November 30, 2010

To: markt-greenpaper-audit@ec.europa.eu

Internal Market
The European Commission
Brussels, Belgium

To Whom It May Concern:

In accordance with Press Release IP/10/1325, dated 13 October 2010, the American Antitrust Institute (AAI) hereby transmits its comments on the EU Green Paper, "Audit Policy: Lessons from the Crisis."

AAI welcomes the opportunity to provide comments on this important aspect of the global financial crisis. The comments consist of a two-page summary and an attachment with further detail and relate mostly to Questions 23, 27-32 in the Green Paper.

We trust these comments will contribute to a meaningful review of the situation and look forward to the Commission's report. Please contact us, if we can be of further assistance.

Sincerely,

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COMMENTS ON THE EU GREEN PAPER: AUDIT POLICY

The American Antitrust Institute (AAI) welcomes the opportunity to provide comments on the EU Green Paper, "Audit Policy: Lessons from the Crisis" [COM(2010) 561 final] These comments relate mostly to Questions 23, 27-32 in the Green Paper.

In August 2008, AAI posted a paper on its Website, "The Audit Industry: World's Weakest Oligopoly?"[1] The paper called attention to the concentration of large firms in the accounting and auditing industry. The Big 4--- PricewaterhouseCoopers, Deloitte Touche Tohmatsu (Deloitte), Ernst & Young, and KPMG--- audit nearly all of the world's public companies with annual sales over $250 million. These four firms are strong and solid. Collectively, they earn revenues exceeding $90 billion a year and employ a half million people. Yet, at that time, the Big 4 and their multinational corporate clients were seeking protection from lawsuits, which they generally characterized as "potentially ruinous." Hence, the AAI paper facetiously was titled "World's Weakest Oligopoly?'

In the following months, Lehman Brothers, a major investment brokerage firm failed, and other financial firms needed government bailouts and mergers to stay afloat. The outside auditors of these firms, the Big 4, thus were exposed to the possibility of further large-scale lawsuits. The public outcry over the collapse of the mortgage and financial systems and the use of taxpayers' money to save individual companies led to U.S. legislation for financial reform. In January 2010, AAI issued another paper on concentration in the audit industry, suggesting that it would be appropriate for the U.S. Congress to include consideration of the audit firms in its review of regulation of banks and other financial institutions, particularly those regarded as "too big to fail."[2] Congress successfully enacted legislation for financial reform to avoid another economic disruption of this kind and to protect consumers, but the role played by audit firms in the financial meltdown was not addressed in the legislation.

Another Congressional effort, however, is underway in the form of a 10-member bipartisan Commission, known as the Financial Crisis Inquiry Commission (the "Angelides Commission"), which was established in May 2009.[3] The purpose of the Commission is "to examine the causes, domestic and global, of the current financial and economic crisis in the United States." Among its responsibilities in reporting on the financial crisis, the Commission is to examine "accounting practices, including mark to market and fair value rules" and "the concept that certain institutions

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[1] See Bernard Ascher, "The Audit Industry: World's Weakest Oligopoly?," AAI Working Paper No. 08-03, (hereinafter AAI 2008) available at http://www.antitrustinstitute.org/Archives/workingpaper08-03.ashx.

[2] See Bernard Ascher and Albert A. Foer, "Financial Reform and the Big 4 Audit Firms," AAI Working Paper No. 10-01 available at http://www.antitrustinstitute.org/sites/default/files/AAI%20Working%20Paper%2010-01_010720101109_0.pdf

[3] The Commission was created by section 5 of the Fraud Enforcement and Recovery Act of 2009 (Public Law 111-21), signed into law by President Barack Obama on May 20, 2009.

are too big to fail and its impact on market expectations." A final report is due on December 15, 2010.

AAI is concerned about concentration in the audit industry because:

- it limits the choice of auditors available to large companies;
- it could lead to increases in audit fees (which could be borne by the client and its shareholders or ultimately passed on to consumers in some form);
- it inhibits the role of regulators, who generally are concerned about the effect of further shrinkage of the number of audit firms (sometimes considered too big--- or too few--- to fail)[4]; and
- it could lead to a decline in independence and quality of audits.

Numerous recommendations have been offered to promote growth of the number of competitors in the audit industry.

