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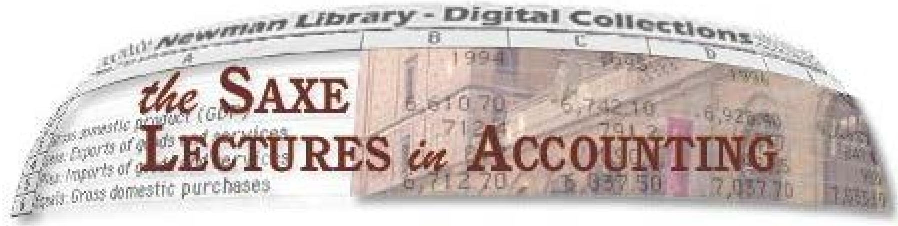

Restoring Investor Trust: The role of auditor competition in the future of the capital markets

by
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Ed has been with Grant Thornton for more than 27 years. Previously Ed was National Managing Partner of Professional Services, served as the Managing Partner of the Philadelphia Office and Grant Thornton's National Director of Assurance Services based in New York. He has been chairman of Grant Thornton International's Audit Policy Committee, chairman of the U.S. firm's Strategic Initiatives Objectives Committee, chairman of Grant Thornton's U.S. Capital Markets Committee, and chairman of the firm's Assurance Services Advisory Committee.

Ed is a member of the Financial Accounting Standards Board (FASB) Advisory Council and a member of the Small Business Advisory Committee. He was previously a member of the FASB Emerging Issues Task Force, and participated on several of the task force's working groups. Ed is member of American Institute of Certified Public Accountants (AICPA) where he has been a member of the SEC Practice Section's Executive Committee and the Professional Issues Task Force. Ed is a former member of the AICPA Auditing Standards Board (ASB) and ASB Audit Issues Task Force. Ed is also a member of the Steering Committee for the Talent Task Force looking at talent in the accounting profession.

Ed holds an MS in Management from Purdue University and a BS in Business Administration, summa cum laude, from The Ohio State University. He writes articles for a variety of publications including *The Wall Street Journal, Journal of Corporate Accounting & Finance and Accounting Today*. He is a frequent speaker at seminars and conferences.

Independent audits are the linchpin between a company's financial statements and their credibility with the investing public. As such, the accuracy and transparency of this information is critical to the integrity of our U.S. capital markets. However, in the wake of major corporate scandals, decades of consolidation, the dissolution of Arthur Andersen and the introduction of sweeping regulatory changes, the transparency of independent audits, as well as the future of our financial markets, may be at great risk.

According to the Government Accountability Office's (GAO) July 2003 Mandated Study on Consolidation and Competition, the Big Four - Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers - audited 78 percent of all U.S. public companies, 99 percent of all public company sales and 97 percent of public companies with sales of more than $250 million at that time.

With the Big Four stretched to capacity, many market participants started to question the current audit system and its resistance against another accounting firm failure. Even America's largest organizations - 86 percent of the Fortune 1000 companies surveyed by the GAO - said they would prefer more than four audit firm choices.

Since the GAO study's release in 2003, more companies have begun looking outside the Big Four for audit service; however, such findings still reinforce a false perception that there are no other audit firms capable of performing independent audits besides the Big Four. The reality is that alternatives do exist for most public companies. There are a number of qualified global, national, regional and local firms - each with different skill sets, market expertise and geographic reach - are available to meet the varying needs of a diverse array of most public companies. By effectively matching a company's size and needs with that of a compatible firm, companies would find the best combination of quality, service, value and reach. U.S. markets would be protected by spreading risk among a greater number of audit firms.

The independent audit's role in a changing accounting environment

For public companies, the independent audit serves as the foundation upon which their financial health rests. Accordingly, it is no surprise that 61 percent of executives polled in Grant Thornton's Business Leaders Survey believe that inaccuracy in this information would be a critical or very serious threat to their business - a larger percentage than the threats from terrorism, a natural disaster, a stagnant economy, product recall or litigation.

