

## Opening remarks to US Treasury Department's Advisory Committee on the Auditing Profession

Paul Boyle,  
Chief Executive  
Financial Reporting Council

3<sup>rd</sup> December 2007  
Washington, DC, USA

**Chairmen and Members of the Committee,**

I would like to thank you for the opportunity to participate in today's meeting.

### **Introduction:**

I address you as CEO of the FRC, the UK's independent regulator responsible for promoting confidence in corporate reporting and governance; our responsibilities include regulation of the audit profession, where our remit has some similarities to that of the PCAOB.

I also am privileged to be the Chairman of the International Forum of Independent Audit Regulators (known as IFIAR), whose members are 22 audit regulatory authorities from across the world and which is promoting regulatory cooperation across the world.

For the record I should make it clear that my comments today are personal and do not necessarily represent the views of the FRC, IFIAR or any of its members.

I would like to supplement the written testimony which I have already submitted to the Committee in order to persuade you of two things:

1. The seriousness of the risks to economic prosperity posed by the current level of concentration in the audit market.
2. There is no "silver bullet" solution, but there are a range of actions which can contribute to reducing the risks, of which the one with the greatest medium to long-term potential is reform of the rules governing the funding of audit firms.

### **The risks are serious and require urgent action:**

It is no exaggeration to say that the current state of the audit market poses significant risks to economic prosperity. Indeed, in one sense it is unnecessary

for me to persuade you on this point, since the very existence of this Committee is confirmation of the seriousness of the risks. However, it is probably worth making the analysis explicit. My analysis is based on the three key dimensions of risk: impact, probability and duration.

The reality is that the US economy, and all major developed economies, have evolved to operate on the assumption that high quality, independent, audit services will be available wherever and whenever required. The ready availability of high quality audit is taken for granted as much as the ready availability of electricity or clean water.

The availability of audit is taken for granted not only in the operation of the securities market but also in other important sectors of the economy too.

It is possible to contemplate a re-designed economy which could operate without high quality, independent audit. But an economy without audit would be a less productive economy. An interruption in the supply of audit would be as damaging as an interruption in the supply of electricity or water.

There are a large number of events which could disrupt the supply of high quality independent audit. However, in my judgement the most serious risk is the possible withdrawal - voluntarily or involuntarily - of one of the major firms from the market.

My assessment is supported by those who presently are in the best position - indeed possibly the only position - to assess the risks, namely the senior management of the major firms. One only needs to listen to the passion with which they argue the case for reform of auditor liability to understand their assessment of the risk.

As regards probability, it would be close to negligent for policymakers to dismiss the probability of the loss of a major audit firm as low.

There have been a number of well-documented actual audit firm withdrawals from the market in recent years and a number of other "near misses". There are no doubt other potential risks which are yet not in the public domain.

The demise of Andersen illustrates that audit firms have some similar characteristics to banks. A loss of confidence can trigger a run (but of clients rather than of depositors) which may be impossible to stop, or which can only be stopped at extraordinary cost.

Once again, the urgency and force of the arguments from the audit firms for liability reform suggests that they too are assessing the probability as higher than low. And for policymakers, the relevant probability is not the same as it is for the management of the firms; the relevant probability is the cumulative probability that any of the major firms would withdraw from the market.

As regards duration, it is axiomatic that we should be more worried about long-lasting risks than short-duration risks.

The key issue is the capacity of the market to absorb, without disruption, the loss of a major audit firm. Some argue that the Andersen incident should give us confidence. However, the problems which will be faced in absorbing one into three are much greater than was the case in absorbing one into four, particularly because of the necessary rules relating to auditor independence.

In the absence of significant changes in policy, the most likely scenario is that the current concentration of the major firms will persist for many years. In other words, on current policies the duration of the risk is very long.

In summary, the risk of disruption to the continued supply of high quality, independent audit is significant and requires action by policymakers. At the risk of disrupting what I know is intended to be a bi-partisan committee, we are faced with what might be called an inconvenient truth.