- Remove existing barriers that inhibit or discourage new entrants. These barriers include lack of size, scale, reputation, capacity, expertise, and global networks.
- Relax restrictions on outside ownership of audit firms.
- Build up the second-tier, medium-sized firms through divestiture of Big 4 clients, award of government audit contracts, and removal of the "perception bias" against non-Big 4 firms.
- Encourage the growth of international networks of medium and smaller audit firms.
- Nationalize the existing Big 4 audit firms.
- Create mandatory federal audit insurance as a quasi-public utility

AAI is inclined to favor a combination approach consisting of the removal of barriers to new entrants and the growth of mid-size firms, coupled with creation of coordination and communication programs with participation of mid-tier and smaller audit firms (the latter proposed by a Treasury Advisory Committee).[5] For individual auditors, it would be useful to conduct continuing education and training programs, and to maintain strict licensing and certification requirements. This approach, although long term, appears to be the most pragmatic and least disruptive of the various proposals. For detailed discussion of the proposed remedies, see Attachment I.

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[4] The exposure of audit firms to massive lawsuits could undermine the viability of the industry, as well, threatening further shrinkage of the number of firms capable of conducting audits of large public companies. Auditors of troubled or bankrupt companies include: **Deloitte**: Bear Stearns, Fannie Mae, Merrill Lynch, Washington Mutual; **Ernst & Young**: IndyMac, Lehman Brothers; **KPMG**: Citigroup, Countrywide Financial, HBOS (Bank of Scotland), Wachovia; **PricewaterhouseCoopers**: AIG, Freddie Mac. Some suits already have been filed. (See "Audit firms left unprotected against claims of negligence," London Times, September 28, 2009.) However, the campaign for liability limitations on lawsuits against audit firms apparently has subsided, perhaps partly because some pending cases against the Big 4 have been settled. For example, in May 2010, KPMG paid $24 million to settle the Countrywide Financial case, and in August KPMG settled the New Century case for $44.75 million.

[5] See Treasury Advisory Committee on the Auditing Profession, Final Report, October 6, 2008, available at http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf; accessed Jan. 5, 2009.

ATTACHMENT I
Attachment to AAI Comments on the EU Green Paper: Audit Policy

DISCUSSION

This discussion is drawn mainly from American Antitrust Institute Working Paper No. 10-01, posted on the AAI Website, available at:
http://www.antitrustinstitute.org/sites/default/files/AAI%20Working%20Paper%2010-01_010720101109_0.pdf

Anticompetitive Practices

In addition to securities regulation, the Big 4 audit firms must be wary of antitrust laws. In its 2003 report on concentration in the audit industry, the U.S. General Accountability Office found, with respect to audit fees, there is "no clear definitive link between accounting market structure and anticompetitive behavior."[6] There appears to be no evidence of anticompetitive behavior in recent public literature and there are no cases reflecting antitrust violations by major accounting firms in the United States. However, in 2000, the then-Big 6 were fined for anticompetitive practices in Italy,[7] which serves as a reminder for regulatory authorities to remain vigilant so that similar anticompetitive activities do not occur in the future.

Exposure to Massive Lawsuits

With respect to lawsuits, the Big 4 remain highly vulnerable. When corporations suddenly fail or suffer severe declines in stock prices, investors, creditors and employees are prone to sue the auditors as well as the corporate management to recoup their losses. The audit firms are targets because their role is perceived as a responsibility to the public and because they are viewed as companies with "deep pockets."

A recent report by a Treasury Advisory Committee indicates that the six largest auditing firms (the Big 4 plus Grant Thornton and BDO Seidman) are currently defendants in ninety private actions related to audits of both public and private companies (either shareholder class actions or actions

[6] GAO, U.S. Government Accountability Office (GAO-03-864), "Public Accounting Firms: Mandated Study on Consolidation and Competition," (hereinafter GAO 2003) Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services, July 2003..
[7] See Italian Authority Press Release, Proceeding Reference 1266, Number 4, February 21, 2000; also Proceeding Reference 97, November 25, 1998 and OECD Annual Report on Competition Policy Developments in Italy, 1999, pars. 72-73; and AAI (2008), p. 28

brought by companies or bankruptcy trustees) with damage claims against the auditors in each case in excess of $100 million[8].