However, as important as a financial statement is to the company it represents, the organization itself is not the only party that depends upon the independent audit and its accuracy. Rather:

- Investors rely on audited financial statements to build their portfolios
- Analysts and rating agencies need audited statements to reach their assessments and evaluations
- Contracts and agreements depend on audited financial results
- Regulators need audited financial statements to do their jobs.

Simply put, without accurate audits, the entire capital markets system would be put in jeopardy - a fact that makes recent changes in our accounting environment of notable importance. This shift began in the late 1980s when accounting firm mergers reduced the number of large audit firms from eight to six. Nearly a decade later in 1997, Price Waterhouse and Coopers & Lybrand merged to form PricewaterhouseCoopers, dropping that number to five to create the world's largest accounting and consulting firm.

It looked as though the mega-merger trend would continue the following year with a proposed combination between KPMG and Ernst & Young. However, the merger never took place. The head of KPMG Peat Marwick blamed the collapse on regulatory and client issues.

The fact that the merger fell through only a few months after being hailed as the best way to serve global corporate clients called into question whether mega mergers were, in fact, the best course for the industry. Regulators in the United States, Europe and elsewhere feared that an Ernst-KPMG firm would dominate the audit market for clients in certain industries and countries, resulting in greater conflicts of interest between the firms' auditing and consulting units and higher audit prices for corporate clients.

At the turn of the 21st century came more unexpected changes in the accounting industry. After several years of great prosperity, U.S. companies and investors watched as a number of very large corporations collapsed, one after another, following some corporate scandals. From Enron to WorldCom to HealthSouth, these scandals seemed to evolve almost overnight, devaluing the public's perception of the company and its industry, and weakening the U.S. markets as a whole. And, alongside one of the greatest corporate falls of all - Enron - came that of Arthur Andersen, one of the world's largest and most powerful accounting firms, making real what the Ernst & Young/KPMG merger threatened years before.

With Andersen's collapse came more auditor concentration; according to the GAO, 87 percent of Andersen's more than 1000 former audit clients switched to a Big Four firm. A new regulatory environment also emerged, as Congress passed and President Bush signed into law the Sarbanes-Oxley Act of 2002.

Designed to restore public trust in U.S. corporations and markets, Sarbanes-Oxley made corporate governance no longer just a good business practice, but the law. It focused on five principal areas of reform, as follows:

(1) expanded responsibilities for management, its board of directors and the audit committee;

(2) enhanced financial disclosures;

(3) reduced analyst conflicts of interest;

(4) expanded penalties for securities fraud; and

(5) creation of an independent Public Company Accounting Oversight Board (PCAOB) as a division of the Securities and Exchange Commission.

Appropriately implementing these changes proved challenging. Auditors suddenly found themselves struggling to meet all of the legislation's demands in a less accommodating, less client/user-friendly and more labor-intensive atmosphere. Finding the right answers often became more difficult than in the past, as companies quickly found that audit questions previously resolved in a matter of hours now required days or even weeks as auditors' work was checked and double-checked. This perceived decline in service - manifested in timing delays, unavailable staff, increased cost and a much more sterile atmosphere - soon began to put a strain on auditor-client relationships.

Along with expanded auditor responsibilities, Sarbanes-Oxley also added another notable element to the audit process; it mandated that corporate directors are legally responsible for appointing, compensating and overseeing their external auditors. It was due in part to this requirement that skepticism of audit professionals increased; not only as boards and audit committees began assessing their auditors' performance, but also as the media and regulatory leaders began to voice their opinions regarding the current audit environment and its problems.

Among those expressing their concern was then PCAOB Chairman William McDonough. In an exit interview with *The Wall Street Journal* published on 17 October 2005, he said that the PCAOB now encouraged issuers to "...really look for an audit firm that makes sense for... them. There's been a sort of a notion that rating agencies and maybe your lenders will think it's particularly spiffy if you're a small or medium sized company and you deal with a Big Four firm. Frankly, I don't think that makes a whole lot of sense."

