

**DIRECTORATE GENERAL FOR INTERNAL MARKET AND  
SERVICES WORKING PAPER:  
CONSULTATION ON CONTROL STRUCTURES IN AUDIT FIRMS  
AND THEIR CONSEQUENCES ON THE AUDIT MARKET**

Interested parties are invited to respond by **28 February 2009**.

Comments, preferably in the form of general remarks followed by answers to the questions listed in appendix, should be submitted by e-mail to the following address: [markt-f4@ec.europa.eu](mailto:markt-f4@ec.europa.eu). Respondents may alternatively send comments by post to the European Commission, DG Internal Market and Services, Unit F4 – Auditing, SPA 2 (JII), 02/085 , B-1049 Brussels, Belgium.

DG Internal Market and Services will make comments publicly available on the Commission's web-site unless respondents specifically request otherwise. In case of e-mail response which includes an automatically generated notice stating that the content is to be treated as confidential, respondents should make it clear in the body of the message whether or not they wish their comments to be treated as confidential.

**November 2008**

# DG MARKT Working Paper

## Consultation on control structures in audit firms and their consequences on the audit market

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## Consultation on control structures in audit firms and their consequences on the audit market

### 1. THE INTERNATIONAL AUDIT MARKET

#### 1.1. Need for more integrated audit market with more suppliers

European capital markets have become much more integrated for companies in the last few years. The introduction of IFRS is just one example. The services and structures offered by auditors to their clients inevitably need to reflect that as well. Multinational companies with cross-border activities and subsidiaries abroad need auditors present or represented in several jurisdictions in the world and able to provide them with an international audit service. However, the European internal market for audit firms has not reached the same level of integration on the supply side as capital markets for companies including banks and insurances on the demand side.

Instead the European Union seems to face fragmented audit markets. Against this background, it is well known that there are only a few audit networks which are able to cope with this fragmentation. The market share of the so-called Big 4, in terms of total revenues<sup>1</sup>, amounts to more than 80% in 2007. This figure seems not have changed significantly over the last years after the demise of Arthur Andersen, the then 5<sup>th</sup> major network in 2003. In order to ensure a sustainable international audit market, more players are needed to meet the demand by international companies. However, under the current market conditions, many mid tier audit firms are neither able nor willing to move into this market. The difference between the global revenues of the big audit firm networks and the mid-tier networks illustrates this situation. In 2007, the global revenues of each of the Big 4 range between EUR 15 000 and 20 000 millions per year. For the 6 biggest mid-tier audit firms following the Big 4, it ranges between EUR 2 000 and 3 700 millions per year.

The current financial turmoil might also contribute to widening the gap between the Big 4 and the mid-tier audit firms. Although there is no evidence about the role of auditors in the crisis and they have not been subject to criticism so far, the risks inherent in the auditor's role might be perceived as higher. This situation might reinforce the lack of interest of mid-tier audit firms for the market of the audit of financial institutions, which is currently even more dominated by the Big 4 than the market for large non financial companies. Given the lack of players available to audit financial institutions, the consequences of the collapse of one Big 4 would be even more serious for them.

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<sup>1</sup> International audit firm networks provide audit and other assurance services, accounting services, tax advice and other consultative services. The provision of audit services represents in average around 50% of the total revenues of the big networks.

**Question 1:** Do you see a need for opening up the market for the audit of international companies in order to have more European wide audit service providers compared to the existing situation? Do we need a more integrated audit market? If yes, why?

## **1.2. The current role of networks**

Auditors willing to address the demand for international services today operate via a network linking audit firms located in many jurisdictions. Auditors are not organised in a single company or group of companies, but in a series of national partnerships, operating under national regulations and sometimes held together by a not for profit making umbrella organisation. This structure partly stems from the fact that auditors, while following the standards of their global firm, are operating under different audit and regulatory requirements, including regulations on control structures (see section 2.1 "The role of capital"). In the current market, the Big 4 are perceived by audit clients as the most internationally integrated networks. This seems even to be one of their competitive advantages.

**Question 2:** Do you believe that the current number and structures of the audit firms' networks are sufficient?

## **2. OWNERSHIP RULES OF AUDIT FIRMS AND THEIR CONSEQUENCES**

### **2.1. The role of capital**

It is uncertain if and to which extent mid-tier firms are prepared to commit themselves to the degree of investment needed to meet the demands for international audit services and to move into the international audit market.

The role of public authorities is not to create a new player. However, time might have come to search for catalysts to accelerate the emergence of new entrants. One possible catalyst could be deregulation of access to capital, as illustrated in the study carried out by Oxera<sup>2</sup> for the European Commission (see section 2.2 "The Oxera study"). Capital is allocated according to the rules allowing the control of an audit firm. These rules are provided for in Article 3 (4) of the 2006 Directive on Statutory Audit<sup>3</sup>, which aims to protect auditors from conflicts of interest with their clients by ensuring the firms are majority-owned by the auditors themselves. But Member States currently impose, within the limit of the Directive, different rules regarding control structures of audit firms. This situation has also an impact on the current structure of audit networks (see section 1.2 "The current role of networks").

