Response to Consultation on EC GREEN PAPER:

"Audit Policy: Lessons from the Crisis"

by

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We would like to thank the Commission for the opportunity to comment on the recent "Green Paper" entitled *Audit Policy: Lessons from the Crisis* (COM(2010) 561 final). We agree that the time is right for an examination and discussion of the accounting and auditing profession's role in the global economic crisis of the past few years. Consequently, we commend the Commission for initiating a dialogue on the topic. The "Green Paper" raises two very important issues as a motivation to address a number of potentially important topics related to the structure, conduct and regulation of the auditing profession:

1. Could the auditing profession have done a better job of signaling risk and potential problems of financial institutions leading up to, and during, the crisis?

2. How does the current level of concentration among international audit firms affect the quality of auditing and financial reporting in the future?

The purpose of our response is to place the issues of accounting and auditing in the crisis, as well as the structure of audit markets, into context based on economic theory and related research in auditing. We feel that such a perspective is important in order to assure a well-informed debate on the issues raised in the Green Paper. Our response does not attempt to provide a comprehensive overview of audit research since the body of knowledge that is potentially relevant to the questions raised is quite large. Nevertheless, we feel that it is critical that future policy decisions properly consider what is known, and what is not known, from the current state of the art in audit research.

Premises

We believe that the financial crisis should catalyze an examination of numerous fundamental issues relating to the accounting and auditing profession including: (a) the role of the auditor in an informationally efficient market, (b) the structure, operation and governance of audit firms, (c) supervision and inspection of an auditor's quality of work, (d) audit market structure and concentration in certain market segments, (e) creation of a European audit market and international cooperation between professionals and regulators, and (f) simplification of accounting and auditing requirements for SMEs and SPEs. Nevertheless, we also note that history has shown that the typical aftermath of a crisis in auditing (or otherwise) is the introduction of regulatory reforms. Given the often overwhelming need to "do something", history has shown that political expediency, rather than insight into the nature of the underlying problems causing the crisis may dominate the regulatory process.[1] In fact, the pressure to respond to the fallout of a crisis may, to some extent, lead to the regulation of the "possible", rather than a direct response to the "problem".

The auditing profession was one of the most heavily regulated in the world even before the economic crisis, being subject to national and international regulations, authoritative guidance of myriad professional bodies, and precedents developed through the legal system. The profession must comply with regulations on a diverse set of issues: who may enter the profession and may conduct an audit; how an audit should be planned and executed including specific required procedures; the nature and scope of the "product" produced, i.e., financial reporting requirements (e.g., IFRS) and auditing standards (e.g., ISA); the operation, structure and internal oversight of the firm; the capital structure and financing of the firm; and the nature of competition in the professional

[1] See DeFond and Francis (2005).

market. The economic theory of regulation tells us that there is a prima facie case for regulatory intervention when there is a market failure.[2] However, that does not imply that a regulatory solution will be more successful in correcting the inefficiencies in the system than market forces or private law. And when regulation does improve a specific problem, there may be significant unintended consequences such as increased transaction costs or misallocations of resources within the economy.[3]

The purpose of our contribution is not to focus on the ideological axis of whether or not there needs to be more or less regulation, but rather on the question of what optimal regulation is in terms of quality rather than quantity. We believe academics of diverse disciplines have a societal role to fulfill in this regard, and need to participate in the public policy debate. Since the European Union is still in the process of implementing the new regulations included in the revised 8th EU Directive (issued in 2006 with full implementation required in 2008), the regulatory climate in Europe during the heart of the economic crisis was fluid and evolving. Consequently, regulations arising from the Directive may not yet have had full effect on the issues raised in response to the economic crisis, and it is not clear what those effects will turn out to be. Hence, we suggest some caution in proposing new regulations until the current efforts have settled in since it is impossible at this time to evaluate whether the in-process regulations (along with proposed new ones) will be effective and/or efficient.

Hereafter, we discuss the following aspects of the Green Paper: (1) the role of the auditor, (2) the structure, operation and governance of audit firms, (3) international co-operation, supervision and creation of a European market, (4) concentration and market structure, and (5) simplification for SMEs and SPEs, followed by a conclusion and recommendations.