PCAOB member Kayla Gillan echoed these sentiments at the Association of Corporate Counsel annual meeting, saying, "I urge audit committees to challenge the assumption that they must use a Big Four audit firm." Gillan encouraged companies to consider one of the other 800 registered public company audit firms when deciding whether to retain their current auditor or hire a new firm.

SEC Chairman Christopher Cox also raised concerns about the current state of the U.S. accounting profession at a meeting of the American Institute of Certified Public Accountants. He called for clearer, more straightforward accounting rules, saying it would benefit investors, public companies and accountants. "Plain English is just as important in accountancy," he said.

Cox went on to discuss auditor concentration and the fact that the Big Four handle the vast majority of public-company audits. He stated that such "intense concentration" isn't desirable. He added that regulators need to consider whether their rules are inhibiting competition in the field.

Furthermore, at a conference of auditing and accounting professionals in December 2004, the existence of a dwindling number of accounting firms even raised concerns among European Union regulators. "This is a very dangerous situation," said Alexander Schaub, Director General of the European Union Internal Markets Commission. "With just four big auditors remaining, you can't guarantee that companies find auditors that aren't already auditing their main competitors. You could introduce strict requirements on conflict of interest," Schaub added. "But in my view, the best solution would be for the market to find its own way."

The topic of auditor concentration was also addressed in May 2005, when a group of 53 men and women - including leaders from the regulatory, accounting, financial, legal, academic, investment banking and journalistic arenas, as well as corporate board members and audit committee chairs - gathered at The University Club in New York City for an American Assembly meeting. During the meeting, most aspects of the current audit environment were discussed, including the actual degree of auditor concentration, whether more competition should be encouraged, how to prevent increased concentration, as well as steps to ensure the continued stability and vibrancy of the accounting profession. As summarized from its published report, *The Future of the Accounting Profession: Auditor Concentration*, meeting attendees found as follows:

- The four largest accounting firms may be able to meet the needs of the largest U.S. companies, but the loss of one of these firms would create an intolerable situation.

> "*The current degree of concentration in the profession raises the specter that the collapse of a Big Four firm would be a threat to the continued existence of the profession. An audit environment with only three large firms may be too small a number to maintain audit quality and independence, and any event that causes another firm's collapse would automatically call into question the viability of the survivors.*"

- The current level of auditor concentration is only a problem for companies that believe they must use a Big Four firm, without knowing that other firms are capable of serving all but the largest public companies:

> "Practically all those present expressed the belief that mid-tier firms could satisfactorily serve a large number of those companies that seem to be principally served by the Big Four."

- There are artificial and real barriers preventing mid-tier firms from increasing their market share. Misperceptions among market influencers are one factor, but participants within these user groups conceded such perceptions are to some extent unwarranted.

The slowly-changing audit landscape and what more can be done

The good news is that things are slowly changing in the independent audit arena, as companies, boards, audit committees and external auditors have begun to re-examine their relationships with one another. This progress is validated by the number of SEC-announced auditor changes from a Big Four firm to another global, national, regional or local firm from 280 changes in 2003 to 421 in 2004 and 414 in 2005.

At Grant Thornton, we attribute much of this movement to the belief that when organizations examine their current auditor relationship, they realize that they can be served as well - and in some cases better - by a non-Big Four firm targeted to their market segment or industry. The secret these companies have learned is "right sizing" - matching company size and requirements with a firm's size and capabilities to find the best fit.

Consider the case of Audiovox. In October 2003, pursuant to the recommendation of its audit committee and its board of directors, Audiovox appointed Grant Thornton LLP as its independent auditor, replacing Big Four firm KPMG LLP. In commenting on the company's switch to Grant Thornton, John Shalam, Audiovox CFO, noted Grant Thornton's ability to perform the same work as their former Big Four provider:

> "In this complex world of controls, finance and accounting, Grant Thornton helps us address these issues. I can tell you, that after working with a Big Four firm for 20 years, they do not have the corner on technical expertise. The technical skills from our Grant Thornton team are exceptional. We have worldwide businesses and whether it's in Germany, Venezuela, Malaysia or China, Grant Thornton has the global reach to assist us in these countries. The international service teams run smoothly and again - there is never a question about technical know-how."

