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Competition and Concentration Panel

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INTRODUCTION

I am Kurt Schacht and I am the Managing Director of the CFA Institute Centre for Financial Market Integrity[1]. I would like to thank Chairman Levitt, Chairman Nicolaisen and the distinguished members of the Committee for inviting me to testify about the recommendations of the competition and concentration sub-committee included in the May 5, 2008 draft report.

The CFA Institute Centre represents the views of investment professionals, including portfolio managers, investment analysts and advisors located in over 130 countries worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users remains of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics and Standards of Professional Conduct.*

Although the sub-committee has made some progress in its assessment of public company audit market concentration and competition, it is extremely difficult to state with any certainty the solutions for improving capacity and competition in the audit industry. Clearly, the impact of concentration and competition on audit quality and effectiveness is an issue of importance to investors. Investors require timeliness, transparency, comparability, and consistency in financial reporting in order to make fully informed and reasoned investment decisions. Analysis and recommendations by the sub-committee which could prevent the disruption of the timing and quality of financial information are welcomed by the investment community.

In addition to the matters discussed by this sub-committee it has also been suggested by several observers that capacity and concentration are impacted by the perception of

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1 The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 95,300 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom more than 79,800 are holders of the Chartered Financial Anal st® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 56 countries and territories.

litigation risk against the auditing profession. Accordingly, the subject of liability reforms or limits has been raised as one potential means of reducing concentration and increasing capacity. We understand that the Advisory Committee continues to have difficulty in obtaining information on actual judgment or settlement data on claims against firms and GAAP basis financial information from firms which could confirm what level of liability reform is appropriate or necessary. As such, we remain uncertain that litigation risk is a meaningful factor in the competition and concentration discussion. In any event, a more important consideration is how to assist the industry in promoting alternative and additional firms with the full range of skills, capacity and international standing to expand competition.

Presented in the next section are some observations and comments relating to the six core recommendations of the sub-committee in its draft report.

SPECIFIC COMMENTS ON THE SUB-COMMITTEE RECOMMENDATIONS

Recommendation 1. Reduce barriers to the growth of smaller auditing firms consistent with an overall policy goal of promoting audit quality. Because smaller auditing firms are likely to become significant competitors in the market for larger company audits only in the long term, the Committee recognizes that Recommendation 2 will be a higher priority in the near term.

(a) Require disclosure by public companies in their annual reports and proxy statements of any provisions in agreements with third parties that limit auditor choice.

Transparent disclosure of agreements which limit auditor choice by public companies, including the reason for the limits, should be disclosed in annual reports and proxy statements.

Of particular interest to investors and companies would be PCAOB attention to artificial or intentional financial penalties/barriers to changing public company auditors. Situations where a predecessor audit firm charges a former client company significant funds to reissue opinions already paid for or otherwise require payment or fees to produce work papers or nominal assistance to the successor audit firms has been brought to our attention. The PCAOB is encouraged to consider appropriate measures to review and investigate the reasons for the auditor change and ensure that the transition has occurred in accordance with the established standards. This would ensure that the investor and company are protected from extraordinary costs and a protracted transition.

(b) Include representatives of smaller auditing firms in committees, public forums, fellowships, and other engagements.

Investors place importance on the reputation and credibility an auditing firm brings to the independent audit of a company. Brand name may be of some importance depending on a number of factors including complexity of the company and its operations, international activities, etc. however, investors are more interested in the quality of the financial report especially the footnote disclosures.

Increasing awareness of smaller firms through involvement on significant committees of regulators and policymakers, such as the SEC, the PCAOB, and the Financial Accounting Standards Board should further strengthen the firm's profile and investor confidence in these firms. The sub-committee's recommendation might also extend beyond U.S. organizations, by encouraging smaller firm representation on international organizations. With the move toward international convergence of accounting standards, demonstrating technical competence in this area is of increasing importance.

