

WRITTEN TESTIMONY OF
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BEFORE THE
FEDERAL ADVISORY COMMITTEE ON THE AUDITING PROFESSION
UNITED STATES DEPARTMENT OF THE TREASURY

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Chairman Levitt, Chairman Nicolaisen, members of the Committee, Treasury staff and
Observers:

Thank you for inviting me to appear before you today. I am the General Counsel of
PricewaterhouseCoopers LLP, a position I have held since October 2002. Prior to that time, I
was in law firm practice in New York for 24 years.

I am pleased to present a perspective on competition and concentration in the auditing profession,
and to offer comments and suggestions on Section VII of the draft report. In doing so, I
recognize that while the Subcommittee on Competition and Concentration's focus is directed at
the operation of market mechanisms, namely competition among audit firms, its ultimate
objective remains promoting the sustainability of an audit profession delivering the highest level
of audit quality.

As Jeffrey Steinhoff of the GAO stated in his testimony at the Advisory Committee's December
3, 2007 meeting, "the big issue here is one of ensuring quality and not ... concentration. And it
is ensuring that everything that is done is focused on ensuring quality."¹ In our view, this is

¹ December 3, 2007 Tr. 168.

precisely the right objective: audit quality is the end goal and competition among audit firms is a means to that end.

Given that premise, we have used two guiding questions in reviewing the Subcommittee's draft recommendations:

1. Will the recommendation help the firms performing public company audits, both today and in the future, compete more effectively, while also supporting high quality audits?
2. Will the recommendation provide capital markets with enhanced tools to make informed choices about audit provider options available in the marketplace?

We agree with the Advisory Committee's underlying objectives aimed at further enhancing audit quality through increased transparency, which we believe may also be important to the promotion of competition on the basis of quality. We also believe the regulator, in this case the PCAOB, should be given the opportunity to determine what types of additional information it may need to assess audit quality. However, requirements to publish firms' proprietary financial information without a more clearly demonstrated need that offsets the risks and concerns I will outline in my testimony would not serve the capital markets' legitimate need for information about audit quality, and could actually harm competition in the audit services market.

Separately, we welcome the Committee's recognition of the threat posed to the health of the audit profession and audit firms by catastrophic risk. We believe, however, that the final report should place greater emphasis on steps to avoid or reduce catastrophic risk to audit firms.

Currently, the recommendations are directed at efforts to keep a firm functioning after a catastrophic event has occurred, which experience would suggest has a low probability of success.

I. Competition in the Public Company Audit Market

I would like to begin by offering some comments on the facts relating to the state of competition in the auditing profession:

1. The Public Company Audit Services Market

PricewaterhouseCoopers' experience is that the marketplace for audit services is highly competitive at all levels of the market. We face strong competition for new audit clients from the other largest firms, as well as from smaller and mid-sized firms. Recently, for example, the firm has been involved in a competitive audit proposal process involving five firms and fee proposals that we understand vary significantly. PricewaterhouseCoopers' experience is consistent with that of other market participants, as this Committee has heard in testimony at earlier meetings: Wayne Kolins, National Director of Assurance and the Chairman of the Board of BDO Seidman, reported that his firm had "participated in a number of proposals competing against other large firms," and testified that he "view[s] the market for services to be highly competitive[.]"² The former Managing Director and Head of Global Technology Investment Banking at Goldman Sachs, Brad Koenig, testified that from an underwriter's perspective, the process of selecting auditors is "very competitive."³ In addition, the Government Accountability Office's ("GAO") January 2008 report on concentration in the auditing profession confirms the accuracy of these observations. The report concludes that while parts of the market for public-company audits are more concentrated than others, competition is healthy at all levels of the

² December 3, 2007 Tr. 162.

