September 24, 2010

Via email: economicaffairs@parliament.uk

The Clerk to the Economic Affairs Committee
House of Lords
London SW1A 0PW

Re: Call for Evidence - Auditors: Market Concentration and their Role

We are writing collectively on behalf of the California Public Employees Retirement System (CalPERS), the largest public pension plan in the U.S. with approximately $210 billion in global assets and equity holdings in over 9,000 companies and the University of San Diego, School of Law, Center for Corporate and Securities Law.

Thank you for providing us with an opportunity to comment on your call for evidence on the concentration of auditors and the critical role they play in maintaining the integrity of financial reporting. We agree that audit is dominated globally by the Big Four accounting firms which does raise some concern about competition, the quality of audited accounts and about possible conflict of interests between audit and consulting. The following provides our perspective on the outlined questions:

1. Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

During the 1960’s and 1970’s, the eight largest auditing firms began to increase their international presence as the companies they audited increased their global operations. These auditing firms acquired or affiliated with other auditing firms in foreign countries, establishing international marketing arrangements under a common international brand name.

As discussed in pages 8 and 9 in the United States Government Accountability Office January 2008 Report, “Audits of Public Companies, Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action,” the largest U.S. accounting firms began merging with each other in the late 1980s. This reduced the number of major international accounting firms from eight down to five. Other large “second tier” firms, such as Main Hurdman, were also acquired. Further consolidation was pursued by the firms as E&Y and KPMG also asked for regulatory approval for a merger, but were declined. In 2002, the market dropped from five to four firms when Arthur Anderson ceased doing business. See also the Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of Treasury, pages V: 4-V: 5, released on October 6, 2008 and available at http://www.treas.gov, for a more detailed history of U.S. audit firm mergers.
Today, accounting firms outside the “Big Four” are not competitive with the Big Four in terms of number of personnel, offices and a presence in foreign countries. In essence, much of the consolidation was the direct result of the large accounting firms responding to the need for a presence around the globe, in order to provide global audit coverage required by businesses operating globally. In addition, the consolidation gave the large auditing firms an advantageous economy of scale that makes it difficult for smaller firms to compete. The larger auditing firms have lower overhead costs, greater presence on college campuses allowing them to recruit new hires more effectively, the ability to provide audit resources in each major country around the globe, and national offices that can provide necessary resources for accounting, auditing, local and foreign taxes and business issues.

Prior to the GAO report, in 2007 the European Commission (DG Internal Market and Services) commissioned Oxera¹ to examine ownership and management rules related to audit firms, their corporate structures and their access to capital. The Oxera study showed that restrictions on access to capital were one of several potential barriers for smaller firms’ entry into the market. Other barriers included reputation, the need for international coverage, international management structures and liability risk.

In addition, in the Highlights section of the GAO Report, it states the GAO found that the “small public company audit market is much less concentrated…[m]ost small public companies reported being satisfied with the auditor choices available to them. The GAO Report also acknowledged that “[s]maller accounting firms face various challenges in expanding to audit more public companies, although most are not interested in these clients.” Despite this, “[s]ome have taken steps to increase their capacity by joining networks with other firms.” The GAO Report concluded that “no compelling need for immediate action appears to exist.”

We agree with the GAO Report findings. We are also supportive of increasing the number of high quality audit firms in the marketplace to increase companies’ choice in selection and to benefit investors.

2. Does a lack of competition mean clients are charged excessive fees?

The Big Four compete very aggressively with one another on fees. According to a CFO.com article, “Auditing Your Auditor,” April 1, 2010, “Audit fees have been dropping across the board since 2007…We have seen price competition return in 2007 and 2008…Not only have fees been falling, but they have fallen for companies of all sizes, including those not directly affected by 404. Companies with revenues between $100 million and $250 million saw an average 8% drop in fees from 2007 to 2008…”

However, the CFO.com article goes on to point out that unusually low fees can also signal trouble such as a weak audit. With the recent market downturn and fees decreasing, in some instances, this may also raise questions regarding whether audit quality is also subject to a corresponding decline. The potential correlation between reduced audit fees and poor quality audits is an issue that should be on the radar screen of regulators and warrants further examination via the audit inspection process.

3. Does a narrow field of competition affect objectivity of advice provided?

A narrow field of competition negatively impacts the objectivity of advice when a firm is concerned that taking a “tough” stance could result in the loss of an audit as auditors may consider audit fees as a “loss leader” in anticipation of other consulting and advisory work in the future. This may provide additional pause on whether an auditor may be willing to hold to a bright line on issues. In addition, this concern is elevated when a company operates in a jurisdiction where it can “shop” among auditors for a specific opinion, and the regulators do not mandate transparency to investors regarding such actions.