1. Role of the Auditor

The accounting and auditing profession exist to serve the public interest. Starting in the late 1970s in the U.S., the leadership of the accounting and auditing profession, and the large audit firms in particular, became increasingly focused on the commercial aspects of their business in terms of growth and global expansion. There are oft-expressed concerns that these "business values" displaced "professional values" such as auditor independence and serving the public interest.[4] One of the forces that may have encouraged this change in attitude was the deregulation of the way in which auditors competed for clients when the traditional prohibitions against advertising and solicitation were removed in many countries. The removal of these prohibitions made it possible to aggressively court new clients and to design new (non-audit) services that could be aggressively marketed to clients and non-clients alike.[5]

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[2] See Ogus (1994).

[3] Stigler (1971) raised important warnings about how regulations may arise in response to the demands of interest groups acting to maximizing their own well-being rather than as a result of a broad policy analysis to benefit society as a whole.

[4] See Zeff (2005a,b). Other researchers have raised similar concerns about a decline in auditor professionalism as a result of competitive forces (Imhoff, 2003; Wyatt, 2004; Healy and Palepu, 2003; Palepu and Healy, 2003).

[5] Based on an analysis of this practice in New Zealand, Hay and Knechel (2010) observed that, in general, deregulation of advertising allowed the largest firms to increase fees while offering better quality services. The deregulation of solicitation had the exact opposite effect and is believed to have led to cut-throat price competition in the audit market which could undermine audit quality.

It is, of course, highly desirable that audit quality reaches the level that is desired by market participants. However, it must also be kept in mind that true audit quality, defined as the extent to which an auditor reduces the risk that financial reports are materially misstated, is not observable.[6] A sizable body of academic research shows that the level of audit quality achieved in practice depends on demand and supply factors, as well as institutional and contextual factors. Hence, it is difficult to both grasp the "general" level of audit quality in the market and to quantify an appropriate target level of audit quality. What is clear is that shareholders, stakeholders and market participants must trust that the profession can deliver an acceptable level of audit quality.

Public oversight can certainly play an important role in improving the perceptions that the profession is delivering an appropriate level of audit quality. However, it must also be realized that it is virtually impossible for regulation to eliminate the possibility of failed audits.[7] Audit failures are typically associated with two distinct circumstances:[8] (1) the auditor does not deliver the implicit audit quality set by auditing standards and regulations, or (2) the auditor has complied with auditing standards and regulation but the audit quality achieved during the course of the audit fails to reveal all material misstatements in the financial statements. The former condition suggests a failure to meet market expectations of auditor's compliance with auditing standards and regulations, while the latter suggests a breakdown in the audit process. Further, to the extent that these issues should be addressed with regulations, the implications for what those regulations should be may be quite different. For example, (1) may be addressed with better rules safeguarding auditor independence, possibly with stricter monitoring and enforcement, while (2) potentially requires improved audit processes and, possibly, new auditing standards.

In both cases, regulators and standard setters must be careful to not fall into the trap that they are always best positioned to specify implicit audit quality. By its very nature, standard setting and regulation encourage a single standardized approach to conducting an audit whereas every audit is unique and will manifest important, and possibly unforeseen, idiosyncrasies that an auditor must address.[9] Consequently, standards and regulation must be simultaneously rigid enough to encourage improvements in auditing while still allowing auditors the flexibility and range of action to adequately address the unique aspects of each audit. Given that the audit process is observable but the outcome of the audit is not, an inappropriate approach to regulation may improve the observable "work rate" of the auditor without actually improving the quality of the audit. In the past, many improvements in audit practice originated in audit firms and were eventually embedded in auditing standards (e.g., standards on risk assessment—ISA 315—followed from audit firms developing new techniques for assessing risks and evaluating controls in the 1990s). It would indeed be unfortunate if regulation somehow undermined the profession's incentives and ability to innovate the audit process.

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[6] For example, see Francis (2004), Barton (2005), O'Keefe, Simunic and Stein (1994), Knechel, Rouse and Schelleman (2009) and Causholli and Knechel (2010).