³ February 4, 2008 Tr. 243.

market. Specifically, 57 percent of the public company respondents to the GAO's survey reported that there is an adequate level of competition for audit services.⁴

The fact that the largest U.S. public registrants rely primarily on the provision of audit services by the four largest global networks reflects a natural meshing of demand with resources. Many large public companies have global operations, complex financial structures, and generate massive amounts of financial data. Not surprisingly, they look to accounting networks with the scope and scale to address their needs. These are organizations that can deploy hundreds of staff to a single audit, that have broad expertise, and that maintain extensive global networks. The PricewaterhouseCoopers network of firms, for example, includes a total of 146,000 partners and employees in 150 countries. As a result, the four largest firms serve the vast majority of public companies with revenues above \$1 billion, a group slightly larger than the Fortune 1000. This share has remained relatively stable since GAO's last study of the profession in 2003.⁵ In looking at the market for public company audit services as a whole, however, the GAO found that between 2002 and 2006, competition increased and the share of the four largest firms decreased. Smaller and mid-sized firms increased their share of audits of public companies with revenues below \$1 billion—in some instances significantly. Small and mid-sized accounting firms now audit nearly 70 percent of the firms below \$100 million in revenue and nearly 30 percent of those with revenues between \$100 million and \$500 million.⁶

Public companies in certain areas of the country, and in certain industries, may find that only a limited number of qualified audit firms are prepared meet their needs. Yet, the GAO concluded that even in these sectors, audit fees are not materially higher, nor is audit quality poorer, than for

⁴ GAO at 27.

⁵ *Id.* at 19.

⁶ *Id.* at 19-20, 48.

public companies as a whole.⁷ Again, these findings bear out PricewaterhouseCoopers' experience as a competitor in the market: even when a public company chooses from a more limited list of potential auditors, whether because of auditor independence concerns, industry expertise, geographic need, or scope and scale requirements, competition for audit business remains robust, fees are not higher and there is no evidence to suggest that audit quality is lower as a result.

2. **Audit Quality Has Been Enhanced By Competition, Increased External Oversight, Auditor Investments, and Regulatory Change**

Competition is a means, but audit quality must be the end. There is a strong body of emerging evidence that audit quality has improved in recent years. Co-Chair Nicolaisen noted at the first meeting of the Advisory Committee in October that everyone he had talked to “has expressed the view that they believe that audits are better today than they were five years ago.”⁸ That is certainly PricewaterhouseCoopers' view. And from my review, nothing in the Advisory Committee's record, or in GAO's findings, is to the contrary.⁹ As the draft report notes, the Center for Audit Quality has reported that 82 percent of surveyed audit committee members believe that audit quality has improved over the past several years, 78 percent said current audit quality is very good or excellent, and another 17 percent said audit quality was good. Given the direct relevance of this recently gathered information, we believe these findings should be included in the Advisory Committee's final report.

In addition, while restatements by public companies have increased over the past 10 years, a recent Treasury Department report found that the proportion of restatements prompted by fraud

⁷ *Id.* at 30.

⁸ October 15, 2007 Tr. 12.

⁹ Draft report at VII:2-3; GAO at 32.

has dropped dramatically – from 29 percent of restatements in 1997 to 2 percent in 2006. The proportion of revenue restatements has dropped from 41 percent to 11 percent over the same period. Finally, market reaction has been more muted to recent restatements. Average announcement returns, *i.e.* market reaction as reflected in stock price, were negative 9.5 percent from 1997 to 2000, but only negative 1.3 percent from 2000 to 2006.¹⁰

As the Advisory Committee recognizes, maintaining and enhancing audit quality going forward requires robust competition by healthy, sustainable audit firms. We also agree with the Advisory Committee that catastrophic risk poses a significant threat to the public company auditing profession and to the capital markets. We therefore agree with the need to address the catastrophic risk issue both to improve audit quality and to foster competition.

3. **Efforts To Reduce Catastrophic Risk**

Virtually every study of the accounting profession in recent years has recognized that the major firms performing public company audits face the very substantial risk of a catastrophic event, and that such risk presents an important threat to the health of the auditing profession.¹¹ As we have said before, in our firm's view, the best way to address this risk is to attack its root causes, a significant component of which is the current U.S. litigation regime under which auditing firms operate.

Our recommendation is consistent with other testimony the Advisory Committee has heard. The draft report notes that “civil litigation was the risk most often cited by witnesses before the

¹⁰ April 2008 U.S. Treasury Department report, *The Changing Nature and Consequences of Public Company Financial Restatements*.