We do feel where the audit firm receives significant fees for services other than an independent audit, and the information is not properly disclosed to investors, the lack of auditor independence negatively impacts the auditors’ objectivity. We feel that some services are in fact, inconsistent with an auditor maintaining their objectivity, such as services that might result in the auditor having a common financial interest, in auditing their own work, or engaging in management activities.

4. Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

We don’t necessarily believe that limited competition makes it easier for auditors to provide unwelcome advice to clients.

5. What is the role of auditors and should it be changed?

The number one objective and priority of an independent auditor is, and should be, to provide investors with an independent opinion as to whether the financial statements and disclosures therein, are materially accurate and complete. If this objective is not achieved, the value of an audit is lost.

As aptly noted on page 10 of the ICAEW Financial Services Faculty June 2010 Report, “Audit of Banks: Lessons From The Crisis, ...”the audit process is highly valued by investors…and seen as essential in providing discipline to directors in their presentation of information, and to the control environment around their financial processes.” However, as noted on page 11 of the Report, investors want less boilerplate language and more commentary from auditors with better risk disclosures.

An auditor can, but does not currently, provide useful information to investors with respect to the financial statements, financial information, and the audit. Such information should include for example:

- Key business and audit risks the auditor believes exist, and which the auditor has considered when conducting the audit,
• The auditor’s perspective on what are the key assumptions used in judgments that materially affect the financial statements, and whether those assumptions are at the low, most likely, or high end of the range of possible outcomes,
• Key audit issues and their resolution which the audit partner documents in a final, summary audit memo,
• Changes to accounting policies that have a significant impact,
• Unusual transactions,
• Accounting applications and practices that are unique to the industry, and
• Change of auditor and background thereof.

Moreover, on page 1 of the July 29, 2009, Report of the Financial Crisis Advisory Group, it identified “Effective Financial Reporting” as one of four key principles and stated as follows:

“Financial reporting plays an integral role in the financial system by striving to provide unbiased, transparent and relevant information about the economic performance and condition of businesses. Effective financial reporting depends on high quality accounting standards as well as the consistent and faithful application and rigorous independent audit and enforcement of those standards. Financial reporting is of great importance to investors and other financial market participants in their resource allocation decisions and to regulators and other users. The confidence of all these users in the transparency and integrity of financial reporting is critically important to global financial stability and sound economic growth.”

In our opinion, we should adhere to a continuous improvement audit profession model to ensure independent, high quality audits by audit firms. Auditors should serve as independent gatekeepers that instil public confidence via high quality audits in public companies seeking capital from investors. In addition, regulators should consider requiring an Auditors Discussion and Analysis (AD&A) as part of the filing to provide investors with the auditor’s perspective on key risks. Such a requirement would help ensure that auditors are not missing anything significant and it would incent auditors to perform better audits.

6. Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?

Questions need to be asked about the scepticism by auditors when auditing banks in the run-up to the financial crisis of 2008. Business is increasingly complex and global in nature, which in turn affects the skills and staffing requirements needed to conduct a high quality audit. Today, the majority of audit work is still being performed by staff that on average has less than six years of experience. Increased training of auditors, from junior members to partners and mid-career professionals will give auditors the up-to-date technical skills they need to help avoid material audit “misses.” In addition, creating professional schools of accountancy at universities to provide better, more targeted coursework for auditors than the present requirement, for example in the U.S. of 150 hours of training, would also be a step in the right direction to ensure high quality audits and fewer audit “misses.”
The importance of professional scepticism is highlighted in the Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury released on October 6, 2008 and available at http://www.treas.gov. The Committee notes in V. Background, page V:1 that “Auditors’ professional conduct requires an attitude of healthy scepticism in performing their work and their assurance is critical to investor confidence and, ultimately, the flow of capital. The auditor’s role in the effective functioning of the capital markets cannot be underestimated.” In Section VI. Human Capital, Recommendation 4 (b), page VIII:19, states, “Develop training materials to help foster and maintain the application of healthy professional scepticism with respect to issues of independence and other conflicts among public company auditors, and inspect auditing firms, through the PCAOB inspection process, for independence training of partners and mid-career professionals.”

As also noted by the Auditing Practices Board on page 3 of its August 2010 Discussion Paper, “Auditor Scepticism: Raising the Bar,” “Audit is essential to public and investor confidence in companies...The application of an appropriate degree of professional scepticism is a crucial skill for auditors. Unless auditors are prepared to challenge management’s assertions they will not act as a deterrence to fraud nor be able to confirm, with confidence, that a company’s financial statements give a true and fair view. On page 4 of the Report, it states the Auditing Standards define professional scepticism as “An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence. It is widely acknowledged that a sceptical attitude of mind is essential if an audit is to be rigorous and performed with professional due care.”