[7] Following Francis (2004), "an audit failure occurs in two circumstances: when generally accepted accounting principles are not enforced by the auditor (GAAP failure); and when an auditor fails to issue a modified or qualified audit report in the appropriate circumstances (audit report failure). In both cases, the audited financial statements are potentially misleading to users.

[8] See Eilifsen and Willekens (2008).

[9] See Knechel (2010).

In our opinion, the financial crisis has more to do with the second problem discussed above. It is not clear whether auditors had an appropriate understanding of the risks that banks were absorbing. Given that the internal risk officers of many banks admittedly did not comprehend their risk in the event of a systemic downturn in real estate markets, it would be understandable why auditors also lacked such an understanding. However, revelations arising from the crisis do indicate a number of areas where auditors apparently failed to fully appreciate the extent of the risks accepted by financial institutions. For example, the issuance of loans to clearly overextended customers, the poor documentation surrounding many credit default swaps, and overreliance on rating agencies to price securitizations all could have been noticed during the auditor's evaluation of internal processes.[10] Further, it is now abundantly clear that none of the participants had a good grasp of counter-party risk. Finally, the numerous problems in applying fair value accounting suggest an incomplete understanding of investment and credit risk.[11]

While it is possible that auditors technically fulfilled their responsibility with regard to the rules and regulations which apply to financial institutions, and may have raised internal warnings about the risks, it is clear that the market was not well informed as to the nature of the risk exposures developing in many sizable financial institutions. Can society expect more from an auditor? At a minimum, the public needs assurance that auditors themselves understand the complexity of these activities and risk exposures. Only then is the issue of reporting such risks a relevant question. In the extreme, an auditor is required to consider issuing a going concern opinion when economic viability is in doubt, but it is probably desirable to have a mechanism for warning market participants about risk even before an entity reaches that level of dire straits.[12] Reporting systems in other fields (e.g., health and safety) have much more differentiated reporting systems which might provide some guidance for new reporting mechanisms in auditing.[13]

2. Structure, Operation and Governance of Audit Firms

At this time, it is not clear to us whether new regulations related to the structure, operation and governance of audit firms are necessary. Nor do we see the need for new independence regulations that go beyond what is already included in the revised 8th EU Directive. We have two reasons for this conclusion: first, as previously noted, the financial crisis occurred at a time that the EU countries were in the process of implementing the new regulations contained in the Directive and therefore it is likely that these had not yet had their full effect at the start of the crisis. Furthermore, this still may be the case as firms wrestle with numerous new regulatory considerations (including the clarified International Standards on Auditing). Second, as pointed out in section (1), we believe that the financial crisis is less related to problems of governance and independence than to the quality of the audit process and reporting (i.e., effective communication with stakeholders).

[10] Reliance on credit ratings would fall under auditing standards (ISA 620) related to relying on an outside expert. It does not seem that auditors followed the requirements of those standards in terms of evaluating the assumptions used by the rating agencies or their freedom from bias.

[11] See for example Sikka (2009).

[12] A going concern opinion has the risk to become a self-fulfilling prophecy (Vanstraelen, 2003) and, in the case of banks, can result in a run on a bank receiving such an opinion. Consequently, it might be appropriate to have the decision to issue a going concern opinion reflect a joint analysis of the auditor and appropriate national bank authorities.

[13] See Power (2009).

We believe that the focus of the current discussion should be on improving audit quality at an engagement level and to assist auditors to better address systemic risk across engagements. For example, in response to the audit problems of 2002 and subsequent years (e.g., Enron, Ahold, Parmalat), the profession developed new techniques and requirements for assessing fraud (e.g., mandated brainstorming sessions). Additional guidance is clearly required now for the issues revealed by the current crisis (e.g., counter-party risk, level of involvement of audit partner in the audit engagement). However, it is not at all clear that these improvements should be mandated with new standards, or whether audit firms themselves should be allowed to determine the best way to address their heightened sensitivities in certain areas of the audit. [14]