¹¹ See *e.g.*, Directorate General for Internal Markets and Services, *Commission Staff Working Paper: Consultation on Auditors' Liability and Its Impact on the European Capital Markets*, January 2007; U.S. Chamber of Commerce, *Auditing: A Profession At Risk*, January 2006.

committee.”¹² Since 1998, there have been at least 10 settlements or awards of more than \$100 million against accounting firms arising out of the auditing of public companies.¹³ Recently, the Treasury Department reported that “[t]here are currently suits pending against audit firms with an aggregate of billions of dollars in potential claims; these claims could result in the bankruptcy of an additional audit firm, with adverse consequences for corporate governance in the United States and the rest of the world.”¹⁴

The current litigation climate is not simply a problem for the largest firms; the liability threat also deters small and mid-sized firms from expanding their public- company audit business or entering the market in the first place. The amount of damages claimed in securities class actions tracks the market capitalization of the audit client.¹⁵ This reality has a chilling effect on small to mid-sized firms that otherwise have the resources and expertise to serve larger public company clients (or simply a larger number of small public company clients), but are not capitalized or sufficiently insured to risk the potential liability. To the extent that more choice among public auditors and increased competition would enhance and reinforce audit quality, as we believe it would and does, mitigating the threat of catastrophic civil damages also would promote audit quality. Such a step would encourage small and mid-sized firms to compete for the largest clients or expand their scope of clients. Indeed, 61 percent of mid-sized and smaller audit firms told the GAO that reforming the litigation system would help them grow their market share.¹⁶

4. **Preservation and Rehabilitation Initiatives**

¹² Report VII:6 n27

¹³ GAO at 33.

¹⁴ U.S. Treasury Department report "Interim Report Of The Committee On Capital Markets Regulation" at xii (November 2006)

¹⁵ *Id.* at 38.

¹⁶ GAO at 55.

The draft report sets forth some useful ideas for preservation and rehabilitation of troubled public-company audit firms after a catastrophic risk has emerged. Both the concept of monitoring potential sources of catastrophic risk and the notion of creating a mechanism for the preservation and rehabilitation of larger firms in crisis deserve serious consideration. As to the former, the complexity of the risk environment in which the major auditing firms operate is well recognized. Thus, this issue may well go hand-in-hand with any evaluation of liability reform that the Advisory Committee undertakes. The challenges for the larger public accounting firms that may face a catastrophic risk situation cannot easily be anticipated or addressed. There may be substantive steps that can be taken to address the perceived problem, but the key market constituencies often impose very immediate and irreversible consequences that defy a managed solution.

The challenge seems to be what the response should be when a crisis – based on real or perceived failures – confronts a major accounting firm. As more recent examples have demonstrated, the speed with which market forces can dictate a catastrophic outcome is stunning. We agree that in such situations the capacity of an accounting firm to respond with a governance system that is capable of taking decisive action is critical. Each major firm should take steps both to anticipate such situations and to be in a position to respond when needed in an appropriate way. Many firms have begun taking such measures in the aftermath of Sarbanes-Oxley and under the leadership of the PCAOB, but more remains to be done.

We believe the “External Preservation Mechanisms” set forth in the draft report are a starting point for an evaluation of what actions, practically speaking, are the correct steps to be taken when a potentially catastrophic situation confronts a firm. However, we must recognize that an accounting firm's value to the capital markets is a function of the firm's reputation for probity

and trust. Catastrophic situations often result in injury to reputation, and therefore are likely to put tremendous pressure on clients, partners, staff and other member firms in the relevant network to seek alternatives

Whether the catastrophic risk arises from a threatened criminal action, an SEC enforcement proceeding, or a private litigation, the suggestion in the draft report of a legislatively approved trustee under SEC oversight is one that may, by definition, simply signal the end of any firm subject to such a process (as has been noted by prior panelists before the Advisory Committee). If a firm gets to this stage and the government is literally interceding to act as a one-step-removed Trustee, it may well be too late to save a firm. In addition, there are other considerations that should be carefully considered with regard to this recommendation as well, such as whether the SEC has the resources, expertise and institutional will to assume such a role. Ultimately, any public auditor rehabilitation initiative faces the fundamental challenge that the ongoing survival of a troubled firm must necessarily be subject to the disparate (perhaps conflicting) market interests and duties of regulators, prosecutors, private plaintiffs, firm partners and professionals, other firms in the relevant global network and, most importantly, the public companies themselves. It is not obvious to us that these constituencies' potentially diverging interests and duties can be reconciled, even when a major audit firm's imminent failure seems clear. This is not to say, however, that members of relevant constituencies – perhaps those party to the Financial Fraud Taskforce and supplemented by representatives of the National Association of State Boards of Accountancy, the American Institute of Certified Public Accountants, the Center for Audit Quality and representatives of public audit firms – could not usefully convene a review of lessons learned and best practices from recent examples of firm

failures and near failures. To the contrary, we believe the complexity of the issue lends itself to disciplined scenario planning.