Professors Tina Carpenter and Jane Reimers found in their academic study, “Professional Scepticism: The Effects of a Partner’s Influence and the Presence of Fraud on Auditors’ Fraud Judgments and Actions,” published in September 2009, that fraud risk assessments are higher with a partner who emphasizes an attitude of professional scepticism than with a partner who places less emphasis on professional scepticism. They further find that auditors’ choice of appropriate fraud audit procedures is responsive to their fraud risk assessments when fraud is present, but only with a partner who emphasizes professional scepticism (as opposed to efficiency).

There was insufficient auditor scepticism as demonstrated by PricewaterhouseCoopers declaring Northern Rock a “going concern.” (See page 114, House of Commons Treasury Committee Report, The run on the Rock, Fifth Report of Session 2007-08). Furthermore, the House of Commons Treasury Committee Report, Banking Crisis: reforming corporate governance and pay in the City, Ninth Report of Session 2008-09, refers to ‘tunnel vision’ on page 78 and states...“the big picture that shareholders want to see is lost in a sea of detail and regulatory disclosures.” (See also pages 80-81 of the Banking Crisis Report for ICAEW suggestions on where the role of auditors might be strengthened in the audit of banks). In page 87, the Banking Crisis Report states, “We believe the complexity and length of financial reports represent a missed opportunity to improve the understanding that users of accounts possess of the financial health of firms and recommend that the FSA consult on
ways in which financial reporting can be improved to provide information in a more accessible way."

7. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

As noted on page 115 of the House of Commons Treasury Committee January 24, 2008 Report, “The run on the Rock,” states as follows:

“299. A lesson to be learnt from this crisis is that the auditor can only provide an assurance of a snapshot of the past state of the company. We recommend that the accounting bodies consider what further assurance auditors should give to shareholders in respect to risk management processes of a company, particularly where a company is regarded as an outlier. We are also concerned that there appears to be a particular conflict of interest between the statutory role of the auditor, and the other work it may undertake for a financial institution. For example, PricewaterhouseCoopers received £700,000 in non-audit fees largely comprised of fees related to assurance services in connection with Northern Rock’s actions in raising finance."

Every major banking crisis has been primarily the result of banks making bad loans which were not repaid. Auditors can make a significant positive contribution to mitigate such risks again by:

1. Recommending financial institutions disclose in a separate section of their reports to investors significant business risks, including risks existing in their lending, securitization and investing activities.
2. Requiring auditors to provide assurance on the risk section report, including the completeness of the report.
3. Reviewing and recommending better disclosures with respect to loans, including:
   a. Risks in lending activities such as underwriting controls and standards, concentrations, credit risks, etc.
   b. A disclosure of key assumptions used when assessing loan quality and losses.
   c. Loan performance (or non-performance) including breakdowns by loan types of nonperforming loans, extent of non-performance, such as how old delinquencies are, extent of loan restructurings etc.
   d. A comparison of actual and historical loan provisions, charge-offs, and allowances for loan losses, for each material class or type of loans.
   e. Having the auditor opine on the additional or supplemental loan information.

We believe that audit firms should consider an auditor’s discussion and analysis which would provide at a summary level audit risks, deficiencies and how these were resolved, similar to the business risk section of 10-K filings, which are widely read by investment professionals. Moreover, with respect to recognition of securitizations in the audit process, we support better disclosure of the following:
• **Valuation.** Current audit standards do not disclose risks when quoted market prices are not available. Assumptions involved in value estimates should be disclosed.

• **Non-Performing Assets.** Increase transparency through more stringent non-performing asset auditing standards at the securitization level and creditor level to assist investors.

• **Special Purpose Vehicles.** Improve disclosure and audit procedures to provide full transparency regarding special purpose vehicles to disclose ownership, capital structure, size of issue, terms of offer, details of the underlying asset pool and its performance history, transaction structure, and service arrangements.

• **Sensitivity Analysis.** Require stress-testing for securitizations with scenario ratings to take into consideration adverse events such as changes in default rates, decreases in underlying asset valuations, higher prepayment and discount rates, changes in the timing of cash flows, and early amortization triggers.