Improved audit quality does have a price, however. It is somewhat disingenuous to argue that audits are too expensive at the same time that criticisms are leveled that auditors are not doing their job carefully or completely enough. While it is desirable to have efficiency in the audit process, effectiveness would seem to be the overriding public concern.[15] In this regard, transparency is helpful. Transparency in the form of public disclosure of audit fees provides a signal to the market when auditors may be under-pricing an audit. Transparency in the structure and operation of an accounting firm instills confidence as to the nature and oversight of the audit process. Although it is fair to state that transparency may also have dysfunctional effects, we believe that more transparency is needed about the audit quality that is delivered and the safeguards of the audit firm to deliver high quality audits. To illustrate how a lack of transparency can stir turmoil is the recent situation in the Netherlands where the public oversight board publicly reported that there are differences in audit quality among Big 4 firms but was unable to provide additional detail due to confidentiality requirements. This is undesirable because the lack of information in the report led to speculations about all of the firms rather than allowing the market to focus on the worst performers. Improved transparency would allow companies to make more informed auditor choices and facilitate evaluation of whether those choices are in the best interest of stakeholders.

Further, transparency regarding the auditor selection and retention process is also desirable. A recent field study out of Canada suggests that management can control the auditor selection process by controlling the flow of information to the audit committee that is needed to evaluate alternative auditors.[16] While the EU 8th Directive sets out the responsibilities of the audit committee,

[14] To illustrate, it is not clear that brainstorming needed to be specifically embedded in auditing standards even though the technique has been shown to be effective (Carpenter, 2007). Rather, it may be more beneficial to use auditing standards to highlight the significance of an auditor's efforts in certain areas. Prior to the scandals in 2002, it was not clear what the responsibilities of the profession were in regard to detecting and reporting fraud. As those scandals were revealed, it became very clear that the profession was going to need to fill in more of the "expectation gap" or risk losing status as independent professionals. While detailed standards may have provided some guidance to firms, it is quite possible that the firms would have developed effective new approaches on their own. Another example is auditor's going-concern reporting in Belgium, where a shift toward rules-based auditing standards engendered both favorable and unfavorable effects (Carcello, Vanstraelen, and Willenborg, 2009).

[15] It should be noted that the perspective presented in these comments reflects the value of the audit as a signal of the quality of financial information. This pertains most directly to large and/or publicly listed firms. SMEs may find the reporting benefit of a statutory audit to be limited but may receive other valuable benefits such as a deterrent effect on the behavior of employees, detection of employee irregularities, access to specialized expertise, and guidance on how to improve internal controls and systems. Many of these ancillary benefits are incorporated in a management letter (Knechel, Niemi and Sundgren, 2008).

[16] See Fiolleau, Hoang and Jamal (2010).

including the selection of the auditor and the supervision of the audit function, we believe that it is important that audit committees fully take up this responsibility in practice. To accomplish this, it is important that the incentives of the audit committee be properly aligned with the stakeholders that they represent rather than management who may have direct access to, and influence over, the committee. Recent reports suggest that fees for audit committee members in the U.S. are rising rapidly and can approach $1 million per annum for the chairman. Given an individual's ability to serve on multiple committees, this level of compensation may create an economic bond that undermines the audit committee's oversight of the audit function. While audit committee members are probably aware of the potential reputational effects—and impact on their market value as a director—of being associated with a financial reporting failure, there is little evidence that audit committee members are personally accountable for such failures.[17] Consequently, while research has shown that firms with audit committees have better financial reporting,[18] it is not clear that such a benefit can be obtained by mandating audit committees to the wider market without also addressing the process and incentives of audit committee performance.

An area where improved transparency may help stakeholders understand the role of auditors is related to non-audit services (NAS) provided to an audit client. A relatively large body of research has generally failed to find evidence that the provision of these services negatively affects audit quality.[19] However, there is some evidence that the joint provision of non-audit and audit services may improve audit efficiency through knowledge spillovers from the consulting activities to the audit staff.[20] What academic research *does* show is that non-audit services provided by the auditor lower the public's confidence in audit quality as it is found that the stock market valuation of earnings surprises is smaller for firms that hire their auditors for non-audit services.[21] This may explain why some companies voluntarily choose to have a policy of strict separation of the audit and all other services, and is also consistent with the empirical observation that compared to firms without audit committees, firms with audit committees purchased lower levels of NAS prior to most NAS being banned in the US by SOX.[22]

