



FEE response to the European Commission's consultation on control structures in audit firms and their consequences on the audit market

Introduction

- (1) FEE welcomes the opportunity to comment on the European Commission's Consultation on control structures in audit firms and their consequences on the audit market.
- (2) FEE appreciates that the European Commission's consultation seeks to stimulate and broaden the discussion on control structures in audit firms and their consequences on the audit market rather than solely focus on the study "Ownership rules of audit firms and their consequences for audit market concentration" prepared for DG Internal Market and Services (October 2007).
- (3) FEE is of the opinion that auditing is fundamentally underpinned by the ethics of professional services, the quest for quality and a commitment to the public interest.
- (4) FEE recognises that there is currently a debate about (i) choice in the audit market, (ii) sustainability of the audit profession in particular in the context of liability issues and (iii) the potential systemic impact of an involuntary withdrawal of one of the major existing audit providers.¹
- (5) In any instance, solving the liability issues both at Member States level and globally is an essential precondition.
- (6) All these issues need to be addressed with great prudence, following a long-term approach and assessing the impact of any steps to be taken.

FEE is of the view that there is no single element which can create more choice and less concentration in general.

¹ Study on the Economic Impact of Auditors' Liability Regimes, Final Report To EC DG Internal Market and Services By London Economics in association with Professor Ralf Ewert, Goethe University, Frankfurt am Main, Germany, September 2006

The matter is complex and consideration should be given to potential impacts on capital markets, stakeholders' confidence and audit quality.

This complexity mainly stems from the fact that:

- there are different parts of the audit market, and only one where choice could be seen as a source of concern: that of larger multinationals active across the globe and sometimes with several listings;
 - this market situation has developed over a long period of time and will only evolve over the long term.
- (7) FEE believes that market mechanisms should shape market structures and that historically regulatory intervention has already had an indirect impact on market structures and consequently on the number of market players.
- (8) FEE is not convinced that the “investor model” as suggested in the current consultation might result in more global players in the audit market. However, a possible option to this end could be to investigate the potential for enabling multi-disciplinary practices where the majority of voting rights will not necessarily be in the hands of statutory auditors or audit firms registered in a Member State.

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. Need for opening up the market?

- (9) A need for opening up the market would imply that the market is considered by the EC and stakeholders as not open.

FEE acknowledges that the Oxera study and similar reports showed that a certain concentration of large audit firms is evident in certain parts of the audit market.

It is however important to note that such concentration is only an issue in relation to the audit of large listed multinationals.

- (10) Although we recognise that there are in effect additional requirements (independence, transparency) linked to providing statutory audit services to listed companies – and in section 16 we discuss the need for less differences in implementing these requirements – we still believe that it is mainly a market issue.
- (11) The number of audit firms and the size of the firms in EU Member States are also largely dependent on the size of the economy.
- (12) Furthermore, FEE is concerned that there may be a contradiction in policy initiatives. On the one hand raising regulatory burdens resulting in higher cost for audit firms and raising thresholds, resulting in a shrinking statutory audit market and on the other hand initiatives aimed at encouraging more firms to become active in a shrinking market could be considered conflicting.

2. Need for a more integrated audit market?

- (13) The Commission is right in noting that, in Europe, the audit market is less integrated than capital markets or banking and insurance markets.

It should be outlined that this fragmentation results from:

- the national differences in the legal frameworks regarding company law and tax;
- the national differences in the liability regimes² and in the potential exposure to and consequences of litigation and
- the national differences in the regulatory frameworks imposed on the audit profession by local regulators.

Education, training, licensing, registration, liability regimes and especially independence provisions and auditing standards (as well as accounting standards) are still largely determined by national jurisdictions. This constitutes a barrier for all audit providers to operate across jurisdictions.

