues? Is that a part of their work, or are they merely seeking liability coverage?
Lynn TURNER

I would agree that in part, the purpose of such representations is to offer liability coverage to the auditors. However, I feel it is quite reasonable that auditors would like to obtain representations on key issues. Business transactions have become much more complex over the past decade, in terms of risk or geographical dispersion. I therefore see no problem with auditors requesting management to declare that it has done its part properly.

- With the increasing use of fair value, it has become increasingly important that fair value estimates are reliable. Are current auditing standards and practices sufficient to ensure they are?

Alain JOLY

From a client perspective, I feel a significant amount of time is spent with auditors on valuation related issues, and particularly on goodwill valuations. However, it should be noted that the components of goodwill valuation models are extremely sensitive to changes. Thus, my concern is that since an increasing amount of goodwill is included in companies’ balance sheets, and since we are no longer depreciating goodwill, we will be facing some serious problems down the road.

- The pharmaceutical sector has been mentioned as a high-risk area. What are other vulnerable or problematic sectors?

Paul KOSTER

The two most rapidly growing activities in the financial markets today are private equity and hedge funds. I have a couple of concerns relating to valuations in these areas. First, the information used to conduct such valuations is self reported, and thereby subject to selection bias. Second, the valuations are based on both unrealised and realised returns, and are thereby subject to biases due to subjective accounting treatment. We should also note that private equity hedge funds have become a liquid pool of money. While returns are said to be exceptional in this area, they are less impressive when the liquidity element is taken into account.

- The most significant problem with audit quality is that when companies fail, they usually do it with a clean audit report. What could be done to move away from binary audit reports to more meaningful statements?

Michael COOK

I do not believe that trying to explain the audit process in a report that is free form and specific for each company is constructive or practical, since it would take too much time. Today, the auditors are trying to provide the investor community with two conclusions: whether the financials are accurate, and whether there are any material weaknesses in internal control. I believe these conclusions should be stated in a simple and straightforward manner, and not be obscured with additional information that would not add value.
On the other hand, I would suggest that receiving real commentary on the quality of a company’s financial management and internal control from an auditor who has spent many hours examining these issues would provide significant value. However, such a commentary could never be provided in the current environment of liability and regulation.

Roel CAMPOS

It is noteworthy that concerns regarding the certification page and ideas for its possible revision were recurring themes in the panel and should be followed-up on.

- Is there any evidence that more detailed auditing standards improve audit quality, and help discipline audit firms?

Edward WAITZER

One of the benefits of shifting from peer review to government oversight of the auditing process is that presumably we can make extensive use of the academic community and other relevant communities. With time, we will hopefully take greater advantage of such resources.

- Could joint audits be one of the ‘offensive’ solutions for better audits? If yes, should they become compulsory for all listed companies?

Edward WAITZER

I believe this question is highly culture and context related. First, the high costs would make such a proposal relevant merely for larger and more complex public companies. In addition, we should remember that a very useful idea on the offence side can be a very destructive one on the defence. Having two audit firms can either enhance or detract from the exercise of professional judgement, depending on the relationship between external auditors, internal auditors, and audit committees.

- Are regulators merely trying to achieve continuous improvement, or do they feel the current system has significant shortcomings?

Paul KOSTER

I believe regulators are very much focused on achieving improvements. However, since there are so many jurisdictions and different legal environments, it is very difficult to adopt a global approach to such improvements.

Roel CAMPOS

I believe the regulators’ job is to protect investors and to allow the economies and systems to work in the most efficient manner. Since auditing and financial accounting is part of that process,
regulators must oversee it. It is a continuous function, and in some instances, we might be obliged to accept imperfect systems.

- The convergence of accounting standards could greatly impact audit quality. What should regulators do to promote this issue?

**Roel CAMPOS**

IFRS is the most well known convergence project. By 2009, foreign issuers will not be obliged to conduct reconciliation to US GAAP in the US, provided they choose to use the IFRS system. Thus, we are making great progress. I believe that US GAAP as established and overseen by the PCAOB, is also considering a convergence project.

I agree that convergence could help solve many issues. In the US, we are examining mutual recognition options. If we can increase our reliance on home country regulation, securities that are not registered in the US could be marketed there, and their oversight will still be conducted by their home country.

**Alain JOLY**

We were very pleased to see the latest position issued by the SEC for consultation on mutual recognition. I believe that is the direction companies favour. At the same time, it should be clear that standard convergence should not lead to identical standards. Europe and the US have different models, with the US being more law-based, and Europe more principle-based.

**Roel CAMPOS**

The US also favours a ‘zone of closeness’, rather than identical standards. I would also like to note that Europeans are often too quick in labelling the US approach as law-based. We do make extensive use of principles.

-Would regulators accept that external auditors rely on the work of internal auditors, or would the external auditor need to revalidate the internal work in order to comply with audit standards?

**Paul KOSTER**

I believe that eventually, the regulator should be able to rely on the work achieved by the internal auditor. However, some conditions must first safeguard the internal audit process. The qualifications of the internal audit staff are extremely important, as is the role of the audit committee.

- Should non-accountants be part of the internal auditor team?

**Paul KOSTER**

Absolutely. People from other areas can be extremely valuable. In fact, two of the best auditors I have encountered were theologists!
- Was the perceived improvement in audit quality a result of regulation or was it more due to the strength of the economy?

Lynn TURNER

I believe the improvement was achieved thanks to both regulation and other steps taken by the auditors themselves.

With respect to the strength of the global economy, I believe the GDP growth in areas such as China and India should raise concern as to whether they reflect potential bubbles, which could once again cause people to lose trust in capital markets.

- Two companies in which analysts identified errors were mentioned. Were the errors identified by using analytics? And were they the result of fraud or misapplication of GAAP?

Lynn TURNER

Our models identify ‘red flags’ automatically, as it did in the case of the two firms mentioned. Our analysts then examined the public files of these companies more thoroughly. In one case, they found extremely aggressive revenue recognition policies and potential fraud had been identified in one of the firm’s foreign subsidiaries. In the second case, the company simply ceased to depreciate fixed assets, and the difference allowed it to meet its earnings for the quarter; it is a matter of opinion whether this constitutes fraud or not.

IV. Conclusion

Roel CAMPOS

I would like to summarise several key ideas put forth by the panellists.

- Everyone agreed that the current certification is not entirely adequate. We should expand the auditors’ position and perhaps include judgements.