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<sup>2</sup> Ownership rules of audit firms and their consequences for audit market concentration, Oxera, October 2007 (hereafter "the Oxera study")

<sup>3</sup> OJ L 157, 9.6.2006, p. 87. Directive as amended by Directive 2008/30/EC (OJ L 81, 20.3.2008, p. 53).

Regarding the role of ownership rules on the cost of capital, the following two issues have to be examined: first, would the same partial relaxation of the restrictions throughout the EU (e.g., requiring a minimum of less than 50% of shares to be owned by qualified auditors in all Member States) already have a significant impact on ownership structures? Second, should the general ownership restrictions be removed completely such that audit firms could, for example, be majority-owned by shareholders other than auditors? In both cases, there would be no differences anymore between the rules applied by Member States.

## **2.2. The Oxera study**

The Oxera study examines whether the difference in the current levels of concentration between Member States can be explained by the differences in the ownership structures adopted. Some Member States with stricter ownership regimes (requiring 75% or more of the owners of audit firms to be qualified auditors) have a low level of concentration, but this might be explained by other types of regulatory intervention at local level. Such regulatory intervention has not found international support or even led to the emergence of major international players.

In this regard, the Oxera study explores the extent to which corporate structures in audit firms affect the market's ability to reduce concentration and enhance choice amongst a higher number of suppliers of audit firms. Oxera examines two key questions: first, would liberalisation of control rules and unbundling of ownership restrictions from auditors indeed bring a change in control structures, or would auditors continue to work under their current structures? Second, if auditors change their structures and open their capital to external investors, would this stimulate the expansion or creation of audit firms?

The key findings of the study in this regard are:

- Important investments might be necessary over years in order to expand and to enter the international audit market. This cannot be financed via the current operating capital in an audit firm.
- The analysis of an investment model developed to assess potential expansion plans indicates that an audit firm essentially owned by external investors, instead of auditors, might take more easily the decision to expand into the market of large audits. One of the reasons is that existing ownership structures may be estimated to increase audit firms' cost of raising capital by perhaps as much as 10%. However, if ownership rules are to be changed to allow access to a lower cost of capital, radical rather than minor changes are likely to be necessary. Although the same partial relaxation of restrictions across the EU (e.g., requiring a minimum of less than 50% of shares to be owned by qualified auditors) might help to create some additional investment opportunities, it is unlikely as such to create a meaningful opportunity for the audit firms to access capital more easily or at a lower cost.
- Finally, Oxera notes that, from the regulatory point of view, existing ownership structures have been justified by the necessity to protect independence of audit firms. There may also be good economic reasons for audit firms to stick to their current structures, such as the need to retain human capital. However, Oxera adds in this respect

that recent developments in the audit market and potential future trends show a tendency to outsource some parts of the audit value chain to low-cost locations e.g. Asia. This might suggest that the relative importance of human capital might be diminishing to some extent, such that the benefits of the current ownership and control rules might become less important.

### **3. A POSSIBLE WAY FORWARD**

Based on the conclusions of the Oxera study (see section 2.2), this section examines two possible ways for finding catalysts to stimulate the emergence of new players: particular focus on deregulation of the capitalisation of audit firms (unbundling) or focus on a wider range of catalysts.

#### **3.1. Particular focus on the deregulation of the financial capital**

Existing ownership structures have been set up to ensure the independence of audit firms. Therefore, deregulating the capital structure implies modification of Article 3 (4) of the 2006 Directive on Statutory Audit, which requires that auditors hold a majority of the voting rights in an audit firm and that a majority of auditors control the management board. However, a change to control rules might lead to a situation in the EU where some Member States continue to require majority of voting rights held by auditors while others do not, thereby fragmenting the market. To avoid this situation, a possible measure could be prohibition at European level to reserve voting rights for certain parties such as a majority of auditors.

Such a prohibition at European level would allow for competing models on the control structures for audit firms. A model based on external investors (such as pension funds) would not be the only model. Such a ban would equally not imply moving to a model of an investment bank which has considerably been challenged in the current financial crisis. It is equally conceivable that auditors, lawyers and tax advisors would invest their capital into a common firm.

Deregulating the capital structure should not be to the detriment of robust independence rules. This is even more crucial in the light of the crisis on financial markets, which has increased the need for high audit quality and robust independence. However, important safeguards already exist today. Such safeguards can mitigate the impact of alternative ownership structures, where the control over the audit firms is no longer with auditors, on the independence of the auditor.

For example, there is a widespread discussion on rules preventing conflicts of interests within credit rating agencies (see the Commission proposal on credit rating agencies of 12 November). However, in this regard, no one questions whether credit rating agencies should be subject to specific ownership rules to ensure independence of ratings.

##### *3.1.1. Safeguards under the Directive on Statutory Audit*

Article 22 of the Directive on Statutory Audit provides for the need to ensure that there is no direct or indirect financial, business or other relationship between the auditor, the audit firm or the network and the audited entity.