² See also Impact Assessment to the European Commission's Recommendation concerning the limitation of the civil liability of statutory auditors and audit firms, dated 5 June 2008, page 13

(14) The accountancy profession's transnational evolution within Europe has been strongly moulded by a fragmented, jurisdiction-specific approach to regulation, and different legal systems and structures.³ To date, there has been only modest transnational coordination of regulatory policy at European level to allow for more simplified transnational structures for accountancy organisations and practices.⁴

(15) It would be helpful if regulators focused on areas of the Statutory Audit Directive where Member State implementation is inconsistent and where differences cannot be justified in the public interest.

One area of particular concern is the implementation and application of the network definition which has a bearing in terms of creating a level playing field.⁵

(16) A consistent implementation of the Statutory Audit Directive is essential to create a context which is conducive to the development of more audit providers operating with potential greater international capacity.

Avoiding gold-plating should be an essential part of a fair implementation process. In certain countries, restrictions on ownership rules appear to go beyond the requirements of the Statutory Audit Directive and make it difficult for specialists of other disciplines to become partners in firms registered for statutory audit in the EU (see question 3).

Question 2:

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

1. Current number of audit firms' networks

(17) FEE recognises that there is an ongoing debate about the current number of audit firms' networks.

³ see FEE study on "Transnational Organisations and Practices within the Accountancy Profession" (TOPS study), published in April 2008

⁴ The term transnational organisations and practices may be a more appropriate term to convey the variety of different organisations and structures in the profession operating cross borders rather than "networks" which has a legal definition through the Statutory Audit Directive which is applicable to many but not all of such organisations and structures (see FEE TOPS study). For simplification purposes, the FEE response refers however to the expression "networks" as used in the questions of the European Commission's consultation.

⁵ see updated IFAC definition of network Firms, <http://www.ifac.org/MediaCenter/?q=node/view/206>

As mentioned above, it is difficult to answer the question without considering the part of the audit market in which the audit firms operate.

The number of audit firms operating in the market of large listed multinationals is clearly small. This does however not mean that there are no other audit firms technically capable of providing high quality audit services to listed international companies.

- (18) FEE would like to highlight that the current number of audit firms' networks is a result of market forces and history. It also depends on the size of the jurisdiction that can make it difficult for all audit firms' networks to be represented.

The number of firms in a specific market is an outcome of the market, it cannot be determined by stakeholders or regulators.

- (19) In principle, it would be helpful if legislators created a context that facilitates market access for small and medium-sized audit firms.

FEE doubts however that organic growth or mergers in the medium-sized audit market will in the short or medium terms close the gap between larger international audit firms and small and medium-sized audit firms⁶ and that concentration in the audit market would be reduced in such a way.⁷

- (20) FEE shares the concerns of the European Commission that a reduction of the current number of larger audit firms' networks risks having a systemic impact.
- (21) A limitation of liability could help in maintaining at least the current level of choice and the further development of audit firms' networks could be encouraged further by implementation of the European Commission's recommendation on auditors' liability.⁸
- (22) Furthermore, the international and in particular the US litigious environment results in the issue of potential extension of liability to networks, which needs to be recognised and also requires a solution.
- (23) Consideration and potential implications of choice and market structure should also be embedded in the impact assessment of all future regulatory initiatives.

⁶ World Survey 2008, International Accounting Bulletin, 18 December 2008, page 6 to 14

⁷ Final Report of the U.S. Treasury Advisory Committee on the Auditing Profession of 6 October 2008, Page VIII:4

⁸ European Commission's Recommendation concerning the limitation of the civil liability of statutory auditors and audit firms, dated 5 June 2008

2. Current structures of audit firms' networks

- (24) FEE understands that the question raises the point of the structures of audit firms' networks and not of the legal structures (forms) available to audit firms. It does also not address the scope of transnational organisations and practices as mentioned in the FEE study "Transnational Organisations and Practices within the Accountancy Profession" (TOPS study), published in April 2008.
- (25) The improvement of the structures of the audit firms' networks is impeded by a number of elements relating to the fragmentation of the market as outlined above (question 1) as well as in the TOPS study.

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?