As the draft report makes clear, for-profit businesses should not and can not be entirely insulated from the legitimate legal and economic consequences of their performance. To be clear, however, an after-the-fact effort to salvage a firm in the throes of a catastrophic risk event would seem to need to intrude on a number of the market forces outlined above, and should not, in our view, be thought of as a satisfactory answer to the question of sustainability. The better course to maintaining the sustainability of the profession, as well as promoting more competition for quality audits, would be to take steps to prevent the catastrophic loss in the first place.

II. Providing Capital Markets and Public Companies More Useful Information Regarding Auditors Enhances Competition and Audit Quality

As public company auditors, we understand the need for transparency of useful information to allow participants in capital markets to make sound and measured auditor selection decisions. We also believe that the transparency proposals should be evaluated based upon the principles laid out at the beginning of these remarks: Would they promote increased competition on the basis of metrics that improve or reflect quality? Would they give markets better information? If yes, they are likely to enhance audit quality. If no, then the utility of the proposal must be further examined.

1. Establishing Objective Indicia of Audit Quality and Requiring Disclosure of Such Metrics Would Encourage Firms to Compete on Quality

Based on these principles, we support recommendation 3 in the draft report that “key indicators of audit quality and effectiveness” be developed and audit firms be required to “publicly disclose

these indicators.” As PricewaterhouseCoopers’ Chairman Dennis Nally stated in his written testimony to the Advisory Committee, “the public transparency that we envision could include firm disclosure and discussion of the levels of partner and staff turnover, average hours of professional training, risk management and compliance measurements, and metrics related to the quality of management and firm governance processes.” We believe that, as the draft report states, such disclosure would “contribute to making the initial auditor selection and subsequent auditor retention more informed and meaningful.”¹⁷

If crafted to be applicable to firms of all sizes, such disclosure should promote competition among the largest audit firms, as well as competition from smaller and mid-sized firms for larger clients currently served by the major accounting firms. For example, small and mid-sized firms report that lack of reputation is a barrier to growth in the public audit market. Objective criteria bearing upon firm quality could create a more level playing field for less well-established entrants into all subsectors of the market. This would be the case regardless of the size of audit, the specific industry, or the geography associated with the client, for these firms to compete with established players. Competition to meet or exceed high standards of governance, auditor retention, training, etc. would clearly be quality enhancing.

The recently adopted European Union Eighth Directive provides a model for a transparency regime that the Advisory Committee might consider. Paralleling the criteria we suggest above, this Directive, if modified to fit the unique aspects of the U.S. legal and regulatory system, would require a governance statement, a description of the internal quality control system, a statement on the effectiveness of the audit firm's administrative function, policies on continuous education requirements, and a breakdown of fees.

¹⁷ Report at VII:11.

2. **Public Disclosure of Firm Financial Statements Does Not Serve Capital Markets' Needs and Could Harm Competition and the Profession**

Some have suggested that audit firms should disclose publicly – on a regular basis – detailed, audited financial statements. In considering such proposals, we believe the Advisory Committee should be mindful of the extensive existing authority of the PCAOB to obtain broad, unencumbered access to public company audit firm proprietary information. We recognize that such authority is necessary for the body charged with maintaining the quality of audits performed by private entities that are not subject to public reporting. However, “transparency” proposals calling for greater public disclosure of audit firm financial statements could harm, rather than improve, competition in a manner that would outweigh any asserted correlative of firm financial results to audit quality.