Smaller firms can strengthen their recognition further by commenting on technical matters under consideration by the International Accounting Standards Board, Financial Accounting Standards Board, the Securities and Exchange Commission, etc. In our experience, small to mid-size firms seldom respond with regular frequency on technical matters under consideration by regulators and standard setters. Responding to exposure drafts, preliminary views statements proposed rules is yet another means of bolstering brand identity.

Recommendation 2. Monitor potential sources of catastrophic risk faced by public company auditing firms and create a mechanism for the preservation and rehabilitation of troubled larger public company auditing firms.

(a) As part of its current oversight over registered auditing firms, the PCAOB should monitor potential sources of catastrophic risk which would threaten audit quality.

The sub-committee's recommendation to extend the PCAOB oversight to monitoring the potential emerging sources of catastrophic risk which would threaten audit quality seems to state what are obvious expectations of markets and investors. This is clearly in the best interest of investors and other users of financial reports. As we understand it, this recommendation is meant to address, more proactively, emerging industry-wide practices rather than firm specific practices which are presently under the purview of the PCAOB mandate.

This monitoring compliments Recommendation 3 which would require the development and disclosure of key audit quality indicators. Pro-active intervention by the PCAOB or others when there is deterioration in audit quality, should lessen the likelihood that a catastrophic audit failures occur.

(b) Establish a mechanism to assist in the preservation and rehabilitation of a troubled larger auditing firm. A first step would encourage larger auditing firms to adopt voluntarily a contingent streamlined internal governance mechanism that could be triggered in the event of threatening circumstances. If the governance mechanism failed to stabilize the firm, a second step would permit the SEC to appoint a court-approved trustee to seek to preserve and rehabilitate the firm by

addressing the threatening situation, including through a reorganization, or if such a step were unsuccessful, to pursue an orderly transition.

Issues regarding the viability of the larger auditing firms and the negative consequences of the loss of one of these firms on the capital markets are important considerations for investors. The loss of one of the larger firms could put pressure on the capacity of the remaining firms to absorb the clients left needing public company audits and other services. To the extent that a contingent internal governance mechanism, involving the creation of an Executive Committee with centralized firm management powers could be put into place to forestall its dissolution as recommended by the sub-committee, would be in the best interest of investors. This recommendation is seen as a means of maintaining a firm intact until the threat is mitigated in an effort to avoid the loss of professional resources and maintain its reputation.

One might question however whether preservation of capacity at any cost, no matter how serious or fraudulent a firm's actions might be, is fully understood as a public policy matter. We further agree with previous comments made before the Advisory Committee noting that an audit firm placed under the management of a Trustee, would likely cause serious damage to its reputation and may not survive in any event.

Recommendation 3. Recommend the PCAOB, in consultation with auditors, investors, public companies, audit committees, boards of directors, academics, and others, determine the feasibility of developing key indicators of audit quality and effectiveness and requiring auditing firms to publicly disclose these indicators. Assuming development and disclosure of indicators of audit quality are feasible, require the PCAOB to monitor these indicators.

Developing and disclosing key indicators of audit quality and effectiveness would be valuable information to investors. The measures, when properly developed and independently monitored by the PCAOB should enhance the overall quality of the audit as well as allow smaller firms to better compete with larger firms. Reporting audit quality and effectiveness metrics will further increase investor confidence in audit opinions rendered.

Audit quality metrics should include items considered important to investors. In a survey conducted by the CFA Institute in February 2008[2], 80% of respondents said that the independent auditor's report should provide specific information about how auditors reach their unqualified opinion.

Further, the respondents to our survey rated the following areas high in importance to improving audit disclosures:

- Key risk areas identified as part of the risk evaluation of a company's business model (84%)

[2] http://www.cfainstitute.org/memresources/monthlyquestion/2008/february.html

- Significant changes in risk exposures affecting the audit procedures and/or ability to exercise professional judgment (83%)
- Reported amounts, or changes in amounts, that have a high degree of uncertainty in measurement, that involve significant assumptions subject to change, or otherwise require a higher level of professional judgment (84%)
- Assessment of materiality, i.e., the threshold for determining the reconciliation and disclosure of information in the financial statements (60%)

We recognize that developing quality metrics for the areas noted above will be challenging, however, reporting on these items will further strengthen investor confidence in the audit firm.