1. Role of financial capital

- (26) In FEE's view, many factors can influence the growth of a firm.
- (27) Financial capital may play a certain role but is not regarded as a key factor for increasing choice in the audit market.
- Auditing is not a capital-intensive business, but a human capital intensive one.
- (28) Of course, audit providers need capital:
- to set up structures to cover all the jurisdictions where there is client demand,
 - to recruit the necessary talent and
 - to develop systems to deliver and ensure the highest quality.

Nevertheless, FEE is not aware of any real difficulty in finding and maintaining such capital.

- (29) Thanks to recent transparency efforts of audit firms, further evidence can be found in the annual accounts and transparency reports published by the firms which generally exhibit a low level of debt.⁹

2. Result of allowing for competing models

- (30) In principle, the partnership model appears to be appropriate for audit firms in particular as it is dedicated to attract and retain appropriately qualified human capital (see also question 6).
- (31) A change of the ownership regime, introducing a prohibition at European level to reserve voting rights for certain parties such as a majority of auditors, as suggested in 3.1 of the European Commissions' consultation paper, retains considerable risks.

In particular, consideration should be given to external perceptions regarding independence.

- (32) FEE has in any case doubts that the "investor model" might result in more global players because financial capital is not regarded as a key factor for going global, neither for the emergence of new audit firms nor for the enlargement of existing networks.
- (33) Furthermore, it is worthwhile to mention that under the current ownership regime the possibility to get external capital already exists in principle.

The Statutory Audit Directive provides that a majority of the voting rights in an entity must be held by audit firms or by auditors¹⁰ and allows thus a minority to be held by non-auditors.

⁹ see for example <http://annualreport.deloitte.co.uk/2008/financial-statements>,
http://www.kpmg.eu/docs/KPMG_AR_29.12.pdf,
[http://www.ey.com/Global/assets.nsf/UK/EY_annual_review_2007/\\$file/EY_Annual_Review_2007.pdf](http://www.ey.com/Global/assets.nsf/UK/EY_annual_review_2007/$file/EY_Annual_Review_2007.pdf),
http://www.pwc.co.uk/annualreport08/AR_2008.pdf,
[http://www.bdo.co.uk/BDOSH/SharedContent.nsf/i/4E0E9151164E9CC0802575080054C293/\\$file/bdo-figures-consolidated3.html](http://www.bdo.co.uk/BDOSH/SharedContent.nsf/i/4E0E9151164E9CC0802575080054C293/$file/bdo-figures-consolidated3.html).

¹⁰ Article 3 paragraph 4 Statutory Audit Directive: "The competent authorities of the Member States may approve as audit firms only those entities which satisfy the following conditions: (a) ...; (b) a majority of the voting rights in an entity must be held by audit firms which are approved in any Member State or by natural persons who satisfy at least the conditions imposed by Articles 4 and 6 to 12. Member States may provide that such natural persons must also have been approved in another Member State. For the purpose of the statutory audit of cooperatives and similar entities as referred to in Article 45 of Directive 86/635/EEC, Member States may establish other specific provisions in relation to voting rights; (c) ..."

It is true to say that this provision of the Directive has been transposed in such a way that very diverging regimes continue to exist in Europe which are not conducive to the development of more audit providers operating with potential greater international capacity.

FEE therefore reiterates the importance of implementing the current provisions of the Statutory Audit Directive consistently.

3. Conceivable other models than those allowed by the Statutory Audit Directive

(34) It should first be noted that the development of new models would require a reform of certain provisions of the Statutory Audit Directive.

(35) A first question to address is whether this would be appropriate and timely, or not.

If the Statutory Audit Directive is to be revised, FEE sees two possible different directions.

(36) One could be the “investor model” as suggested by the European Commission in the current consultation which remains, in our view, unconvincing at this stage.

Such an “investor model” has existed in certain countries before the Statutory Audit Directive was enacted. At those times, audit firms could be owned by banks or by the state. The model was put into question because of its perceived risks for auditors’ independence and was finally abandoned.