With pending claims totaling billions of dollars, the Big 4 audit firms face serious threats to their survival. Catastrophic results could follow inasmuch as "liability exposure substantially exceeds the combined partner capital of the Big 4 firms."[9] Thus, in seeking government protection against massive lawsuits, the major audit firms and their clients contend that liability limits are necessary to prevent the loss of another Big 4 firm, "which would throw the global financial system into chaos."[10]

Proposed Remedies

Liability limitation is among a wide range of proposals to reduce the risks of current and future audit market concentration, to increase competition, and to improve audit quality and independence. Because each proposal has disadvantages, the U.S. Government Accountability Office (GAO), in a recent report, made no recommendation for action at the time (January 2008). In a more recent study (October 2008), the Treasury's Advisory Committee on the Auditing Profession made 31 recommendations, but did not reach a consensus with respect to liability limitations.[11]

Liability Limitations

Proposals for governments to set monetary caps on liability are highly controversial. Many investors view litigation as a supplement to regulation, constituting a useful incentive for auditors to be more perspicacious in detecting corporate fraud and questionable practices. Limiting liability would deprive injured parties of a mechanism to obtain adequate relief for their losses. In the United States some limitations already exist in the form of proportionate liability and contractual agreements.

In absolute terms, litigation costs of the major audit firms are substantial. According to information provided to Treasury's Advisory Committee on the Auditing Profession by the six largest auditing firms (the Big 4 plus Grant Thornton and BDO Seidman), over a 12-year period (1996-2007) these firms "paid out $5.66 billion to resolve 362 cases related to public company audits, private company audits, and all other non-audit services, with 65% of the total ($3.68 billion) related to public company audits…" Supporters of liability caps on the Committee felt these large sums plus potentially catastrophic costs in the future justified legal monetary limits.[12]

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[8] Forty-one of the ninety cases seek damages in excess of $500 million, twenty-seven cases seek damages in excess of $1 billion, and seven cases seek damages over $10 billion. Treasury Advisory Committee on the Auditing Profession, Final Report, October 6, 2008, (hereinafter Treasury 2008) available at http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf; accessed Jan. 5, 2009.

[9] Wallison, Peter J., "The Sorcerer, the Apprentice, and the Broom: What to Do about Private Securities Class Actions," *AEI Online*, Posted: Thursday, Mar. 8, 2007, accessed July 20, 2008 .

[10] Committee on Capital Markets Regulation, *Interim Report*, 87, cited in Wallison, op. cit. fn 14.

[11] For further detail see Treasury 2008, Sections VI, VII, and VIII. Of course these figures do not include attorneys' fees which might be covered by insurance in industries where liability insurance is available.

[12] For further discussion see Treasury 2008, op. cit., fn 15, pp. VII:23-VI:32.

Those opposed to liability limitations felt that in relative terms, the costs did not justify legal limits inasmuch as "the weighted average of 'litigation and practice protection costs' was 6.6 percent of these firms' revenues and 15.1% of these firms' audit related revenues for the most recent fiscal year…Some Committee members noted that the payments made by auditing firms upon settlement or final judgment are on average only a small percentage of the alleged claims. For example, over the 1996-2007 time period median settlements in shareholder class actions (a subset of litigation against auditing firms) in which an auditing firm was named as a defendant were 4.8% of the total estimated damages." The Committee report contains an in-depth discussion of litigation costs and the issue of liability limitation.[13]

In Europe, however, after extensive study, the European Commission in June 2008 recommended that its 27 member states adopt measures to limit liability, consistent with their own legal systems. Five member states already have monetary caps on liability (Austria, Belgium, Germany, Greece, and Slovenia) and five others allow audit firms to limit liability through contractual agreements (Denmark, Luxembourg, Netherlands, Spain and United Kingdom). [14] Considering that large public companies and their auditors operate across national borders in Europe and in many other countries around the world, the differential in treatment of liability limits is striking and calls attention to a possible need for harmonization.

Other Proposals

In addition to risk reduction through liability limits, as viewed by the GAO, other proposals to create a larger field of competitors and increase the choice of available auditors include: requiring divestment of audit clients by one or more of the Big 4; removing barriers to growth of mid-tier and smaller audit firms and to new entrants; allowing outside ownership of audit firms (ownership by non-accounting firms); and building additional networks and reputations, changing the "perception bias" against non-Big 4 firms. Some of the Treasury Advisory Committee proposals included education and training programs, strict licensing and certification requirements, continuing education to keep accountants up to date on new developments, creation of coordination and communication programs with participation of mid-tier and smaller audit firms. The Committee apparently did not consider divestiture remedies.