- Additional information should be provided, such as business matrices and other information used by the industry to estimate the future value of companies.

- Audits of large and complex companies could be enhanced through the use of internal auditors.

- It might be useful to implement some fraud enhancement mechanisms within the regular audit process, although separate forensic investigations were not deemed appropriate.

- Annual reports were perceived as too long, although technology might help in dissecting the information and making it more useful.
Impacts of Auditor Liability on Behaviour and Quality

Chair: Jeffrey LUCY
Commissioner, Australian Securities and Investments Commission

Panellists:

- Richard FLECK (Chairman, UK Auditing Practices Board; Chair, Consultative Advisory Group – IFAC International Ethics Standard Board for Accountants),
- Jeremy JENNINGS (Chair, European Contact Group, Ernst & Young),
- Professor Kai-Uwe MARTEN (Director, Institute of Accounting and Auditing, Ulm University; Vice Chairman of the German Auditor Oversight Commission; European Commission Observer, Public Interest Oversight Board),
- Gérard DE LA MARTINIERE (Chairman, French Federation of Insurance Companies), and
- Lynn TURNER (Director of Research, GlassLewis LLC; former Chief Accountant, US SEC)

Jeffrey LUCY

The title of this session is Impacts of Auditor Liability on Behaviour and Quality. I would like to begin with the behaviour element.

Gérard DE LA MARTINIERE

All service providers take into account that when they fail to meet the expectations of their clients or the environment, they risk being penalised. This is part of their incentives for delivering high quality services. I therefore cannot see how limiting liability can improve the behaviour of auditors.

From the audit committee perspective, I believe regulators should ensure that investors do question to what extent the information they are provided with is reliable, and the auditor feels responsible for his work. Thus, I believe audit committees would be extremely reluctant to consider any sort of ex-ante liability caps. Rather, I believe regulators should consider to what extent they are able to assess the real responsibility of the auditors in any given case.

Jeffrey LUCY

- Turning to the professional view, Jeremy, how do you perceive the link between behaviour and quality?
Jeremy JENNINGS

I believe we should first consider the various degrees of liability, with zero liability at one end of the spectrum and unlimited liability at the other. I believe we all agree that the auditing profession must have some ‘skin in the game’. However, I believe that the definition of skin should not include one’s internal organs.

Clearly, one of the most important quality drivers is the ability to employ high quality people. Although we do not face problems in attracting talented people to the accounting profession, it is becoming increasingly difficult to convince them to pursue a career as audit partners. The European Contact Group commissioned a research in 2005, which surveyed 1,500 of our people across the EU. 78% of partners and directors surveyed noted that they find the auditing career today less enjoyable and rewarding than they did two years prior to that. Clearly, the liability regime is responsible for some of the concerns our people have.

We should also examine the issue of auditing standards. On one hand, the profession recognises the need for principle-based standards, since they require us to exercise our professional judgement. On the other hand, we have perceived a dangerous trend within our firms, whereas people feel more comfortable using rules than professional judgement, due to the liability regime. A third significant driver of auditor behaviour is reputation, as the Arthur Andersen clearly demonstrates. Yet another development is the independent oversight regime, which is now emerging across the EU thanks to the Eighth Directive.

According to the London Economics Study on Auditors’ Liability, which is the most authoritative study on the subject ever performed in the EU, there is no positive impact of unlimited liability on audit quality. Quite reversely, the study’s authors actually concluded that excessive liability could have negative impacts on auditor behaviour. These views were not expressed merely by the auditing profession, but by the users of financial statements.

Jeffrey LUCY

- Richard, what legitimate interest do regulators have in audit liability?

Richard FLECK

Regulators have a fundamental responsibility for creating an environment where audit quality prospers and the market expectations in that regard are met. Liability is part of their responsibility, since it is one form of accountability, and can stimulate those responsible to achieve the standards society expects. There are three levels of liability: criminal, regulatory and civil, and their combination has significant impact on audit quality.

Regulators should also consider whether the degree of liability is appropriate. They must ensure that in their efforts to improve audit quality, they will not create an environment that gives rise to adverse defensiveness on the part of the profession.

Jeffrey LUCY

- Kai-Uwe, could you describe the German experience?
Kai-Uwe MARTEN

The German auditor liability regime, which is based on limited monetary caps, has been in place for over 70 years. I believe that the quality of audits achieved in Germany is no worse than that of countries with different liability regimes.

From a regulator perspective, we must ensure that audit firms operate in a competitive environment. Since limited liability lowers the insurance premiums, such premiums no longer constitute a market-entry barrier for smaller auditing firms, which I believe is extremely important.

Jeffrey LUCY

Lynn, it has been suggested that unlimited liability has a downside, but no upside.

- Would you accept that US audits are inferior to German ones?

Lynn TURNER

I have seen poor and high quality audits in both Germany and the US. Thus, I believe the most critical factor to audit quality is the individual auditor.

It is clear that audit partners consider the liability implications of their potential mistakes. Suggesting otherwise would be ignoring the basic fundamentals of human nature. I thus believe liability does have some positive deterring impact. If auditors do not fulfil their contractual obligation to provide high-quality service, I believe they owe it to investors to put them in a position as if they had. I believe that when liability was reduced in the US, it had a negative impact on audit quality.

I would agree that at some point, liability claims could be so high, that they would be unrealistic and serve no purpose. However, I would argue that before applying any liability caps, we should require greater transparency on the part of auditors. Since auditors have not made their financial information public, they have not provided us with any financial reason for imposing caps. Auditing firms would not even adopt the good governance practices we require from public companies, which I feel is problematic, considering the important public function they provide to the worldwide capital markets.

Auditors should also increase their efforts to detect fraud, since in a number of cases, the auditors knew there was a problem, and did not inform investors about it. In addition, in many of the high claims cases, the auditors’ errors were in the range of a billion dollars. It does not seem wise to grant such auditors a liability cap. When firms demonstrate the actions they are taking with respect to transparency, better governance, fraud detection and audit quality, investors could consider making some liability concessions in return.

Jeffrey LUCY

- What is the impact of liability on the insurance aspects?
Gérard DE LA MARTINIÈRE

I am not aware of any professional liability that cannot be covered by an insurance scheme. It is generally a question of cost, not capacity. I believe that imposing artificial limitations on liability would make the risk analysis, and thereby the insurance coverage, more complex.

However, increased transparency of audit firms would certainly facilitate external insurance coverage. Typically, the high prices proposed by insurance companies take into account the insufficient information level.