8. **How much information should bank auditors share with the supervisory authorities and vice versa?**

An external auditor brings an independent and objective view to an institution’s financial reporting process which provides useful information to investors, management, audit committees and other stakeholders. Supervisory or regulatory authorities focus on key aspects that would also be helpful to the external auditor. In this context, we agree that cooperation between external auditors and supervisory authorities should be deepened and considered so that the authorities have an opportunity to learn and obtain some assurances from the auditor through for example:

- periodically requiring financial returns to be audited – some of the information does not form part of the accounts, for example, regulatory capital ratios;
- greater use of powers by regulators in order to gain more information on the operation and application of controls in compliance with regulatory requirements;
- review the ‘Pillar 3’ disclosures introduced by Basel II; and
- more regular meetings between the authorities and the auditors.

If there has been a supervisory examination in the most recent period under audit, the independent auditor should be required to inquire of the supervisory authority, as to significant matters and risks that came to the attention of the examiner, and document how those items will be addressed in the course of the audit. The supervisory authority should also make available to the auditor any and all agreements the regulator has entered into with the institution.

Conversely, the independent auditor should make available to the supervisory authorities their audit workpapers, audit reports, and management letters. They should be receptive to inquiries by the authorities regarding audit scope, significant audit risks and issues, and significant audit findings, including with respect to deficiencies in internal controls, governance or management.

9. **If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?**

A “carrot and stick” approach may be considered. On one hand, if the auditor provides such advice, they should be rewarded with continuation as the independent auditor. However, if
the supervisory authority finds the auditor did not provide objective advice, including in the case of where it would likely not be welcomed, the supervisory authority should be given the authority to require a change in the auditors.

Periodic rotation of the audit firm (rather than just the audit partner) would also provide an incentive to provide objective advice, especially when such advice may come under scrutiny by the subsequent auditor. When an audit firm takes over an audit from another firm, it does an exceptional job of checking, reporting and due diligence in order to prevent assuming liabilities for the previous audit. This is a compelling argument for rotation every seven to ten years.

10. Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

We agree with the House of Commons Treasury Report, “Banking Crisis: reforming corporate governance and pay in the City,” Ninth Report of Session 2008-09, published on 15 May 2009 (“Treasury Committee Banking Crisis Report”), which states in paragraph 237, at page 83, “We remain concerned about the issue of auditor independence. Although independence is just one of several determinants of audit quality, we believe that, as economic agents, audit firms will face strong incentives to temper critical opinions of accounts prepared by executive boards, if there is a perceived risk that non-audit work could be jeopardised. We strongly believe that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the Financial Reporting Council consult on this proposal at the earliest opportunity.” As also noted at page 82 of the Treasury Committee Banking Crisis Report, “other commercial interests can compromise auditors in their ability to confront directors on difficult issues.”

We strongly support this view of auditor independence and not permitting auditors to provide non-audit services to audit clients, including but not limited to the prohibition of the following non-audit services: internal audit, information technology, valuation, actuarial valuation, tax, litigation support, legal, recruitment and remuneration, corporate finance, transaction related, and accounting (See The Auditing Practices Board Ethical Standards, “Consultation on Audit Firms Providing Non-Audit Services to Listed Companies they Audit,” October 6 2009, pages 28-31). In addition, a November 15, 2009 Study, “Auditor Independence and the Cost of Capital Before and After Sarbanes-Oxley: The Case of Newly Issued Public Debt,” by Eli Amir of the London Business School found that the Sarbanes-Oxley Act of 2002, by enhancing auditor independence, has resulted in a lower cost of borrowing. Investor confidence in financial statements will be enhanced through greater auditor independence, expertise, and effective risk management.

In addition, all the fees the independent auditor charges a company should be disclosed annually in a transparent manner to investors.

11. Should more competition be introduced into auditing? If so, how?

Yes. This issue warrants further study and consideration. These firms and the independent audits they perform are very important for establishing trust and confidence on the part of investors in the global capital markets. However, at the same time, they should not be considered “Too Big to Fail.” In the Final Report of the Advisory Committee on the Auditing
Profession to the U.S. Department of the Treasury released on October 6, 2008 and available at http://www.treas.gov. The Committee made seven recommendations that, at a minimum, should be considered for implementation, such as greater transparency for, or elimination of, contractual provisions limiting the choice of public company auditors. Audit firms could, as major banks have been required to do, develop a plan for orderly and legal hand over of audit clients should a firm be in terminal difficulties.