Another area where academic research provides some insight is that of mandatory audit firm rotation. Overwhelmingly, prior empirical evidence does not support the need for, or the benefit of, mandatory audit firm rotation.[23] In terms of market response, most recent research points to a complex relationship between auditor tenure and audit quality. For example, research has shown that the cost of equity *decreases* as a function of auditor tenure for up to thirteen years, after which the risk premium increases.[24] Theoretical and experimental research suggests that mandatory audit firm rotation may be beneficial but only under very specific circumstances, e.g., when the cost to

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[17] In spite of the increased regulation of audit committee structure and activities in the U.S. coming about because of the Sarbanes-Oxley Act of 2002, there is little evidence of an audit committee member being penalized for negligence. In fact, many have argued that such penalties would have a chilling effect on the ability of firms to recruit qualified audit committee members.

[18] See for example Carcello and Neal (2000) and Klein (2002).

[19] See Francis (2004) and Knechel and Vanstraelen (2007) for an overview.

[20] See for example Knechel and Sharma (2010) and Knechel, Sharma and Sharma (2010).

[21] See Krishnan, Zhang and Sami (2005) and Francis and Ke (2006).

[22] See Abbott et al. (2003).

[23] See Francis (2004) for an overview. See Carey and Simnett (2006) for a study on the association between audit quality and long audit partner tenure, providing some evidence based on Australian data consistent with a diminution in audit quality associated with long audit partner tenure.

[24] See Boone, Khurana and Raman (2008).

change auditors is low, the market for audit services is not competitive, and reputation has limited effect on auditor performance.[25] Further, other research has indicated that audit failures are likely to occur in short tenure cases as well as long tenure cases, although the causes may differ, i.e., when an auditor's tenure is short they are less likely to detect fraud but when an auditors' tenure is long they are more susceptible to forces that motivate management to manage earnings.[26] Consequently, it is unlikely that mandatory audit firm rotation is a panacea since it may simply trade one problem for another.

3. International Co-operation, Supervision and Creation of a European Market

It fits European thought to adopt a single set of accounting and auditing standards to be applied in the member states. In our opinion, there appear to be at least two natural consequences of adopting a single set of standards in the EU. The first is to implement common CPA education requirements across EU countries and create a European passport for auditors. This is a natural response to the current mobility problems of CPAs within Europe that audit firms are faced with. The second is to create a common approach to inspections of audit firms, which requires more integration and cooperation on audit firm supervision at the EU-level. In today's globalized economy, Europe cannot function as an isolated island with its own rules and regulations. In this regard, the EC has already chosen to adopt IFRS which are the most commonly applied accounting standards around the world. It is therefore a logical next step to adopt the ISAs, and to create more international co-operation in supervising compliance with these international standards.

Public oversight should be both efficient and effective. A recent study in the US is quite critical of the way the PCAOB has organized and executed its activities, suggesting the need for improvements in their approach to regulation.[27] It is undesirable for the organization charged with public oversight to be assigned potentially inconsistent responsibilities, as may be the case when the PCAOB both sets standards and conducts inspections of professional firms. Furthermore, it is important that public oversight bodies have the resources and skills available to execute their responsibilities effectively and with the least cost and disruption to professionals. For example, separating oversight of financial reporting from the oversight of the related audit activities may not be effective. Currently, we do not yet know much about the quality of public oversight bodies. Future research on the quality of public oversight should be of concern to both the profession and existing regulators.

4. Concentration and Market Structure

There is little doubt that the market for audit services has become increasingly concentrated in the past few decades, especially for public interest entities (PIEs). However, there is still significant variation across EU countries in the level of market concentration.[28] Also, audit market concentration is much less of an issue for private firms which represent the vast majority of clients in the European statutory audit market. We feel it is more important to understand that concentration

[25] See Dopuch, King and Schwartz (2001).
[26] See Casterella, Knechel and Walker (2005).
[27] Glover, Prawitt and Taylor (2009).
[28] See Francis, Michas and Seavey (2010).

does not necessarily lead to a lack of competition.[29] The link between concentration and competition is rather complex because of the nature of auditing, and contracts to provide audit services do not resemble a typical "product" market. Clients come to the market on an irregular basis and the portion of audits up for tender in any given year is relatively small. Research has shown that at the point of tender, auditors can be very competitive in their pursuit of new clients, particularly as indicated in reductions in fee levels at the time a new auditor is appointed.[30] However, since clients do not change auditors frequently, there may be transaction costs that favor an auditor for a few years after appointment.