Jeffrey LUCY

Richard, the FRC has recently examined the drivers of audit quality.

- Could you comment on the areas that deal with liability?

Richard FLECK

The FRC undertook a project to try and identify the key drivers of audit quality. The main drivers fell under five main headings: Culture, or the tone at the top; skills and resources within the firm; the quality of the audit process; the output, namely the audit report; and some external factors, including to the way people respond to the information that has been made available. The FRC conclusion was that liability influences a number of these areas, such as culture, and thereby impacts the quality of the audit process.

However, I believe the clearest conclusion was the need for increased transparency. We have achieved governance transparency with respect to the corporations we report upon, and I believe an equivalent transparency should be achieved with respect to the governance and culture of auditing firms. For example, it should be clear where the people who are responsible for quality sit within the firm, so that their tone and culture could be judged. Furthermore, currently it is extremely difficult to estimate the extent to which the auditor practice is disadvantaged by liability, since the relevant information is not available.

Jeffrey LUCY

Regulators pay special attention to the manner in which audit firms examine the risk profile of the work they are undertaking. There are concerns that high risk companies might be audited by less competent firms.

- Jeremy, do you feel these concerns are justified?

Jeremy JENNINGS

Ernst & Young examines not merely new clients, but existing ones. If the integrity of a potential client’s management has already been questioned in the past, it is probably preferable to refuse the engagement. It is true that cases in which a large firm refuses a client, and a middle-tier firm then accepts the risk have become more prevalent. I would rather not comment on the impact of that trend on risk management and audit quality.
Lynn TURNER

While I believe that firms that are too small may not possess sufficient resources to deliver quality audits, I have not perceived differences between the big four and the big six, in terms of restatements and material weaknesses. I believe one of the key problems today is that the large auditing firms do not compete on quality, since they are satisfied with their market position. However, I am confident that if they decided to compete on quality, those that manage to demonstrate a satisfactory track record would also benefit from better insurance rates.

With respect to risk profiles, a recent report demonstrates that in the US, the big six tend to play musical chairs; when one firm has a problem with an audit, it resigns, and often another big six firm replaces it. This clearly indicates that risk management practices should be improved.

Jeffrey LUCY

Richard, participants in the first panel suggested that auditors could increase the usefulness of financial statements by making additional commentary, without necessarily assuming full responsibility for it.

Richard FLECK

The UK examined the possibility of expanding financial reporting to include performance information. The intention was that the auditors play a role in reporting on the process by which that information would be prepared. The audit profession has resisted the initiative, and, regrettably from my view, it has been rejected. Interestingly, investor interest in such information has been maintained, and many of the FTSE 100 companies are currently likely to provide such a service on a voluntary basis.

The Audit Quality Forum, which is sponsored by the ICAEW, has also produced a report suggesting that auditors comment on the sensitivities and judgements of audits. Personally, I believe this task should remain the responsibility of the companies’ management. Auditors should intervene only when they feel the information provided by management is misleading or erroneous.

Jeffrey LUCY

Kai-Uwe, you are engaged in standards setting as a PIOB member. We have heard concerns that standards have become more prescriptive, thereby reducing the implication of auditor judgement.

Kai-Uwe MARTEN

I believe audit judgement is absolutely necessary. In Germany, candidates are required to pass high-level oral and written exams, and demonstrate that they possess practical experience, in order to become CPAs, in order to ensure that they are able to make auditor judgements properly. With respect to standards, I believe regulators must seek the proper balance. Clearly, standards cannot cover the numerous different business models and cases auditors are requested to address, so we must often rely on their judgement.

I would also like to note that I believe that the risk of reputation damages has a great impact on audit quality, particularly following the demise of Arthur Andersen.

Paris, 1 June 2007
Lynn TURNER

With respect to the impact of reputational damage, it seems that in reality, the series of accounting scandals did not change the behaviour of many firms, at least in the US.

Jeffrey LUCY

Personally, I believe the day professional judgement would no longer be relevant would mark the end of the audit profession.

Jeremy JENNINGS

I would first like to respond to some comments made by my colleagues. Gérard DE LA MARTINIÈRE suggested that investors’ confidence in financial statements is lower in regimes that apply liability caps. However, Germany, the largest and most vibrant economy in the EU has been applying such caps for many decades. There is no evidence that the caps have affected reliability, and Germany’s responses to the EC liability consultation actually support liability reforms.

I would also argue that there is a problem of insurance liability, with respect to large claims, which can total up to GBP 3.5 billion.

I also believe that Lynn TURNER’s suggestion that audit firms agree to take certain actions in exchange for liability reform is slightly missing the point. We all agree that audit is a fundamental underpinning of capital markets. Thus, the question at hand is not the reduction of audit costs through liability limitations, but the sustainability of the private-sector audit profession.

However, I agree further discussion regarding the transparency and corporate governance of audit firms is necessary. Audit firms have already begun to increase their transparency in reference to the Eighth Directive of the EU. Their efforts include public disclosures of audit revenues, quality control procedures, and the basis of partner remuneration. The Directive will come into force at the end of June 2008. I believe we should give it a chance and see how the investor community responds to the increased transparency.

Finally, many of the issues discussed so far have been discussed in the statement of the six CEOs of our firms, whose objective was to launch a dialogue with the regulator and investor community.

Lynn TURNER

None of us would like to see another auditing firm exiting the market. However, so far shareholder liability has not threatened the existence of any auditing firm, and I do not believe it is likely to do so in the future. If auditing firms would like to argue sustainability, they should provide the public with their financial statements.

Jeffrey LUCY

Before proceeding to the questions, I would like to ask John HEGARTY from the World Bank to provide us with a unique perspective on audit quality.
John HEGARTY, the World Bank

The World Bank is probably the world’s most diversified consumer of audit reports, in a geographical sense, since every single operation we finance must be audited. Furthermore, the Bank has also been entrusted by the international community with the role of assessing the quality and robustness of countries’ financial reporting regimes.

Without a doubt, we have noted the impact of enhanced regulation on audit quality. In many of the developing countries, the new institutions and practices have not yet fully taken roots. However, in the more advanced middle-income countries, we can already see the positive impacts. We have also perceived that audit quality is higher in regulated sectors, and particularly in the banking sector. Unfortunately, exposure to liability is not always a strong incentive, since many of our partner countries have dysfunctional judicial systems.

Question and Answer Session

- If liability is limited, would audit partners accept, for example, a 25% reduction in their remuneration?