### **Mitigating actions are feasible**

I suspect that a number of policymakers have been aware of this inconvenient truth for some time, but have not acted because they had been unable to identify solutions. This is no longer the case.

It is worth noting that the FRC has not sought to reduce the risks to zero, but rather to move from a high risk position to a lower - not necessarily even low - risk position.

I would commend to you the report of the FRC's Market Participants Group (MPG). The MPG consisted of equal numbers of corporate representatives, auditors, and users of financial statements. Its report was unanimous.

When considering the MPG's recommendations, three points are worth bearing in mind.

Firstly, throughout the two-year public debate in the UK, no commentator identified a "silver bullet", ie a single policy proposal which, on its own, would

solve the problem. For this reason the MPG proposed a package of proposals, some of them modest, which have the potential, cumulatively, to reduce the risks.

Secondly, it is possible to criticise the MPG's recommendations for this or that imperfection. However, given the risks presented by the status quo, perfection is a luxury which we cannot afford.

Thirdly, the extent to which the 15 recommendations of the MPG are internationally transferable varies considerably. Some of them are very much set in the context of the UK; corporate governance law and traditions which differ from those in the US. Some of them do, in my view, have greater potential relevance internationally.

The recommendation which in my view offers the greatest medium to long-term potential for reducing the risks is reform of the rules governing the funding of audit firms.

The present position in many jurisdictions is that only qualified auditors are permitted to control and be the source of equity capital for audit firms. The origins of this requirement date back many decades. The policy objective appears to have been protecting audit quality and auditor independence.

Let us consider an analogous example. Everyone would agree that air passenger safety is an important public policy objective; but no-one would agree with a rule which required that only qualified pilots can own airlines. Simply put, there are other regulatory tools which can be successfully deployed to provide reasonable assurance that airlines owned by non-pilots can be safe. The position is similar for other important public policy objectives such as food safety, drug safety and the fairness of financial advisory services. The time has come to reform the position in relation to audit.

Why? The reason is that if we are to reduce the risks posed by the collapse of a major audit firm we need to have more firms capable of auditing major public companies so that the economy is less vulnerable to the withdrawal of any one firm.

One of the issues which the MPG report emphasised is the need to avoid damaging audit quality. For this reason, the additional firms which we would like to see need to have the systems and people necessary to deal with the scale and complexity of major audit assignments. This requires investment. If the only source of capital is from the partners of a firm then the rate of investment undertaken by existing mid-tier firms or potential new entrants will be much less

than would otherwise be the case. The effect will be to extend the duration of the risks.

There is no reason why a change in the ownership rules need damage audit quality and independence. The existing regulatory requirements for audit standards and independence can remain substantially unaltered. It is just that their operation will focus on the management and operations of the audit firms, not on their owners. The new arrangements for regulating audit firms, such as the PCAOB in the US and the FRC in the UK, can continue. These new arrangements make a more direct contribution to audit quality than does the indirect operation of the ownership rule, which has in any case proved to be an inadequate source of protection of audit quality and independence.

The possibility of changing the ownership and funding rules is now the subject of serious debate in the UK. The FRC will be publishing a further paper on the issue early in 2008. It is also the subject of serious debate in the European Union. I referred in my written testimony to a research report recently published by the European Commission and I expect the debate in the EU will move to a more advanced stage in 2008. The issue is raised in your own Committee's Working Discussion Outline.

I believe it is a possibility which merits detailed attention from the Committee.

Finally, a word on reform of auditor liability, on which the firms place much weight. I accept the firms' arguments that it is not appropriate for them to act as insurers of the world's capital markets. For this reason, liability reform is desirable but it is not a sufficient step. Audit firms are exposed not only to audit risks but a much wider set of financial and reputational risks. And, of course, it is neither possible, nor desirable, to reduce to zero the risk of the withdrawal of a major firm from the market. I am not confident that we can, or should, prevent the withdrawal of a major firm, so we need to be better placed to respond to it if it happens.

Thank you for your attention and I look forward to answering your questions.