The aforementioned AAI Working Paper of August 2008 recognized the disadvantages of the various proposals, noting that they may prove to be costly and ineffective. Of all the proposed remedies, the Working Paper leaned toward removal of barriers--- including state restrictions on outside ownership of accounting firms--- as the most pragmatic approach. New and existing firms need to overcome competitive disadvantages due to lack of size, reputation, capacity, expertise and global networks. Outside ownership (with appropriate safeguards to avoid conflicts of interest with other businesses owned by the entrepreneurs) could help to attract new, well-financed entrepreneurs

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[13] Ibid.

[14] EU Press Release IP/08/897 June 6, 2008, "Auditing: Commission issues Recommendation on limiting audit firms' liability" (see MEMO/08/366) available at http://ec.europa.eu/internal_market/auditing/liability/index_en.htm.

with management expertise to acquire and combine smaller companies into larger networks and enhance their reputations. Significant disadvantages to this approach, however, are that it would take a long time and might also prove to be ineffective.

The 2008 Working Paper also considered proposals to break up the Big 4 or to require one or more of them to spin off a portion of their operations to create additional firms with the capacity to audit large public companies. The disadvantage of such proposals is that they could have disruptive consequences for existing audit firms and their employees, as well as for clients. Despite these drawbacks, divestiture could prove to be beneficial, as further discussed below.

The 2008 Working Paper dismissed other proposals, such as nationalization (to which AAI is strongly opposed), and mandatory federal audit insurance, as being too disruptive, too radical and unrealistic. Such proposals are well intentioned and may remove a basic conflict of interest in the current system by which audit firms are paid, but they raise questions concerning operation, cost and efficiency of the system and how such a drastic change would affect the business community.[15] A similar proposal would convert audit firms "into something akin to a regulated public utility. For any public company or investment fund, or for any newly issued security, auditors and raters [would] be assigned by exchanges or regulators at random and on a rotating basis. The firms would be paid from the proceeds of a small tax on transactions and new issues, based on rates competitively bid at the beginning of each year. Those firms that make serious mistakes would be subject to significant fines; those that screw up more than that would lose their licenses."[16]

Divestiture and Liability Limits

While AAI does not advocate the legislation of a cap on litigation damages, it did consider the possibility of using such legislation as a means of providing an incentive to the audit industry in exchange for divestiture. The 2010 Working Paper stated that no such relief should be granted without also setting conditions that are likely to make the auditing of public companies more competitive. Thus, to be eligible for a liability limit, a Big 4 audit firm would have to meet the following sort of criteria:

1. A Big 4 auditing firm must within five years divest itself of no less than 20% of its domestic client revenue and the professionals who are needed to service the clients that are transferred out of the firm.
2. The divestiture must be to a firm other than a Big 4 firm on terms to be negotiated with the buyer.
3. The buyer as well as the Big 4 firm will receive the benefit of the limitation on damages.
4. At the end of five years, the Congress will consider whether sufficient progress has been made toward the creation of a more competitively structured industry for the auditing of public corporations. A competitively structured industry would be defined to include no fewer than six auditing firms fully capable of obtaining and servicing engagements to audit large public corporations.

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15 AAI 2008, op cit pp 40-48.

16 See Pearlstein, Steven, "Madoff's Lessons For the Market," Washington Post, December 17, 2008; D01.

Such legislation could provide incentives for the Big 4 to become a Big 6 or Big 8 by virtue of voluntary decisions on how best to accomplish divestitures. Presumably, there would be negotiations between the Big 4 and today's second tier firms or networks of smaller firms, which would necessarily take into account how to satisfy the clients who will be spun off as to such matters as appropriately experienced professionals, the handling of audits in foreign countries, and the fees that would be charged to the transferring clients. If transferring clients are not satisfied, they have the ability to move their business (and should have more options than in the past). If the Big 4 firm only offers to divest its least desirable clients, the smaller audit firm does not have to make a deal.

With a time limit and the threat that some additional deconcentrating action might be taken if qualifying divestitures are not made, and with substantial incentives on the table for all parties, we believe that an open season of negotiating would likely lead to an efficient transfer of resources that would benefit the public generally and public companies in particular by reducing concentration and increasing competition.

Of course, this type of legislation would have to be carefully constructed to deal with the many situations that could arise. Public hearings would need to be held to elicit the views of interested parties, it will be necessary to sort out the various specific issues on how the open season for divestiture would operate. Such issues include the following:

- the percentage of divestiture required to justify liability limitation;
- in catastrophic cases, whether the cap should apply only to punitive damages or to compensatory damages as well;
- whether or not the liability caps should expire after a certain period or remain in effect permanently, unless revoked or amended by Congress; and
- whether or not safeguards should be built into the legislation to prevent a Big 4 firm from reacquiring a client after receiving liability caps for the original divestiture.