Jeremy JENNINGS

As I have noted, the objective of liability caps is not to reduce audit costs. The objective is to limit the threat to the sustainability of audit firms, by reducing catastrophic risk. Such risk cannot, by definition, be priced into an audit firm’s business model. Thus, while there might be a slight reduction in audit costs, it would not be significant.

- How important is the financial situation of the managers of audit firms for audit quality?

Kai-Uwe MARTEN

I believe that if an audit partner faces a difficult financial situation, he or she could be pressured more easily. Enhanced transparency would be extremely useful in that respect.

- When the auditors take active part in fraud, it is understandable their liability should not be limited. However, is seems nowadays they are treated as accomplices even in cases of errors or incompetence. In such cases, audit liability should be limited, since audit firms should not be regarded as insurance firms.

Richard FLECK

That was more of a statement than a question. I agree that the correct liability level should be identified. In the UK, for example, we do not have adequate proportional liability. Thus, if one party is 50% liable, but the remaining parties are unable to pay their share, the first party will be obliged to pay the entire sum. We must consider whether some of these aspects are appropriate.

- Several panellists agreed that audit quality has improved after Arthur Andersen faced the direst form of liability. Does that not present a case against limiting liability?
Gérard DE LA MARTINIERE

Reputation management is a crucial aspect of the auditing sector. I cannot envision how firms will manage to maintain their reputation, if another case involving significant loss to investors was to occur, and proper compensation would not be provided due to liability caps.

Richard FLECK

However, it is important to note that the demise of Arthur Andersen was not the consequence of liability claims, but of regulatory and judiciary action.

Gerald RUSSELL, Chair of the Audit Quality Forum

Auditors offer assurance over an information flow from a company to its investors. Historical accounting is on the various ways of achieving such assurance. In an investor confidence survey recently carried out in the UK, auditing reports were cited as one of the top three sources of information used by investors to make decisions. The fourth, on both side of the Atlantic, was management commentary.

I thus believe the auditing profession should attempt to offer assurance over that type of information as well. However, since it would require a shift into more judgemental areas, it would be difficult to achieve under the current liability regime. Thus, I believe liability reform is an essential part of moving in that direction.

Jeffrey LUCY

Two different opinion layers have been identified. One is based on financial information, and the other on management information. The auditor can express his opinion on both, but not with the same level of confidence.

- First, do you believe the reason some errors are not identified, and other are not reported, relates back to auditor skills, training, and supervision? Second, it has been noted that the audit quality depends on the quality of the auditors. Thus, should we not focus on the pre-admission and ongoing education of the auditor, rather than on liability?

Lynn TURNER

I believe that the education system of the accounting business is severely behind the times. Over the past decades, business has become increasingly complex. Greater knowledge is required in areas such as finance and marketing, which today can significantly impact the numbers. In order to catch up with the business world, accounting schools should become professional type schools, and stronger emphasis on ethics should be placed from the start.

Kai-Uwe MARTEN

I agree that the complexity level in the accounting area has greatly increased over the past decade, with standards changing at an extremely fast rate. We should encourage talented students to choose the accounting and auditing profession, since high skills are extremely relevant for audit quality.
Audit Firm Concentration: Potential Effects on Audit Quality

Chair: Michel PRADA
Chairman of the Technical Committee of IOSCO; AMF Chairman

Panellists:

- Daniel BOUTON (CEO, Société Générale),
- Peter BUTLER (CEO, Governance for Owners),
- James COX (Brainerd Currie Professor of Law, Duke University School of Law),
- Mami INDO (General Manager and Senior Corporate Analyst, Daiwa Securities SMBC Co),
- Paul KENNEDY (Commissioner, Hong Kong Securities and Futures Commission)

Michel PRADA

This panel will address potential concerns raised by the high market concentration of accounting firms. For example, in the UK, the big four audit all but one of the FTSE 100 companies, and 97% if the FTSE 250. In France, all CAC 40 companies are audited by a big four firm. The big four enjoy comparable dominance in other industrialised countries, and a great divide separates them from the mid-tier firms.

I. James COX: Factors Contributing to Market Concentration

I will try to explain how the number of large audit firms was reduced from eight to five or four. First, auditing clients have become larger, more complex, more global and more computer-based. Accounting firms were therefore obliged to pursue economies of scale, particularly in the technology areas. The size of M&A deals also increased. Auditors were therefore required to deal with more bodies, which entailed a larger workforce.

Second, accounting firms began offering non-audit services, such as consulting services, in order to diversify their revenue stream. Providing auditing services enabled them to get a foot in the door, and compete against companies such as McKinsey.

Third, there has been a fundamental worldwide shift in anti-trust approach. Official guidelines actually favoured concentration, provided it led to better audit quality at unchanged or lower prices. Thus, the reduction in the number of firms was not perceived as the creation of an oligopoly. In many ways, regulation got us to the present state, since the decision that signalled the death of Arthur Andersen was a regulatory one: an indictment.

We might wonder why the small and mid-level auditing firms did not become larger. The biggest hurdle documented was the reputation effect. There seems to be a halo effect to being audited by a big four firm and the market does not believe smaller firms possess the necessary skill package.
II. Paul KENNEDY: Hong Kong Audit Market

I believe it is important not to neglect the less developed Asian market when discussing market concentration. I believe the practical reality of the Asian market is slightly different than that of Europe and North America. First, the views on concentration in a fast growing market will be different than those in a more stable market. Second, the level of second-tier choice is lower in developing markets. Third, I believe that the concentration risk in such countries is not related to the choices of audit firms, but to resources.

In Hong Kong, 70% of the firms, which represent 98% of the market capitalisation, were audited by big four firms. However, despite this very high percentage, there seems to be a clear consensus in the market that the concentration level is not problematic, and that there is no price cartel. There also seems to be a fairly strong consensus that regulators should not intervene in the market. I believe these views are largely due to the unique competitive factors of developing markets. Since these markets are not mature, companies are still competing for future market share. In addition, due to the high growth levels, everyone gets a piece of the pie.

The percentage of second-tier firms in Hong Kong is also significantly lower than in countries such as the UK and the US. Although over 40 firms audit public companies in Hong Kong, over half of them have merely one or two listed companies among their clients. Although there are clearly quality second-tier auditing firms in Hong Kong, the lack of institutional investment in that sector, as well as other factors, have contributed to a fairly shallow second tier. Consequently, second-tier audits have become more price sensitive, so it is less profitable for companies to enter the segment.