The perceived risks result in particular from the fact that the investor model is characterised by the possibility of majority and thus controlling shareholders seeking short term gains. Ownership in the partnership model is much more fragmented, which creates an environment that is more suitable to secure the quality of the audit and the independence of those individuals who are engaged in the performance of audits.

(37) Another option could be to investigate the potential for enabling multi-disciplinary practices where the majority of voting rights will not necessarily be in the hands of statutory auditors or audit firms registered in a Member State.

The current limitation in external ownership sets an upper limit on professionals of other disciplines¹¹ to become partners in the audit firm, because the majority of the voting rights has always to be in the hands of registered statutory auditors or audit firms.

One should observe that accountants are continuously carrying out services other than statutory audit (in a number of cases due to increased audit thresholds and in response to market demands in new areas of competence) and therefore do not necessarily need to be registered as statutory auditors, a fact which strengthens the need for multi-disciplinary structures.

Furthermore, many professionals of other disciplines, e.g. lawyers, tax advisors, business and IT consultants are also working in audit firms and have ambitions of becoming a partner.

The removal (in line with the Services Directive) of existing restrictions to the access to partnership for professionals working in the firm is a possibility to facilitate the emergence of multi-disciplinary networks and therefore of new market players that would respond to business demand.

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?

1. Independence impact of other models

- (38) A majority of externally-owned capital and control would probably be expected to have an impact on the applicable independence rules, the consequences of which would require careful analysis, both in relation to the internal workings of audit firms and to external perceptions.
- (39) External perception might differ if external capital (and/or detention of the majority of voting rights) is owned by other professionals subject to the rules of their professional bodies working within the audit firm as opposed to financing organisations external to the firm.

¹¹ One could observe that this also applies to qualified auditors from third countries who are not registered in the European Union

2. Need for additional safeguards

- (40) Under the current circumstances and legal regime, FEE believes that there are already ample safeguards to protect auditors' independence. For example Article 24 of the Statutory Audit Directive relates to the independence and objectivity of the statutory auditors carrying out the statutory audit on behalf of audit firms vis-à-vis the owners of the firm.

According to this provision, Member States shall ensure that the owners, shareholders and management of an audit firm do not intervene in the execution of the statutory audit.

It is unclear how Member States would implement this article should the majority ownership rules be revised.

- (41) If the European Commission would nonetheless consider a revision of the Statutory Audit Directive, the possibility of unintended consequences should be carefully considered.

It should also be kept in mind that any additional regulatory measure(s), which would bring more complexity, would ultimately be an additional barrier to enter the market.

It should also be noted that the reservation of the majority ownership to auditors is a safeguard in itself. Were such safeguard to be removed, another safeguard would most likely have to be found to close the gap.

Question 5:

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

- (42) Companies, their external advisors (banks, lawyers) and regulators are often influenced by the "IBM effect" whereby they select a statutory auditor and often go to the larger firms without necessarily fully considering the real capabilities and competencies of other audit firms.
- (43) The European Commission and Public Oversight Systems should turn their attention first to the demand side and the process for selecting statutory auditors and audit firms.

The following measures which do not necessarily require regulatory intervention could be considered:

- Stronger governance principles regarding the role of audit committees in selecting the external auditor;
 - Transparency of tendering procedures with a view to ensure that smaller firms are not prevented from competing. In this respect it should be noted that mandatory rotation of firms would be counterproductive and that experience has shown that it may well hinder audit quality.
- (44) Regarding the supply side and keeping in mind the need to avoid gold-plating in the implementation of the Statutory Audit Directive (see above section 15), FEE would like to suggest prioritising the following catalysts:
1. Ensuring a consistent implementation of the Statutory Audit Directive and avoiding divergences such as with the network definition;
 2. Continuing progress on auditors' liability reform;
 3. Enhancing convergence of standards and adopting the clarified ISAs;
 4. Ensuring convergence on independence requirements;
 5. Ensuring that careful thought and analysis is given before increasing the audit thresholds which inevitably shrinks the audit market. It also means that many persons training to be professional accountants will not gain any audit experience. This could severely limit the number of qualified audit staff in the future.
- (45) FEE is convinced that a European harmonised solution (and if possible one at international level) to limit auditors' liability is a prerequisite to facilitate a broader access of audit firms to the market part related to listed companies.¹²
- FEE would also like to point out that the international and in particular the US litigious environment resulting in the issue of potential extension of liability to networks, definitely inhibits the further development of current or new players. On the contrary, it appears that certain mid-tier firms have recently been taking measures to reduce trans-national quality assurance programmes in light of concern over the implications for liability risk.
- (46) Overall, creating a context that facilitates the market access for small and medium-sized audit firms/audit providers currently operating principally outside the large company audit market would be beneficial.