Right sizing is not only about cost or technical expertise. It's also about service and attention, communication and responsiveness. Companies owe it to themselves and their investors to evaluate an array of qualified global, national, regional and even local firms to ensure they are receiving the best combination of quality, service, value and reach to meet their needs. It's good governance, and it's good business for companies to seek better service.

Grant Thornton's five steps

However, as much as right sizing is the responsibility of the company to reassess and do their homework, it is also the responsibility of others in the capital markets. Investment and commercial bankers, lawyers, insurers, analysts, rating agencies and other opinion leaders should not limit public company auditor choices to just the Big Four. With this in mind, Grant Thornton has developed five steps for increasing company choice and auditor competition, an initiative led by Mr. Cono Fusco, Grant Thornton LLP Managing Partner of Strategic Relationships, as follows:

1. The SEC and our nation's stock exchanges should encourage, as a best practice, that public companies conduct a periodic review of their audit firm choices to be sure they are getting the best combination of quality, service, value and reach.

It should be noted that Grant Thornton is not advocating mandatory auditor rotation in which companies would be required to change auditors even if they are already working with the firm best suited to meet their needs. But, as a matter of good governance and good business, Grant Thornton believes that companies should be encouraged to periodically evaluate their audit firm choices to ensure they are getting the best combination of quality, service, value and reach from their external audit firm.

Encouraging the periodic review of auditor choices as a best practice is consistent with Grant Thornton's belief in free market solutions, as opposed to more drastic, regulation-based proposals, such as breaking up the Big Four or placing limits on a firm's market share. Both of these latter proposals place artificial constraints on the competitive landscape and limit company choice.

It should be further noted that The Conference Board Commission on Public Trust and Private Enterprise, as part of their Best Practice Suggestions, also called for periodic review of audit firm choices. According to the official report issued in 2003, companies should evaluate their external audit firm on an annual basis and conduct a more thorough review - giving serious consideration to alternative firms - every five to seven years.

Some firms may find it difficult to change auditors if they have employed separate firms for their audit, tax and consulting work. Therein, if they want to change their current auditor, they would then have to change multiple service providers to avoid any independence issues. This issue is a difficult and potentially expensive one. As a result, we believe this issue should be noted and addressed by regulatory bodies.

2. Public company boards and audit committees, in this changed audit environment, should "right-size" their audit firm by matching company size, complexity and requirements with firm size and capabilities.

In matching company size and requirements with firm size and capabilities, companies may very well reaffirm their decision to continue working with their current audit firm. But they may also find that another firm could combine the same or better technical expertise with service, attention and market or industry expertise for a better fit.

3. Companies and other capital markets influencers - including investors, analysts, commercial and investment bankers, and attorneys - should open the door to more audit firm choices. There are more than four audit firms capable of serving public companies, but misperceptions in the capital markets on occasion pre-empt company choices. Some underwriters encourage companies planning an IPO to use a Big Four firm. Limiting auditor choice in this way is prohibitive in that it:

- pre-emits or vetoes the Sarbanes-Oxley mandated responsibilities of audit committees to select company auditors,
- stifles competition with a potentially negative impact on service, value, innovation and quality, and

- further exacerbates the limited choices companies face in selecting new auditors.

An integral part of this process includes updating auditor change disclosure requirements, which for three decades have helped fuel the negative perception that organizations change auditors in order to gain a more favorable opinion or escape a problem. This issue first began in the 1970s with the creation of a system for reporting auditor changes through 8-K filings, and still persists today. It distorts assessments of analysts, ratings agencies, investors and others involved in the capital markets.