Finally, both Hong Kong and China suffer from a severe shortage of professional staff, and mainland China’s growth is rapidly sucking resources out of Hong Kong. As a result, the share of the big four firms in Hong Kong, in terms of number of firms, is dropping by around 7.7% per annum, although their market capitalisation remains fairly stable. This drop might intuitively seem as a positive development. However, in reality, the resource shortage is causing the big four to drop high-risk or low-profit clients, which are then cascaded into the second tier. From a regulatory perspective, this cannot be viewed as a positive development. Thus, perversely, based on this evidence, a greater concentration will be preferable.

Finally, I would like to comment on the risk of potential bubbles in fast growing economies. Mainland China has grown at an 11% rate per annum over the past 20 years. Over the same period, the growth rate of the audit market in China was at least twice as large. Therefore, I believe regulators must ask themselves how this rapid growth, coupled with shrinking resources, would impact ability of auditors to properly serve that market.

Michel PRADA

Seeking concentration in order to address quality issues is an interesting paradox.
III. Mami INDO – Audit firm Concentration in Japan

I would like to describe the present situation in the Japanese audit industry. The big ‘four and a half’ auditing firms in Japan are currently Aarata and Misuzu, which belong to PwC; KPMG; Ernst & Young; and Deloitte & Touche.

Following the decision of the Japanese Financial Services Agency (FSA) to suspend the activities of previous PwC entity ChuoAoyama, the company has been split into two new entities Aarata and Misuzu. The FSA has given consideration to the timing and scope of its suspension order. It has announced its decision to suspend the activities ChuoAoyama in May 2006, but implemented it in July, thereby allowing the firm sufficient time to prepare. As a result, the impact of the regulatory action on the stock market has been limited.

In February 2007, Misuzu announced its decision to exit the Japanese audit market by July 2007. Misuzu’s withdrawal was the result of self purification led by the capital market, rather than of regulatory pressure. As the media repeatedly reported Misuzu’s audit quality problems, capable partners, staff and clients began to leave the firm. Misuzu finally concluded that they will not be able to maintain sufficient audit quality.

It is reassuring to see that the self-purification mechanisms have worked as expected. However, the withdrawal of Misuzu from the market will further accelerate the concentration level of Japanese audit firms, as the companies currently audited by Misuzu are likely to turn to the remaining large firms. If another big firm exits the market, I believe it would significantly impact the Japanese capital markets.

I therefore believe stronger preventive measures should be taken by both the regulators and the professional organisations. I would suggest strengthening the monitoring function of bodies such as PCAOB and professional organisations, and establishing a robust feedback process to and from auditing firms.

IV. Peter BUTLER: Shareowner Responsibility

My message to the regulators is that shareowners should assume greater responsibility with respect to audits, since they suffer from the failures of both audit companies and companies. Today, many people who trade on financial markets do not perceive themselves as owners, unless the company they invest in fails, and they must face the loss.

The primary objective of the audit is to report to shareowners on the performance of their agents, the directors. However, the shareowners are still responsible for controlling their agents. Today, they have shifted that responsibility to audit committees, and trust regulators to intervene if all else fails. I thus believe that the links between shareowners and auditors should be further examined. I believe that Board audit committees are the most practical way forward, although in some cases, shareowner audit committees might be appropriate.

In order to improve the dialogue between auditors, investor and owners, I would strongly advocate requiring that shareowners conduct an annual vote on the audit committee report. Similar votes are already conducted on remuneration committee reports in several countries, and have greatly
improved the dialogue between shareowners and remuneration committee members. The audit committee report should cover several topics, such as the range and skills of audit committee members; a performance review of the committee; and contingency plans. Perhaps more importantly, it should include the key judgements discussed by the auditors with the audit committee, and issues pertaining to independence and potential conflicts. I believe that currently, most investors may not possess the sufficient skills for such a dialogue. However, they could seek advice from independent audit partners, in order to expand their skills.

In conclusion, I believe that the involvement of share owners could be a key contributor to improving audit quality and choice. It has already been demonstrated that shareowner engagement improved the accountability of managers. I firmly believe shareowners should hold their other agent, the auditor, accountable in a similar manner. I also believe such an approach would facilitate a regulatory light environment.

This was a presentation of the philosophical approach. A recent report of the FRC’s Market Participant Group offers some recommendations that could be implemented immediately.

First, regulators should develop protocols that would allow them of offer a consistent response to audit firm issues, based on their seriousness. Second, audit firms should comply with the Combined Code on Corporate Governance on a ‘comply or explain’ basis. Third, every public company should include in its Audit Committee Report a summary of its contingency plan, in the event its auditor withdraws from the market. I have added a fourth recommendation: if a big four firm exits the market, regulatory measures should be taken to prevent a permanent four to three scenario, similar to the one that is currently being realised in Japan.

Michel PRADA

You have raised some interesting points with respect to the relations between shareowners and their agents. It is true that we tend to limit the discussion to regulators, auditors and company managers. Five years ago, the discussion included merely auditors and regulators.

V. Daniel BOUTON: The French Auditing Market

I believe that listed companies are the victims of an oligopoly. Société Générale is an international Group with a 90 billion USD market cap. It operates in 77 countries, and employs 130 000 workers. Since we operate in sophisticated financial markets all over the world, we must hire a global auditor. Since the collapse of Arthur Andersen, the choice of audit firms has become ridiculously low.

In addition, French companies must comply with several specific regulations, issued either by the EC or the French Parliament. Many of these regulations have contributed to the solidification and maintenance of this oligopoly. For example, an ancient French regulation, which is excellent in theory, requires every large listed company to be audited by two auditors. I admit that such a ‘four eyes rule’ might have prevented the Enron debacle. However, when companies are required to select two auditors out of a choice of four, it is like beginning the Roland Garros Tournament with only Maria Sharapova and Amelie Mauresmo.

Another excellent French rule forbids a company’s statutory auditor from serving as the advisor for another mission, in order to keep the two tasks clearly separated. Similarly, any audit company that
has performed an advisory mission for a firm cannot be selected as its auditor for two years. It is extremely difficult to comply with such requirements without relying on less competent auditors when making acquisitions around the world.

Thus, French regulation has created an unhealthy situation that penalises the international expansion of audit firms, to the benefit of the big four. This high concentration naturally impacts the price of audit services. Over the past ten years, Société Générale net banking revenues have increased by 2.4 times, while its audit expenses have increased by 3.6 times. Thus, to be bold, I believe it might be useful to apply anti-concentration rules to the big four names.