The Directive on Statutory Audit also already addresses the problem that the existence of outside owners of an audit firm might give rise to potential conflict of interest that could compromise the independence of the audit firm. One key question in the context of control structures and voting rights is who, within the audit firm, is most important when determining the degree of objectivity and integrity of the firm as a whole, and whether the auditor is to be independent of the client only. In this regard, Article 24 of the Directive requires that owners or shareholders do not intervene in the execution of a statutory audit in a way which jeopardises the independence of the auditor. This new rule is of major importance. Article 24, as it stands today, would allow Member States to ensure by conduct of business rules that the decisions of an auditor in an audit firm owned by external investors, such as pension funds, are not influenced by such investors. The same provision would equally enable Member States to ensure by conduct of business rules that for instance a lawyer or a tax advisor cannot provide advice in the context of an audit assignment carried out by an auditor belonging to a firm owned by all these professionals.

In terms of safeguards on independence, several regulations and practices of market participants more generally mitigate risks to audit quality and auditor independence (corporate governance mechanisms, code of ethics, auditing standards, independent inspections by public oversight bodies, disciplinary arrangements of audit regulators, disclosure of non-audit fees in the accounts of companies, role of the audit committees in companies).

### 3.1.2. *The market forces*

Furthermore, the analysis of the decision-making processes in large audit firms carried out by Oxera indicates that alternative ownership structures are unlikely to significantly impair auditor independence in practice. In particular, the separation of decisions on an individual audit from strategic business decisions would make it difficult for the external investor to influence the outcomes of individual audit assignments. It is also unclear why, in the long term, the interests of persons other than auditors in protecting the independence of auditors in such entity would be fundamentally different to those of individual audit partners. The risk of a strong reputational loss would also maintain the auditor's independence: audit firms themselves have to ensure their reputation.

**Question 3:** Is access to financial capital a key factor to accelerate further integration of audit firms and emergence of new players? Do you share the view that allowing for competing models (e.g. partnership model, investor model, ...) will create the opportunity for more investments resulting in more global players? Are other models conceivable?

**Question 4:** Would models other than the current one negatively affect auditors' independence? Is there a need for additional safeguards at European level to protect independence? If so, what safeguards should be strengthened?

### 3.2. Focus on a wider range of catalysts

One might argue that too much emphasis should not be given to deregulating control rules and to unbundling ownership rules from audit services. Furthermore, there may also be good reasons for audit firms to stick to their current structures: for example, to retain their human capital, which is critical in business such as audit. Therefore, it might be preferable to include in the discussion further catalysts able to facilitate the emergence of new and/or more integrated players in the audit market.

#### 3.2.1. Further catalysts mentioned in the Oxera study

Oxera identified other barriers than access to capital which also play an important role in affecting the entry and could be investigated in parallel with the potential change in ownership rules as a means of improving access to capital: the brand and the perception/reputation, which are used as proxies of the quality per se, the quality and expertise of staff, the low switching rates (reasons for companies not to change their auditor), the differences among firms in their international outreach (the Big 4 are perceived to have greater capacity and international coverage to deliver the technical audit), international management structure. It is important to clarify whether such barriers can effectively be addressed and catalysts put in place promoting emergence of new players. Oxera also identified the liability risk as a barrier. In this regard, the European Commission issued a recommendation on the limitation of auditors' liability<sup>4</sup> in June 2008.

#### 3.2.2. Further catalysts currently debated

The International Organisation of Securities Commissions (IOSCO)<sup>5</sup> and the UK Financial Reporting Council (FRC)<sup>6</sup> are discussing the future of the audit market. As for the audit profession, reducing differences in national requirements seems to be also relevant in the current debate, instead of (or in addition to) deregulating control structures. For example, further converging or even harmonising independence rules and the network definition within the EU would represent one aspect to allow the entry of new players. This would allow better forging of cross-border networks and would make the profession more attractive. These issues are addressed in the FEE (European Federation of Accountants) study on "Transnational Organisations and Practices within the Accountancy Profession", published in May 2008<sup>7</sup>.

**Question 5:** Should the Commission examine other catalysts accelerating access to the international audit market? If so, which one and why?

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<sup>4</sup> OJ L 162, 21.6.2008, p. 39

<sup>5</sup> <http://www.iosco.org/news/pdf/IOSCONEWS105.pdf>

<sup>6</sup> <http://www.frc.org.uk/press/pub1614.html>

<sup>7</sup> Study published in May 2008 and updated in October 2008.

**Question 6:** Are the current partnership forms of ownership indispensable in order to recruit, retain and further develop human capital? Could alternative structures under revised control rules allow audit firms to retain human capital and preserve audit quality?

**Question 7:** Is human capital a factor more important than financial capital to expand internationally? Do you see in the current regulation for the audit profession any obstacles related to human capital preventing further integration of audit firms?

#### **4. CONCLUSIONS**

The Commission services would invite comments and views on the issues set out.

Interested parties are invited to respond by 28 February 2009. Comments, preferably in the form of general remarks followed by answers to the questions, can be submitted by e-mail to the following address: [markt-f4@ec.europa.eu](mailto:markt-f4@ec.europa.eu).

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