¹² See Impact Assessment to the European Commission's Recommendation concerning the limitation of the civil liability of statutory auditors and audit firms, dated 5 June 2008, page 18 and 28

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?

1. Indispensability of current partnership forms

- (47) The expression “partnership” might be misleading (in certain jurisdictions) and should be defined in advance.

Partnership forms should not be understood in the context of national company law, because large audit firms are rarely organised in “genuine” partnership forms any more. From the legal point of view, large audit firms are often incorporated, but with all the shares in the hands of the “partners” and operating in a “partnership-like” manner.

- (48) Partnership forms have long been perceived as providing the most appropriate structure for a profession that is driven by professional values and ethical principles.
- (49) The partnership form as a model of bottom-up organisation is more suitable to protect the personal professional responsibility of the signing partner than the investor model which is rather top-down.
- (50) In addition, the desire to become a partner in an audit firm helps to attract and retain appropriately qualified human capital. Being one of the owners of a firm or having the opportunity of becoming one can also be a strong driver for providing services of the highest quality.
- (51) Commercial ownership and industrial models produce other types of incentives; the question is: what is the most appropriate for maintaining audit quality? Additionally, currently some of the reward structures within these other types of business structure are facing considerable scrutiny as to whether they have the desired impact, e.g. bonuses, short-term stock options etc.

FEE urges the Commission to ensure that there is adequate consideration of these issues in this area.

2. Consequences of alternative structures under revised control rules

- (52) The consequences of any changes in the model should be carefully investigated, which includes, but is not limited to their impact on audit quality.

FEE has no evidence as to the effectiveness of alternative structures 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?

1. Importance of human capital

- (53) FEE understands from the audit profession that investing in human capital is considered by the profession as far more important to increase international capacity than having access to financial capital (see question 3) as highly qualified and motivated human resources are the basis for the national and international success of any audit firm.

The profession has always developed an innovative range of incentive schemes in order to retain human capital. FEE doubts that the involvement of external shareholders would contribute to enhance these schemes.

2. Obstacles to further integration

- (54) FEE has concerns that some aspects of the audit work such as (i) unlimited liability, (ii) the prohibition to provide non-audit services to audit clients and (iii) the amount of regulatory constraints are not likely to help firms to recruit and retain quality young professionals.

The current regulation in this area has therefore some potential for improvement in order to attract human capital and thus enhance the further integration of audit firms.



About FEE

FEE (Fédération des Experts comptables Européens – Federation of European Accountants) represents 43 professional institutes of accountants and auditors from 32 European countries, including all 27 EU Member States.

In representing the profession, FEE recognises the public interest. FEE has a combined membership of more than 500.000 professional accountants working in different capacities in public practice, business, government and education, who all contribute to a more efficient, transparent, and sustainable European economy. To learn more about FEE and about the accountancy profession in Europe, read the FEE 2007 Annual Review, downloadable from our website (www.fee.be).

FEE would be pleased to discuss any of the points above in further details. To this end, or for further information, please contact Henri Olivier (henri.olivier@fee.be) or Petra Weymüller (petra.weymuller@fee.be) from the FEE Secretariat.

Fédération des Experts comptables Européens – Federation of European Accountants

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