Recent Developments

Since August 2008, the world economy has suffered serious setbacks in deflated values of homes, real estate, and other assets; bad loans and flawed investment instruments. The financial sector has experienced the collapse of major investment banks, insurance companies and credit institutions, a loss of confidence in lending, and a loss of over $1 trillion in stock market values. Governments responded quickly to the emergency by taking over failed banks and lending institutions, by forcing mergers with healthier companies, by allowing some firms to fail, by bailout loans, and by cash infusions in return for company shares. Regulatory agencies are subject to sharp criticism for allowing this to happen. The situation remains unsettled. Audit companies are now exposed to greater risk of lawsuits than ever before[17]. Some accounting rules are suspected of contributing to the downturn[18]and some international accounting rules have been bent.[19] Subsequently, in April

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[17] Auditors of troubled or bankrupt companies include: **Deloitte**: Bear Stearns, Fannie Mae, Merrill Lynch, Washington Mutual; **Ernst & Young**: IndyMac, Lehman Brothers; **KPMG**: Citigroup, Countrywide Financial, HBOS (Bank of Scotland), Wachovia; **PricewaterhouseCoopers**: AIG, Freddie Mac. Some suits already have been filed. See "Audit firms left unprotected against claims of negligence," London Times, September 28, 2009.

[18] In a recent Congressionally-mandated report, the Security and Exchange Commission found that fair accounting reporting ("mark-to-market") did not appear to play a meaningful role in the bank failures that occurred in 2008." See Securities and Exchange Commission, "Congressionally-Mandated Study Says Improve, Do Not Suspend, Fair Accounting Standards, Press Release 2008-307, December 30, 2008. "The conclusion is a clear shot at a banking lobby

2009, the so-called "mark-to-market" accounting rules were eased for U.S. banks and other financial firms.[20]

Fresh Look at the Remedies

As an integral part of the financial system, the audit firms could fit very well into the legislative reform. Now that governments have taken drastic actions to rescue financial institutions, some of the previous proposals for the audit industry seem more palatable. Some major banks in the United States and other countries are at least partly nationalized. AIG insurance company is beholden to the U.S. government for loans exceeding $150 billion and two large automobile companies also have received $17 billion in bailout loans. In addition a fraudulent $50 billion hedge fund scheme (Ponzi Scheme) came to light, affecting charities, foundations, banks, and wealthy investors.[21] As yet, there are no signs that the audit industry needs to be bailed out, although they are (and will be) injured by loss of clients through bankruptcies and mergers, through the general economic downturn, and through prospective lawsuits. This may be a good time to look at formalizing the public role of audit firms by requiring federal charter or federal appointment of auditors to particular clients or by establishing government incentives to break up the Big 4 into smaller, more competitive firms. In the current economic climate, large public companies may seek to reduce high audit costs by requesting competitive bids as they did in the 1980s prior to the merger and acquisition trend in the industry. A larger number of qualified firms would heighten the competition. In any event, the current crisis may afford an opportunity for wholesale reform in regulation of the financial sector, including the audit firms.

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that has pushed with increasing force during the year to see fair value standards suspended in an effort to protect banks that critics say have had to mark their books too aggressively amid market fear." See Jackson, Paul, "SEC: Mark-to-market's not the problem," Housingwire.com, December 31, 2008. In Europe, however, "in October, largely hidden from public view, the International Accounting Standards Board changed the rules so that European banks could make their balance sheets look better… The results were dramatic. Deutsche Bank shifted $32 billion of troubled assets, turning a $970 million quarterly pretax loss into $120 million profit. And the securities markets were fooled, bidding Deutsche Bank's shares up nearly 19 percent on Oct. 30, the day it made the startling announcement that it had turned an unexpected profit." See Kessler, Glenn "Accounting Standards Wilt Under Pressure," Washington Post, December 27, 2008, p. A01.

[19] Ibid.

[20] See "Under New Accounting Rule, Toxic Assets May Be Revalued," Washington Post, April 2009.

[21] Auditors of money management firms already are being sued for not detecting the fraud. "KPMG has been named as a defendant in a suit against Tremont." See "The Madoff Scandal: Follow the Feeders," *The Economist*, January 3, 2009, p. 55.

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