VI. Panel Discussion

Michel PRADA

I would like to ask each participant one action that should be taken to improve the current situation.

Peter BUTLER

I have already mentioned conducting an annual shareholders vote on the audit committee report.

A second and perhaps more provocative recommendation would be to impose minimum capital requirements on audit firms. The requirement should be introduced in a disproportionate manner, so that the greater a company’s market share, the higher the capital required from it. Thus, if one of the existing big four withdrew from the market, its partners would have a financial disincentive to split up and join the remaining firms.

In addition, if ownership rules were changed and capital markets were permitted to invest in audit firms, that could create opportunities for the emergence of a new large firm.

Paul KENNEDY

I agree that we should focus on barriers to entry. In the context of the Hong Kong market, I believe we should focus on two barriers. First, we should try to eliminate the barriers to competition between the big four and the second-tier firms. Second, we should introduce higher barriers at the bottom, in order to consolidate and strengthen the sector outside the big four.

Mami INDO

Since auditing seems to be a black box, I believe enhancing the disclosure might be the best approach by regulators.

Daniel BOUTON

First, I believe that the oligopoly benefactors should have no influence on standard setters, since their interest is to keep the barrier of entry as high as possible. Thus, I would suggest that the EU and US standard setters be forbidden to include any big four partner in their working groups.

Second, following Peter BUTLER’s suggestion, it might be useful to require that large multinational public companies be audited by a listed audit firm, which will be obliged to comply with corporate governance and transparency rules.

Paris, 1 June 2007
James COX

First, I would like regulators to ensure that their administrative decisions do not further contribute to market concentration. Second, I believe that PCAOB should be encouraged to adopt a nurturing approach with respect to the quality of second-tier firms. They should not publicise merely their criticism, but also their praise, in order to increase the chance that listed companies consider second tier firms.

VII. Question and Answer Session

Vincent BAILLOT, CNCC President

I would like to make two comments. First, I am strongly convinced that this issue cannot be solved exclusively by regulation, but that further market-oriented solutions should be considered. Second, I am convinced that the existence of large audit firms responds to specific market needs, in terms of international coverage, competence, and organisation. Thus, I cannot envisage how splitting up the existing firms can be seriously considered as an appropriate solution.

Since 1966, France has implemented a system of joint audits for a certain type of listed companies. I believe that the effective presence of professionals from two different firms, provided it is well designed and balanced, might have a significant positive impact on audit quality. Do you think such an approach could continue to be developed outside France?

Paul KENNEDY

Based on my experience, joint audits are not productive. I can imagine that some value could be obtained from such an approach in cases where there is a pairing of equals. However, I believe that in most joint audit circumstances, one of the auditors is a clear leader, and that is an unhealthy situation.

Daniel BOUTON

Although I used to be a supporter of the double audit system, I am now prepared to change my position. I believe that currently the benefits of the system in terms of fraud detection are far lower than its costs.

In addition, the two audit firms tend to share the workload in a pragmatic manner. Thus, African subsidiaries of a large company, for example, will not benefit from two pairs of eyes. It is true that when there is a doctrinal problem relating to complex accounting questions, the doctrine setters of the two auditing firms are consulted, and two different answers may be obtained. Even in that respect, I suspect that the doctrine setters of the big four often consult on such complex questions.

Michel PRADA

From the perspective of the French regulator, I have witnessed a significant case in which problematic issues were raised following a disagreement between the two auditors. Thus, I believe that if it is well organised, and I admit that in some cases it is not, the joint audit is valuable.
Philippe Richard, Secretary General, IOSCO

Daniel BOUTON noted that second-tier firms were not competent enough.

- Is that claim based on perception or experience?

Daniel BOUTON

I did not mean to suggest that second-tier firms are incompetent; I believe they are competent. However, few audit firms can offer the wide geographical reach, as well as the technical competence required by large multinational companies.

- Should regulators assist the middle-tier firms in expanding their competencies?

Paul KENNEDY

I believe that regulators should try to reduce anti-competitive barriers, but that they should not interfere in market forces unless there are quality issues concerned.

Stella FEARNLEY, University of Portsmouth

I believe one of the consequences of setting global standards was the increase of barriers for entry for smaller firms, since they do not have sufficient resources.

Once you apply international standard setting, the regulatory space in which people operate is significantly increased, so that the standard setters become practically unaccountable. We should therefore examine how standard setters obtain input from the market. The current model, under which merely those with the vested interests are represented, is both insufficient and inadequate. A proactive model of view seeking should be developed, in order to insure standard setters are receiving a balanced view from all the stakeholders in the marketplace.

Daniel BOUTON

I agree, and I would like to use Ms. FEARNLEY’s comments in responding to two written questions from the audience.

- Who do you anticipate will facilitate the standard setting process, if the auditing firms are no longer involved?

- Do you believe that limiting audit firm liability would deter further audit firm concentration?

It is extremely important to understand that all these factors are linked. The big four firms have great influence on standard setters, and their interest is not to ensure that the best information is provided to shareholders, but to protect auditors against the unlimited liability risk. Thus, we have created a vicious internal circle, and I believe that if we change the unlimited liability rule, that circle could be disrupted.
- Would you agree that allowing outsiders to invest in audit firms might negatively impact the professionalism of such firms?

Peter BUTLER

No, I would argue that the impact would be a positive one. External investors could drive quality, through decisions that affect reputation.

Mike Starr, International CEO, Grant Thornton

First, I would like to note Grant Thornton has three billion dollars in revenues worldwide, 25,000 employees, and is operating in over 100 countries. Therefore beg to differ with an implicit claim made by panellists that if a company does not belong to the big four, its services are not high quality. Second, I cannot understand what the phrase ‘second tier’ refers to, since Grant Thornton does not perceive itself as a second tier company.

From the Floor

- Do panel members believe audit firm concentration has had a negative effect on audit quality?

James COX

Although the monopolistic power may not be reflected in the price function, I believe it might lead to parallel conducts. For example, I find it astounding that in the pre-Enron era, all the big five auditing firms have provided non-audit services that seriously compromised their independence as auditors.

Ian HARRISON, London Investment Banking Association

Various studies present considerable evidence that companies, particularly large ones, almost never change auditors, and it seems most of them do not even consider it.

- Do you believe there is any merit in encouraging, or even requiring companies to examine the market every several years, and see whether they can receive better quality or a lower priced auditing services?