Available empirical evidence documents a positive association between competition and the quality of Big 4 audits, i.e., the more competition there is among the Big 4 in a country (as measured by the relative balance in their market shares), the higher the level of audit quality.[31] More specifically, audit quality is lowest when one or two Big 4 firms dominate an audit market. Interestingly, this positive association only holds in countries with the strongest investor protection regimes, while the level of competition has no systematic association with audit quality in countries with weak investor protection regimes. Surprisingly, the evidence also suggests that Big 4 audits are of higher quality when there is *less* competition from non-Big 4 auditors. Consequently, even if one focuses on competition rather than concentration in an audit market, it is not clear what an appropriate level of competition is. Quite possibly, serious competition among a few large firms capable of providing high quality service to PIEs may be the most efficient market structure. This also suggests that there are significant barriers to entry for non-Big 4 firms to compete with the Big 4 for the audits of large PIEs. However, those barriers may have more to do with the systems, training and other non-variable costs of providing high quality services than with market power based solely on size.

Audit market concentration may become problematic if it unduly affects audit fees or limits auditor choice by leaving a client with a very small set of auditor options, especially in the face of increasing restrictions about an auditor providing non-audit services to a client. As noted, the evidence suggests significant competition on price occurs at the time of an audit tender even after the demise of Arthur Andersen. Thus, the remaining issue deals with auditor choice. One way to resolve this is to strictly limit the nature of services an audit firm can offer to even non-audit clients. That is, if accounting firms can provide only audit services in general, large firms would not be in a position where they could determine whether it was more profitable to do a client's audit or to be free to sell other non-audit services. This would effectively turn accounting firms into pure "inspection" units. As previously noted, a large body of research fails to provide evidence that

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[29] See Buijink, Maijoor and Meuwissen (1998) providing evidence for the EU market that high levels of concentration do not necessarily reduce competition.

[30] The phenomena of fee reductions at the time of an auditor switch is usually referred to as lowballing (e.g., Hay, Knechel and Wong, 2006). On the one hand, such lowballing can be perceived to potentially result in increased economic bonding between the client and the auditor that could undermine audit quality (DeAngelo, 1981). On the other hand, an auditor's reputation and potential to gain or lose audit clients in the future may provide a very strong incentive for auditors to maintain their quality even in the case of economic bonding (Klein and Leffler, 1981). Finally, it is also possible that an audit contract can be considered a set of bundled services, delivered in sequence rather than contemporaneously, so the expected fees over the expected life of an audit contract may reflect competitive forces. In this regard, some EU countries have chosen for renewable fixed audit terms (e.g., Belgium: 3 years; France: 6 years).

[31] See Francis, Michas and Seavey (2010).

auditor provided non-audit services undermine audit quality. Also, the unintended consequences of such a change might be extreme (e.g., make the profession less attractive to new professionals and graduates, squeeze firm margins to the point where they could not invest in innovations of the audit process). Furthermore, the impact on SMPs and SMEs might be even more extreme since much of the benefit they may obtain from the audit relates to guidance and access to unique expertise that a client cannot afford to maintain on an in-house basis.

Another potential problem arising from a concentrated market is the possibility that individual firms will be viewed as "too big to fail". This may create a moral hazard problem that undermines an auditor's incentives to continue to pursue high quality in the conduct of an audit. While we believe that the current market structure with only four large firms is highly competitive in many ways, we also recognize that a collapse of one of the large audit firms could disrupt the availability of audited financial information for some PIEs at least temporarily. Such a possibility suggests that regulatory enforcement that follows a breakdown in audit quality should focus on the professionals most directly responsible and not on the firm as a whole, except to the extent the problem reflects a problem with the firm's internal governance. However, we also believe that large audit firms realize that they would not be "bailed out" by governments if they fail to fulfill their fundamental responsibilities. To the extent that large audit firms are not insulated from bad outcomes of their decisions, they are unlikely to take excessive risks. Even in the event of a firm collapse, it is not clear how long it would take the market to adjust. The collapse of Andersen resulted in relatively little turmoil in most countries as the remaining firms quickly scaled their operations to absorb ex-Arthur Andersen clients. This transition was facilitated by the fact that much of the capacity in the human capital dominated system was retained by simply moving personnel, and in cases entire audit teams or offices, to one of the remaining firms.