We agree with the proposition that public company auditing firms bear an important public trust. However, we view this quite differently from what is required of publicly-traded companies. For public registrants, financial disclosure is essential to let their owners—public shareholders—understand and monitor how the companies are performing. For audit firms, the equivalent disclosure would involve the metrics that provide the government and the capital markets confidence that audit firms are providing trustworthy, quality audits. Disclosure of audit firm financial statements would not meet that objective. In contrast, investors in public companies are, by law, entitled to periodic reports containing audited financial statements. These audited reports would likely be demanded by the markets even if not mandated by law, as companies seek access to investor capital and potential investors need sound, reliable financial information and reporting to make investment decisions. The same rationale has no application to accounting firms, which are owned by their partners. Directors of public companies seeking to make

meaningful and informed choices about auditor quality and competence would not be better informed by having access to financial statements of the accounting profession. The fact remains that there does not appear to be a grassroots or institutional investor groundswell for such disclosure. Again, however, greater information about firm quality and audit quality could better inform choice and, not surprisingly, is supported by major institutional players in the capital markets. Moreover to the extent that capital markets need some baseline assurance about public auditor fiscal soundness, regulators such as the PCAOB have existing authority to request such information as deemed necessary to performance of their oversight functions and to determine audit quality.

Objective parties that recently have looked at this question agree that public disclosure of audit-firm financial statements would not enhance competition or audit quality. The GAO report stated that, “[m]ost market participants we interviewed on this proposal did not believe that requiring audit firms to publicly disclose their financial results would be very effective in reducing the risk of anticompetitive pricing among the largest accounting firms.”¹⁸

Similarly, the American Assembly, in making recommendations about how the PCAOB should exercise its oversight authority, noted that lack of public disclosure would be essential to effective regulation of the public-company auditing profession: “Assembly participants believe that the PCAOB should adopt a supervisory approach to regulation...a supervisory format would permit accounting regulators to operate protected by the same degree of confidentiality that currently governs the proceedings of bank examiners. The greater the publicity surrounding these complex matters, the harder it becomes for members of the accounting and auditing

¹⁸ GAO at 53-54

profession to both retain their focus on the tasks at hand and maintain the confidence of their clients and the public.”¹⁹

Indeed, we believe that proposals for public disclosure of financial information run counter to the goal of enhancing audit quality through competition. The burdens of public disclosure will deter the entry of smaller firms into the sphere of those larger firms subject to a financial reporting mandate. In other words, if reaching a certain threshold of public company audit clients trips such a reporting requirement, smaller firms may resist entry into the sphere of auditing that would trigger such a burden. This unintended consequence could occur even if the disclosure were limited to the largest public company auditing firms, as smaller firms may feel market pressure to voluntarily follow.

Furthermore, auditors who fall outside the reporting regime may face a different problem: the false impression that lack of disclosure means that such firms are less well-regulated than their larger competitors. If such a bias in the market were to undermine the efforts of small and mid-sized firms to attract and retain clients it would be all the more regrettable, especially since public disclosure of firm financial statements would provide no materially useful information to capital market participants. Some have pointed to the requirement in the United Kingdom that public accounting firms provide financial statements to the public as proof that the sky would not fall if a similar regime were imposed in the United States. The liability regimes in the U.S. and the U.K., however, are entirely different. U.K. law, for example, does not allow shareholder class actions to be brought against auditors or companies based on a drop in share price.

¹⁹ AA 2003 p. 14

This last distinction is particularly important given the other major objection to disclosure of public audit firm financial statements: such disclosure would likely further divorce private, civil damages awards from the merits and relative culpability, and pushes such awards to be based to an even greater degree on audit firms' perceived ability to pay. As has been noted in other testimony to the Advisory Committee, one of the principal issues facing the major firms is the difficulty in taking cases to trial in a proceeding focused on the merits of the audit firm's position. The risk inherent in the current securities litigation damages model limits severely the number of claims that prudently can be tried. Moving to a model that would put detailed audit firm financial information in the hands of those asserting such claims will promote neither sustainability nor competition.

Finally, in prior hearings before the Committee, some have suggested that there should be an express link between liability reform and disclosure of firm financial statements. The view expressed was that audit firms' assertions that their viability is threatened by massive civil damage awards cannot otherwise be intelligently evaluated. The six largest firms have provided the Committee with information regarding pending claims demonstrating that the potential for catastrophic risk is real. And, as we have discussed above, this risk is well documented from other sources as well. At best, the argument for the disclosure of such financial information is only a premise for disclosure to those with a role to play in enacting such reforms (*i.e.*, the PCAOB or the SEC). It is not an argument for periodic public disclosure of financial statements of the partnerships.

III. **Conclusion**

I appreciate the opportunity to present this testimony and to appear before the Advisory Committee. I would be happy to answer any questions you may have.