Section VIII. of the Final Report, Concentration and Competition, page VIII:4, states more specifically as follows:

“Recommendation 1. Reduce barriers to the growth of smaller auditing firms consistent with an overall policy goal of promoting audit quality. To address these issues, the Committee recommends that policy makers press for the reduction of barriers, to the extent consistent with audit quality and other public interest factors, to the growth of smaller auditing firms. For smaller firms, this includes encouraging and promoting development of technical resources in such areas as international financial reporting standards (IFRS) and fair value accounting, and development of specialized or “niche” practices or industry “verticles” where they are in the best interests of investors and can lead to more effective competition. Pressure also should be applied against nonjustifiable resistance to using smaller firms on the part of a variety of market participants.”

Awareness may also assist in the removal of “stigmatism” of not using one of the big four auditors. For example there are many U.S. Public Pension funds, such as CalPERS which utilize an auditor outside of the big four network.

**12. Should the role of internal auditors be enhanced and how should they interact with external auditors?**

The role of the internal auditor can be enhanced through steps that include:

1. Having the internal auditor report directly to the audit committee, enhancing the independence of the function.
2. Having the audit committee evaluate and set the compensation levels for the internal auditor.
3. Requiring the internal auditor to establish its own charter, including compliance with applicable professional and educational standards.
4. Giving the audit committee oversight responsibility for the internal audit function, including the oversight of the annual internal audit plan.
5. Periodically have an independent evaluation and/or peer review of the internal audit group and its work product.

With proper management, vision and oversight, internal audit can be used to examine and strengthen internal controls, financial reporting and transparency, risk management and operations.

**13. Should the role of audit committees be enhanced?**

Consistent with the Enhanced Disclosure Working Group, Guidelines for Enhanced Disclosure to Assist Directors, Audit Committees, Shareowners, and Investors dated April
2009 and available at http://pdf.standardlifeinvestments.com, the role of the audit committee should be enhanced through:
1. Standards for serving on an audit committee;
2. Education of the audit committee;
3. Audit committee charters setting forth the objectives of, and work carried out by the audit committee; and
4. Transparency of the work of the audit committee.

Audit committees should be comprised of diverse members who are:
1. Knowledgeable of the industry and business in which the company operates;
2. Knowledgeable of the financial statements and disclosures;
3. Informed with respect to external and internal audit practices; and
4. Informed of their responsibilities to investors.

In essence, there should be requirements that set forth and ensure audit committee members know what they are doing when overseeing the financial reporting and auditing process, including with respect to internal controls, of the financial institution or company. There should also be broad education requirements that require board members to obtain continuing education on relevant topics on a periodic basis.

A charter should be required for each audit committee that sets forth its obligation to investors, principle responsibilities, and how those objectives will be met or responsibilities will be carried out. The charter should be disclosed to investors and periodically updated. The audit committee should have to make an annual report to investors with respect to the work they performed in carrying out their obligations and responsibilities. Such a report should avoid boilerplate language and be written in Plain English. The report should discuss matters such as:

- From the perspective of an investor, were there any independence issues with respect to the independent auditor?
- Significant matters that were discussed with the auditor including audit scope, significant risks, internal control weaknesses, audit staffing, etc.
- Whether the auditor would make any changes to the financial statements?
- Whether the auditor would make any changes in internal controls?
- Did the auditor receive sufficient cooperation and information?
- Are there accounting practices that the company or institution uses that are acceptable, but not the preferred method of accounting?

14. Is the auditing profession well placed to promote improvement in corporate governance?

Currently no, as audit firms around the globe have themselves often times lacked transparency and have not adopted preferred governance practices. This is not the case in some model countries such as the U.K. where the largest audit firms have provided greater
levels of transparency with the recommended Audit Firm Governance Code”\(^2\). We believe that globally, audit firms should first proactively address their own governance structures and practices before advising clients on such matters by agreeing as an international firm to do the following:

1. Publish an annual report that includes their financial statements prepared in accordance with applicable accounting standards (preferably audited), along with a discussion of their governance, operations, risks, and key audit quality indicators;
2. Create independent oversight of the governance of the audit firm through independent board members, or advisory boards, that report to investors on their activities. The independent board members should be accountable to the public, given the public role legislated for the firms; and
3. Audit firms should improve their own firm governance and transparency by requiring the engagement partner to sign the audit report along with the name of the firm (as opposed to the current practice in some jurisdictions of signing only the name of the audit firm).

As an independent gatekeeper, the audit profession, among others, should most certainly be involved in improving corporate governance for the benefit of investors and the global capital markets generally. However, the firms should first demonstrate their commitment to excellence in the governance and transparency of their own firms.

If you would like to discuss any of these points, please do not hesitate to contact Mary Hartman Morris, Global Equity, CalPERS at 1-916-795-4129 or Cynthia L. Richson, Co-director, University of San Diego, School of Law, Center for Corporate and Securities Law, at crichson5@gmail.com.

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