It is not difficult to understand how negative perceptions of auditor changes developed. When first addressed by the SEC as a means to curtail opinion shopping, Form 8-K filings were only required when there was a disagreement between a company and its auditors. As a result, changes were continually associated with problems - real or perceived - in a company's financial statements.

In 1988, the SEC updated these rules, requiring all companies to report auditor changes in 8-K filings, as well whether or not there had been any one of four reportable events or any disagreements between a company and its audit firm. (1) This updating expanded the auditor change disclosure requirements to include all auditor changes. However, the only required disclosures surrounding the auditor change were negative disclosures, despite the fact that there are some positive reasons for an auditor change, such as changing to work with a firm that specializes in your industry or market segment, getting better service from your firm, or getting a better value for fees.

Accordingly, over time, an auditor change had become a false signal that problems may exist with a company's financial statements. As a result, many companies are reluctant to change audit firms, even if they want to change for the right reasons.

Luckily, some companies are listening, proactively addressing these misperceptions in the market by offering reasons for auditor changes even in instances where the current rules do not require a stated reason. Eleven percent more companies offered reasons for auditor changes in 2004 than in 2003, even though there was virtually no change in the number of required disclosures of disagreements and reportable events.

Public acceptance of audit firm changes is improving. Nevertheless, the current 8-K rules must be reformed to increase the level of transparency surrounding audit firm changes and to assure that communications between the new audit firm and its predecessor firm allow for the highest standards of accountability. Accordingly, Grant Thornton suggests the following changes to improve the disclosure process:

- All public companies should be required to give a reason for an audit firm change, and all audit firms should be required to document why they are resigning as auditors from a company or not standing for reappointment.

- Successor auditors should also be given full access to all of the predecessor's working papers and accountants who previously worked with the client. Full discussions and access could reduce the risk that a sensitive area is not given appropriate attention by the successor.

4. The PCAOB and the audit profession should share and coordinate best practices for the audit process, including audit procedures, evaluation of fraud risk and possibly audit software. All firms should periodically assess whether or not they have the requisite attributes to serve specific clients.

Sharing best practices among the leading audit firms would significantly enhance audit effectiveness and increase public confidence in quality audits. Grant Thornton also believes that the best audits are completed when companies and audit firms are appropriately matched. Accordingly, just as companies should periodically evaluate firm choices, auditors should evaluate their resources in relation to client needs to determine if they are still appropriately matched in terms of size and service capabilities.

For the largest firms, this may mean resigning from certain clients in order to reallocate resources to serve the largest clients. For smaller firms, this may be an opportunity to recognize that certain clients have grown beyond their capabilities or have entered industries in which the firm is not experienced.

5. A debate and discussion on the topic of auditor liability exposure should begin.

American Assembly findings

In addition to Grant Thornton's efforts, the American Assembly meeting and report also produced a number of observations for improving auditor consolidation and competition, as follows:

- Audit committees should reconsider the performance of their external auditors at regular intervals. This will provide non-Big-Four audit firms with more opportunities to compete for clients of the Big Four.

- Non-Big Four firms should consider performing outreach to audit committee chairs, attorneys and investment bankers who work on IPOs, as well as to members of the Big Four who help companies consider alternatives when they end client relationships. Such involvement could improve the chances that a Big Four firm would advise a former client to consider a non-Big Four firm.

- As more firms either outsource their internal audit function or use an external auditor to bolster their own internal audit department, non-Big Four firms may have more opportunities to become associated with the larger clients of the Big Four. The fact that a smaller firm may not have the capacity to conduct an audit of a multibillion dollar international corporation does not mean that the same firm could not assist the internal audit function.

- More non-Big Four firm representatives should be invited to participate in debates concerning new regulations and reforms.

- Analysts, credit rating agencies, investment bankers and lawyers should not be as authoritative as they appear to be in persuading their clients not to use non-Big Four firms.