Another way to increase auditor choice is to facilitate the continued growth of second tier firms (e.g., BDO, Grant Thornton) so that they can more effectively compete in the market for PIE audits. Part of the challenge here is reputational, which in turn derives from the perception that the Big 4 somehow conduct better audits. We believe this is probably the easiest obstacle to overcome since audit quality is simply the result of systems, processes and training which can be developed at any firm level. Inspection reports from public oversight bodies also assist with this point because they show that the Big 4 audit firms have deficiencies and that there is variation in audit quality among the Big 4. However, one potential barrier to entry that may not be so easy to overcome is the sheer size and reach necessary to provide a global presence to service clients that operate on a global basis. Another issue related to reputation that may be difficult to overcome is the so-called deep pockets of the largest firms which reflects the potential exposure to legal risks that are easier to absorb by very large firms.[32]

Overcoming barriers to entry based on size is difficult. One suggestion that has been made is to require joint audits of the largest PIEs so that smaller firms can begin to be integrated into the audits of these companies, potentially facilitating their growth and improvements in audit quality. We doubt that this would be an effective response, however. Such a requirement has been recently abolished in Denmark, and research suggests that a joint audit is not efficient and may not be any

[32] We do not address the issue of litigation reform related to the auditing profession because that has been the subject of another EU Consultation (IP/07/60.). We do note that the need to protect against very large legal exposures may serve as a barrier to entry for mid-tier firms trying to penetrate the market for PIEs.

more effective than having a single auditor.[33] Another, potentially more effective, approach is to re-consider the capital structure of accounting firms. Historically and traditionally, accounting firms have been structured as partnerships (albeit, now with limited liability options available). Thus, the capital of the firm is limited to the individual investments of the existing partners. Admitting new partners can generate more capital in relatively small increments but may also reduce profit sharing so we often see partners being dropped from firms when there are market pressures as we are observing now. This is an inefficient way to rapidly "grow" larger accounting firms, which may result in an unstable capital structure, and may not produce adequate cash flow to invest in process quality and innovation. Consequently, the time may be ripe to cautiously consider alternative capital structures up to, and including, public equity.

5. Simplification: SMEs and SMPs

In our opinion, we feel that the debate about having separate standards for SMEs is an artifact of the regulatory environment. Standards and regulations are written with an eye to the extreme cases, which are usually reflected by the largest PIEs. We feel that it is important to maintain the principle that "an audit is an audit". Thus it is not desirable to have separate auditing standards for SMEs. Such deviations have the potential to reduce the comparability of financial statements and may lead to confusion among clients, stakeholders and market participants. However, we understand that the cost of audit compliance can be quite high for SMEs, especially when the value of the statutory audit is solely compliance-based and the real value may be in aspects of the audit that do not relate directly to the opinion itself (e.g., access to expert accounting advice). One possibility is to replace mandatory audits with voluntary audits for certain SMEs as there is evidence that imposing audits suppresses the signaling value of an audit and it is difficult to force companies to privately contract for stringent audits.[34]

Instead of relaxing standards on audits for a subclass of engagements, we would point out that there are at least three potential remedies for SMEs when compliance costs are excessive from an organizational and societal view. First, SMPs, or even large firms that service SME clients, should explicitly address the aspects of regulation that pertain to an SME and not attempt to apply a one-size-fits-all approach to the audit that fails to consider the actual conditions of the client. It is possible that the many standards and regulations do not apply to a given client, not because of special exemption but because some standards are not relevant to the situation of the client.[35] Second, SMEs may be offered a choice of services that provide a lower level of financial statement assurance but still provides them with the ancillary benefits of engaging a high quality auditor (e.g., a review versus an audit). This option would directly relieve some of the regulatory overload while still meeting the objectives of the client and related stakeholders.