Such a requirement might help second-tier firms.

Daniel BOUTON

In France, an auditor must be replaced after six years. Combined with the joint audit system, listed companies enjoy a fresh pair of eyes every three years. Although I have changed my position with regards to the joint audit system, I fully agree with the benefits of rotating auditors.
Ian HARRISON

I was not necessarily advocating that approach, since I believe changing auditors might be an efficient way to conceal information. However, I do believe posing the question of whether the service provided is optimal does have merits.
Concluding Analysis
Roel CAMPOS

Panellists:

- Mark Anson, CEO, Hermes Pensions Management Limited
- Pervenche Berès, Chairwoman, Committee on Economic and Monetary Affairs of the European Parliament
- Richard Kilgust, Global Managing Partner, Public Policy and Regulatory Affairs, PricewaterhouseCoopers; Chair, Global Public Policy Group
- Nicolas Véron, Research Fellow, Chief Development Officer, BRUEGEL
- Joseph Wan, CEO, Harvey Nichols

The objective of this final panel is to revisit and hopefully crystallise some of the interesting ideas presented during the day. I would like to remind you that the purpose of this conference is to inform, and hopefully educate the regulator. We intend to study the ideas that have been put forth very closely, and then conduct a follow-up consultation. Despite Daniel BOUTON’s suggestion, we do not intend to totally isolate ourselves from the profession.

I. Mark ANSON: Demand for Independent Audits - a Review of US Equity Risk Premiums

I would like to present a case study of the US financial markets. The Equity Risk Premium is the additional return investors should earn in order to prefer holding stocks over bonds. The ERP helps measure the cost of capital, as well as investor risk aversion. The ERP is implied by current market conditions and can be estimated by using stock market valuations.

I would like to examine the peaks and valleys of the US ERP over the past 25 years. The first valley occurred in 1987, following the fallacy of portfolio insurance. Back then, when investors believed stock market risk could be eliminated, the ERP level dropped to zero. It also approached the zero mark at the height of the 2000 technology bubble, which also turned out to be a fallacy. There have also been two significant ERP peaks in recent years. The first followed the 9/11 terror attacks on the US. The second, during which the ERP has reached its highest level in the past 26 years, was at the height of the US corporate scandals in 2002. The uncertainty associated with financial statements and the conflicts within the auditing industry completely destroyed investor confidence.

Thus, from an investor perspective, our goal is to ensure that the ERP does not soar to similar levels, and erode stock market value.
II. Panel Discussion

Roel CAMPOS

I will try to cover the topics of the three panels held today.

1. First Panel – Audit quality

During the first panel, panellists greatly criticised the auditor’s certificate. They felt the actual opinion rendering of the financial reporting process was not useful. There has also been considerable discussion on the possibility of including performance matrices in the financial reporting package. Panellists also felt that some ‘red flag’ fraud detection analysis should be performed.

Richard KILGUST

Lynn TURNER noted that if an auditor opinion remains in its current binary state, auditor certificates should be removed from the annual reports. I agree that such certificates may not be optimal for the current complex business environment, and I therefore welcome the suggestion to reconsider the binary model. However, since the environment is very litigious, we should first find the correct model.

I would also agree that it might be useful to expand the content of financial statements. However, since many feel the statements are already too long, perhaps replacement would be more appropriate than expansion. Thus, some of the current detailed and complex information could be substituted with information that is more meaningful to investors.

I also believe that the expectation gap with respect to fraud detection will not be sustainable in the long term. If auditors will not be able to meet market expectations, they will begin to lose relevance. We might be able to learn from the experience of hedge or private equity funds, which some claim are currently more successful in identifying fraud. We should also ensure that we are properly exploiting new technological tools that might improve audit quality.

Roel CAMPOS

It is noteworthy that as an industry representative, you are open to such ideas.

Nicolas, how do you feel about improving external audits through the use of internal auditors?

Nicolas VERON

I believe external auditors must still bear the ultimate responsibility of informing the investor community whether the numbers provided in financial statements present a fair picture of the company’s operations. The extent to which an external auditor should rely on internal audits is thus a question of means, not ends. I believe it is not obvious that the internal employees’ inevitable conflict of interests could be overcome. Thus, although there is an obvious place for cooperation on the most technical aspects of audits, I frankly cannot see how internal auditors can relieve the external ones from any significant part of their responsibility and accountability.
Roel CAMPOS

Mark, do you agree that more needs to be done in the area of fraud detection? Will investors be willing to pay for enhanced audit detection?

Mark ANSON

Clearly, in some cases, external analysts managed to identify problems that auditors and management did not. It might therefore be useful to teach accountants to analyse and digest financial statements in the way analysts do. I believe investors will be willing to bear the additional cost. If a single major scandal could be prevented, it would be worth its weight.

Nicolas VERON

Luigi ZINGALES from the University of Chicago conducted a groundbreaking study on fraud detection. The results were surprising, since they indicate that the most efficient fraud detection mechanisms are the media and whistleblowers, rather than auditors and regulators. Thus, freedom of the press and a strong media sector is also important in this regard.

Roel CAMPOS

Joseph, as a CEO, how would you feel about including business performance matrices in the financial reports?

Joseph WAN

I support the idea, since I believe useful information could be provided. However, I believe it might be problematic to require auditors to comment on such information. For example, the stocks of some listed companies are performing very well compared to their competitors as a result of the company’s specific know-how. It would not make sense to compel the company to reveal its bright ideas to its competitors. Thus, inviting the auditor to comment on such information would present significant ethical difficulties.

With respect to fraud detection, I believe that even if investors were willing to spend an additional several millions per years, it would not necessarily prevent another major corporate scandal. I also believe that the robustness of regulation relating to the financial independence of auditors should be examined.

Roel CAMPOS

Would you suggest putting some restrictions on how auditors can allocate their profits?

Joseph WAN

No, I am not suggesting regulators should interfere in the way partners split their profits. However, I do believe we should establish stringent rules that test the auditor’s financial independence before accepting an engagement.
Richard KILGUST

It is important to recognise that some safeguards have already been put in place. In the US, this process was the consequence of Sarbanes-Oxley, and largely driven by the PCAOB. While the peer-review inspection process was largely focused on examining work papers, the PCAOB is more focused on the tone at the top. They therefore examine partner remuneration systems, as well as the remuneration of each single partner.

Roel CAMPOS

Pervenche, are European parliamentarians lobbied with respect to fraud and potential restatements of European issuers?