White House meeting

Following the American Assembly meeting, the President's Council of Economic Advisors Chief of Staff also held a roundtable in the fall of 2005 to discuss the topic of auditor concentration. Participants of the meeting included the AICPA, Grant Thornton, BDO Seidman, McGladrey & Pullen, Crowe Chizek, Eisner & Co., Plante & Moran and Moss Adams.

At the meeting, it was noted that today more public companies are audited by non-Big Four firms than prior to Sarbanes-Oxley; however, the lack of auditor choice by the largest of public companies continues to be a public policy concern. Four major concepts were discussed as possible means of correcting this issue and increasing auditor choice, as follows:

1. Competition forces related to conflicts--Some companies face real or perceived conflicts of interest with their Big Four auditors because the Big Four firm provides non-audit defined services in addition to performing the audit . This could be improved by having more firms perform non-audit services, thereby keeping a maximum number of Big Four firms not conflicted and thus able to compete for audit work.

2. Liability reform--Liability claims in those firms below the Big Four have made insurance less available, thus making it more difficult for smaller firms to move up market. This liability issue could be addressed in many ways, including: regulatory preemptions, proportionate legislative caps, minimization of vicarious liability and proportionate liability as opposed to joint and several liability.

3. Marketplace permissions/messages--To enhance the likelihood of public companies using non-Big Four firms, it is important for key policy makers to recognize the depth of quality that exists in the firms below the Big Four firms. Policy makers at the highest levels should embrace non-Big Four firms by including them in policy discussions and on appropriate councils and committees, by speaking of the profession more broadly than just in terms of the Big Four firms, and by encouraging market leaders to be more receptive to using non-Big Four firms. In addition, policy makers should encourage audit committee members to look at the profession more broadly.

IPOs

In particular, greater policy-maker support would be advantageous to non-Big Four firms during the IPO process. As of the two-year period that ended Sept. 30, 2005, 85 percent of all IPOs had Big Four firms as their auditors. Many of these companies were former clients of non-Big Four firms; however, in the process of becoming a public entity, they were encouraged to switch to a Big Four firm as a perceived risk mitigation strategy by underwriters or Wall Street advisors.

Audit committee risk

Today, audit committees are empowered to hire auditors and other firms for non-audit services. However, due to the high amount of risk considerations, audit committees often select Big Four firms because they believe that the choice of a Big Four firm is less likely to be second guessed in the event of negative future problems. Audit committees are empowered to hire other firms. While they may feel that a non-Big Four firm has the best needs of the company.

Regulatory inspections

In addition, regulatory bodies must also be certain that inspections and enforcement activities are not biased toward a Big Four approach. Regulators must address this issue and inform audit committees that non-Big Four firms might approach audit work in a different, but equally acceptable, if not better way.

4. Access to greater capital

Capital is a necessary element for a non-Big Four firm in building international networks, advancing technology and expanding other competencies in an effort to serve larger public companies. Unfortunately for these firms, current forms of practice rules, some rooted in state law, minimize capital raising opportunities. Greater access to capital through more innovative structures other than essentially partnership structures could fuel growth and competition among the smaller accounting firms.

Conclusion

Companies, boards, regulators and other market influencers are becoming more aware of the current audit environment. To some extent, the discussion of those challenges facing the accounting profession is beginning to intensify - particularly as it relates to capacity and liability concerns.

Perhaps over time, market forces alone could lead to greater auditor diversification and reduce the systemic risk of auditor concentration. But "over time" is too long to wait and simply too risky.

The fact is, no one group or action will be able to effectively address all the challenges our profession - and our markets - now face. Rather, it is the responsibility of the collective capital markets to affect change. With this in mind, Grant Thornton urges all parties involved in the audit process and financial reporting to embrace the realities of auditor concentration and examine all possibilities to improve audit firm competition. The future of our financial markets may depend on it.

Footnote

(1)The four reportable events pursuant to Item 304 of Regulation S-K areas follow:

(1)Internal controls necessry for reliable financial statements do not exist.

(2)The auditor no longer is able to rely on management representations.

(3)Serious audit scope problems have arisen.

(4)An unresolved financial reporting issue.