[33] See Holm and Thinggaard (2010) for a discussion of the Danish experience. See Francis, Richard and Vanstraelen (2009) and a study by the AMF (2007) for a discussion of the French experience.
[34] See Lennox and Pittman (2010).
[35] Recent research has raised the possibility from both a theoretical and empirical view that an auditor, being a rational and economically motivated participant in the audit market, can have the incentive to oversupply audit effort (and increase their fee) when there is significant information asymmetry between the client and the auditor about what is required in a standards-compliant audit. See Causholli and Knechel (2010) and Causholli, Knechel, Lin and Sappington (2010) for more detail.

Finally, it may be that audit firms that audit PIEs are not well suited to conducting audits in the smaller client market given the infrastructure (i.e., overhead) that they need for audits of PIEs that then gets factored into their billing structure. Thus, reducing the compliance cost for SMEs may simply require an informational campaign about the services rendered by SMPs and how they match the needs of smaller clients. A related observation follows from our discussion above: in the case of SMPs and SMEs, a prohibition against non-audit services may be particularly unjustified since the nature of service to small clients makes the distinction blurry, difficult to enforce, and may remove some of the most important benefits that a client obtains from their relationship with an accounting firm.

Conclusion and Recommendations

We started our response with two key questions raised in the "Green Paper" as a motivation to address a number of potentially important topics related to the structure, conduct and regulation of the auditing profession:

1. Could the auditing profession have done a better job of signaling risk and potential problems of financial institutions leading up to, and during, the crisis?

2. How does the current level of concentration among international audit firms affect the quality of auditing and financial reporting in the future?

Our approach has been to address these issues in the context of what we do and do not know from the current state of the art in audit research.

We conclude that the answer to the first question is positive. We argue that the financial crisis is less related to problems of governance and independence and more to the quality of the audit process and auditor reporting (i.e., effective communication with stakeholders). Furthermore, given that it is likely that the new regulations on governance and independence included in the 8th EU Directive had not yet had their full effect at the start of the crisis, it seems premature to develop extensive new regulations at this point. Hence, we recommend the EC to wait for the full implementation of the 8th EU Directive and then evaluate how it has influenced audit quality before developing new regulations concerning firm governance and independence. Instead, we recommend the EC to focus current discussions on improving audit quality at the engagement level and to assist auditors to develop better tools to address systemic risk across engagements.

With regard to the second question, we conclude that based on extant empirical evidence there is no support that the current level of concentration negatively affects audit quality and it seems that the current market structure with only four large firms is still highly competitive in many ways. At the same time, the concentrated market creates problems in terms of auditor choice for certain PIEs. Solving this issue is complicated and needs a careful economic analysis as many of the potential solutions are likely to have unintended economic consequences.

We would like to conclude with the following observations: First, it is desirable that audit firms compete on quality, rather than price, which could subtly change the nature of the audit market and have a direct impact on the tender process when a new auditor is engaged. Such a shift could go a long way to alleviate current concerns about the accounting and auditing profession. Such

a perspective is well-grounded in the theoretical and conceptual foundation of the auditing profession which assigns the auditor the role of serving the public interest. In a market setting with a high degree of transparency about audit quality, possibly achieved through inspection reports by public oversight bodies, *and* assuming that public oversight bodies have the competence to adequately perform such inspections, incentives for auditors would shift such that audit quality becomes the focus of their audit process and marketing, improving both the quality of audits and public perception of audit quality.

Second, it would be desirable if audit committees more fully take up their responsibilities set out in the EU 8th Directive and play a more prominent role in the supervision of the audit function (i.e. selection and monitoring). The continued development of best practices and guidance for audit committees can assist in this regard.

Our final point is to state the obvious: management is ultimately responsible for the quality of financial reporting. This responsibility cannot simply be transferred to regulators, public oversight bodies, auditors, or any other governance mechanism. In this regard, "it is crucial to understand that the Achilles' heel of any regulatory system is not likely to be lack of oversight but a lack of foresight."[36]

We again thank the Commission for allowing us this opportunity to share our understanding of audit research in the context of the current economic crisis and potential actions that may follow in its aftermath. We look forward to observing, and participating in, this dialogue as it moves forward.

[36] See Humphrey and Moizer (2008, p. 277).

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