In addition, the recommended public disclosure of the audit quality drivers suggested in previous Advisory Committee testimony by the retired Big 4 partner, along with metrics which may develop from the analyzing the Financial Reporting Council's recently published paper, might also be considered.

Recommendation 4. Promote the understanding of and compliance with auditor independence requirements among auditors, investors, public companies, audit committees, and boards of directors, in order to enhance investor confidence in the quality of audit processes and audits.

(a) Compile the SEC and PCAOB independence requirements into a single document and make this document website accessible. The American Institute of Certified Public Accountants (AICPA) and states should clarify and prominently note that differences exist between the SEC and PCAOB standards (applicable to public companies) and the AICPA and state standards (applicable in all circumstances, but subject to SEC and PCAOB standards, in the case of public companies) and indicate, at each place in their standards where differences exist, that stricter SEC and PCAOB independence requirements applicable to public company auditors may supersede or supplement the stated requirements. This compilation should not require rulemaking by either the SEC or the PCAOB because it only calls for assembly and compilation of existing rules.

We are not certain how this item may relate to the notion of concentration and capacity but we do clearly support efforts to reduce conflicts and improve audit independence. Establishing both in fact and appearance, the independence of a public company auditor contributes significantly to the credibility of financial reporting and the reliance placed on the audit opinions by investors. Strong independence standards ensure that the independent auditor is objective and neutral.

To that end, we suggest that the regulatory bodies consider not merely compiling the requirements into one document but actually adopting a single set of effective independence rules which would include both public and non-public standards. While the recommendation to compile the independence rules into a single document should enable investors, regulators and others to better understand the requirements we feel that one set of standards would better strengthen and clarify the rules.

In the end, while investors are interested in understanding the independence requirements, they are most interested in knowing that violations of such requirements are detected and appropriate enforcement actions taken.

(b) Develop training materials to help foster and maintain the application of healthy professional skepticism 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 noted by the sub-committee, independence that is objectively focused on lessons and extends beyond a "check the box" mentality is essential for the effective functioning of the established independence rules. Periodic training regarding the independence rules will better ensure compliance with the requirements.

Recommendation 5. Adopt annual shareholder ratification of public company auditors by all public companies.

Adopting annual shareholder ratification of public company auditors by all public companies is a good best practice including the disclosure of the lead audit partner and other key individuals assigned to the engagement. Currently such ratification is based on very little information and shareholders are expected to ratify as a matter of routine. Ideally, key indicators of audit quality as discussed in Recommendation 3 should be established and disclosed, including an assessment of the firm's significant exposures to litigation, financial position, etc., as the basis for shareholder ratification.

Transparent disclosure of audit quality, firm financial strength, and professional skill level should be available. At a minimum, if not publicly disclosed, such information should be available to the audit committee.

Recommendation 6. Enhance regulatory collaboration and coordination between the PCAOB and its foreign counterparts, consistent with the PCAOB mission of promoting quality audits of public companies in the United States.

We believe that this is the most important recommendation given that many countries are preparing for the adoption of International Financial Reporting Standards. Enhancing regulatory collaboration between the regulatory agencies should greatly strengthen the quality of public company audits internationally.

CONCLUSION

The CFA Institute Centre for Financial Market Integrity commends the Committee for developing recommendations relating to the sustainability of the auditing profession.

As Secretary Paulson said[3], “A transparent financial reporting system and vibrant auditing profession form the backbone of a marketplace investors can trust. Any plan to strengthen our capital markets must be based upon this principle.”

Thank you for the opportunity to participate in the Panel discussion.

[3] *“Paulson Announces First Stage of Capital Markets Action Plan”*, May 17, 2007