Pervenche BERES

EU parliamentarians followed closely the US corporate scandals, and the Sarbanes-Oxley crisis-based answer to that situation. Such issues are on the top of EU legislators’ agenda. We believe we share the responsibility with regulators for establishing regulation that would prevent fraud. I believe regulators would increasingly take into account other stakeholders besides regulators and investors, such as employees, and NGOs.

Roel CAMPOS

Do you expect Europe to adopt ISA as the formal audit standards?

Pervenche BERES

I am not sure I am qualified to answer that question, although the subject did come up while we were revising the Eighth Directive on accounting standards. We will be very careful with the implementation of such standards, since there are some negative experiences we would like to avoid.

However, this raises a wider question. Europe is seeking international accounting standards since they benefit companies. However, their implementation is greatly constrained by local practices and structures. Often, we are discussing at the EU level issues that should be discussed with partners outside the EU. That is one of the reasons it is important that regulators meet at the international level. However, there is no equivalent forum for legislators.

2. Panel 2 - Auditors liability

Roel CAMPOS

During the second panel, there has been considerable discussion on audit liability caps. While some panellists felt there was no justification for such caps, other favoured them. Richard, as an industry representative, what is your view on the subject?

Richard KILGUST

I would like to clarify that audit firms view liability caps as a way of ensuring their long-term sustainability, which is also important for capital markets. At present, we cannot obtain
commercial insurance to cover these large claims, since the risk cannot be priced. Thus, it is not a question of reducing our insurance costs. If anything, we fear that if a high liability cap would be set within the sustainability level, every litigator would attempt settling for that amount. Thus, while the caps would protect us from the fatal piece of litigation, they might actually drive up our costs.

It is also important to recognise, at least in the context of the US legal system, that currently audit firms cannot afford to fight liability cases. Thus, in actuality, the merits of such litigations are not being determined by the court systems. Rather, the involved parties negotiate a settlement based on their perception of the risks. These risks are typically not determined by the quality of the audit performed, but by factors such as the quality of expert witnesses, the trial’s location and judge, and the potential jury members.

Thus, even if the liability cap was set at a very high level, it would still allow audit firms to obtain commercial insurance. They could also afford to try a higher percentage of litigations, whose outcome could then be determined based on merit.

**Roel CAMPOS**

Panellists also felt that audit firms should become more transparent, reveal their earnings, and adopt a modern governance structure. If these conditions are satisfied, they felt that investors might support some type of liability caps.

**Mark ANSON**

The US is a very litigious society. Thus, even if investors might currently feel that such an approach is reasonable, they would probably be persuaded by plaintiff attorneys to file a lawsuit when something goes wrong. Since the UK is a less litigious society, we face fewer problems in that area.

**Richard KILGUST**

I do not view transparency as something that should be avoided at all costs. There are different levels of transparency around the world. In the UK, audit firms have begun publishing their financial statements, and the market absorbed the change pretty quickly. I believe the same would be true in other countries.

**Roel CAMPOS**

It has been suggested that audit firms be allowed to be set up under a traditional corporate structure, and to raise capital. Would investors consider investing in such a firm?

**Mark ANSON**

I believe investors would face the same problem insurance companies do. Auditing firms that operate US offices face a risk of unlimited liability, and it is not possible to estimate the frequency of potential losses. On the other hand, investors do tend to focus on cash flow return on investment, and audit firms are extremely efficient at generating cash.
Nicolas VERON

I was struck by the prevalence of the transparency issue and by the fact that panellists who typically hold very different opinions agreed with respect to it. I believe transparency is also at the core of some of the other questions raised. It is difficult adopt a stance on issues such as liability or legal structure reform without knowing what is happening within the firms.

I believe that since the current capital market situation is favourable, it might be an appropriate time for obtaining the prerequisite information for such reforms. Many questions relating to the business model of audit firms should be addressed: Should information be provided at the national or global level? What sort of corporate governance disclosures should be made? Who should audit the financials of public audit firms? Thus, while I do not believe transparency will solve anything by itself, it is nevertheless a prerequisite for addressing complex liability and market structure questions.

3. Panel 3 – Audit firm concentration

Roel CAMPOS

During the third session, Daniel BOUTON noted that he felt he was a captive of an oligopoly. Joseph, do you share that feeling?

Joseph WAN

As the CEO of a much smaller company, I do not feel it is problematic that there are merely four large audit firms to choose from. I thus believe it might be best not to interfere with the market. I also believe that turning auditing firms into public companies might actually have a negative impact on market concentration, since investors would only be interested in investing in the big four firms.

Richard KILGUST

I would like to make two comments. First, I would like to stress the importance of the inspection process, which sends a clear message to auditors. I believe many positive changes were driven by the actions of inspectors over the past five years. However, it is necessary to insure inspection consistency among oversight regimes.

Second, I believe the area of professional education and qualifications merits a further examination. Business has become increasingly complex, not merely from a technical perspective, but with respect to many behavioural issues. Auditors should therefore be provided with sufficient tools to handle such issues.

Roel CAMPOS

In the US, the PCAOB is using an efficiency indicator as part of its audit firm inspections. That is, it is examining whether audits were performed efficiently in terms of hours. How does the industry feel about that?
Richard KILGUST

Regulators should ensure that the pendulum does not swing too much in one direction. While inspections are useful, regulators should not send mixed messages. Their role is to ensure high quality audits; that is it.

Pervenché BERES

I would like to make a few comments with respect to liability caps. As today’s discussion demonstrates, there is a clear link between liability reform and good governance of audit firms. In the eyes of the public, it is paradoxical that audit firms, whose objective is to ensure that public firms are completely transparent, do not adopt similar principles.

It should also be determined whether liability caps would increase the audit quality, as well as the competition level of the auditing market. Many members of the EU Parliament feel that Competition Commissioner Neelie Kroes should launch a sector inquiry into the auditing market. I am confident that this issue will be voted by the EU Parliament before the end of 2007. There is no reason why we should be concerned with the concentration level of all sectors except this one.

Finally, IOSCO should also examine the claim levels, since auditing seems to be the only sector in which the claim level is merely a negotiating position.

Roel CAMPOS

Our time is up. I would like to thank all participants. We appreciate your support and interest. IOSCO will follow-up on this initiative to study audit quality. We have also established a sub-committee that deals with contingency planning, and we plan to consult industry, academics and other professionals on both subjects. Please contact us if there is any information you would like to make available to IOSCO.