FINAL REPORT

(Executive summary)

Study on the effects of the implementation of the acquis on statutory audits of annual and consolidated accounts including the consequences on the audit market

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I EXECUTIVE SUMMARY: THE EUROPEAN AUDIT MARKET, ISSUES AND IMPLICATIONS FOR FUTURE REFORM

I.1 A heterogeneous European audit market, with diverse market characteristics and two different market segments

One of the main observations arising from this study is how diverse the national markets are. Differences between Member States exist on several issues:

- Legislative and regulatory frameworks, including:
    1. The value of thresholds for statutory audit exemption vary significantly, based on three criteria – net turnover, balance sheet totals and number of employees between Member States, with Finland using the lowest threshold;
    2. Auditors' liability;
- Education or professional training and audit standard setting;
- The share of the market of accounting, bookkeeping, auditing services and tax consultancy, in which audit firms are active, as a percentage of GDP varies from 0.3% in Lithuania and Romania to 3.5% in Luxembourg (while EU average stands at 1.0%).

Market trends therefore need to be analysed on a country-by-country basis, rather than at a "regional" European level (e.g. market dynamics in Northern and Western vs. Southern and Eastern Europe, or for the six founding States vs. for more recent entrants).

Two different market segments, with specific market dynamics emerge from the analysis:

- Audit services for listed and large companies;
- Audit services for small and medium-sized companies.

Since most issues identified impact mainly the listed or large companies segment, analyses and recommendations focus primarily on this part of the audit market.

I.2 Main issues regarding the criteria to assess the functioning of the market

I.2.1 A concentrated European market

When taking into account the whole audit market, i.e. all audited companies, the market share of the Big 4 remains moderate, except in four Member States:

- In 19 Member States, the market share of the Big 4 is under 26%, and below 10% in five Central/Eastern EU Member States (Czech Republic, Estonia, Hungary, Poland and Slovenia);
- In Denmark, Luxembourg, Sweden and the United Kingdom, the share of the Big 4 is significantly higher (ranging from 35% to 44%).

However, when the audit market of listed companies is considered[1], most EU Member States have high concentration levels:

- The average market share of the Big 4 firms is above 90%;
- Only Bulgaria, Greece and France come out as not concentrated or moderately concentrated;
- The market share can even get close to 100% when a combination of the largest companies and specific sectors are taken into account (e.g. in Sweden, Price Waterhouse Coopers holds a 97% market share in turnover of the 53 IT companies listed on the regulated market).

This situation could pose a significant risk in the case of the demise of one of the Big 4.

Mid-tier audit firms have been gaining market share (partly due to external growth strategies targeting “statutory audit” clients) but still have a relatively weak position in the audit market of listed companies. Mid-tier audit firms remain rather national than international players: only three mid-tier firms have more than ten mandates in more than three of the eight largest EU Member States.

Two main reasons explain this high concentration level:

1. Intense M&A activity of the Big 4 audit firms until 2005, followed by a similar trend among mid-tier and smaller audit firms;
2. Significant barriers to entry and development of mid-tier firms in the audit market of listed companies. These main barriers are in particular lack of size or insufficient capacity in terms of number of auditors in mid-tier audit firms, limited geographical reach of mid-tier audit firms, a strong preference among large companies to choose Big 4 audit firms because of

[1] Using CR1/CR4/CR8 and HHI as concentration measures, and calculating market shares in turnover of audited companies, i.e. the most relevant proxy for audit fees.

their reputation, resistance among companies and the absence of incentives to change the audit firm.

The increasing requirement in the audit market for sector expertise and the impact of technology on the audit process have also become challenges faced by mid-tier audit firms. Mid-tier firms realise they need to increase their professional capacities but are faced with increasing costs and the risks related to listed company audits. Also, given the low prospect of winning a mandate, it is difficult to justify investment in certain cases. If these barriers are not addressed, concentration in the market of the largest companies could further increase in the near future.

I.2.2 Quality and independence issues

Two quality and independence issues affect the current functioning of the European audit market:

- Quality of audit seems increasingly challenged, or even mistrusted, by some investors and regulators;
- The independence of audit firms is increasingly questioned given:
    - The low "switching rates", or changes in audit firms
        - In the United Kingdom, the average switching rates for the FTSE 100 and the FTSE 250 were 2.1% and 2.8% respectively, during the period 1996-2004[2]
        - In the United States, audit tenure can reach 121 years and is considered as a key issue regarding independence;
    - The relatively high level of audit firms' revenues deriving from "non-audit" services (non-audit fees charged to statutory audit clients amount to between 10% and 40% of total fees).

Inspection reports by regulators, both in the EU and in the US, confirm these views. Given the key role played by audit firms towards confidence by the different stakeholders in the financial statements and thus financial markets, these issues need to be addressed to avoid a legitimacy risk for the audit function in the mid-term.

I.2.3 Potential risks regarding audit fees

The analysis of audit fee levels relative to concentration levels does not demonstrate a correlation between the two (r^2 coefficient ranging from 0.01 to 0.1), suggesting an overall correct functioning of the market regarding prices, despite the high market share of the Big 4. Interviews and focus groups support the view that competition remains strong among the Big 4.

[2] House of Lords – Auditors: Market Concentration and their role – March 2001.

Three risks were nonetheless identified regarding audit fees:

1. On the most concentrated market segments, one or two Big 4 firms could become price-maker, generating higher than average audit fees;
2. Decreasing fees (e.g. when calls for tenders are launched) could negatively impact the quality of audit, since both appear highly correlated;
3. The risk of cross-subsidization using audit as a loss leader to sell higher margin consulting services as discussed by a number of academics and supported by interviewees could be considered a real risk given the strong M&A activity of the Big 4 audit firms targeting since 2005 non-audit services.

I.3 Overview of possible measures to improve the functioning of the market

I.3.1 No "magic bullet"

No "magic bullet" can address all the issues currently facing the European audit market. Therefore, to significantly impact the functioning of the audit market, a package of measures is likely to be necessary.

Moreover, measures that could be taken will have a different impact on the functioning of the market depending on each Member State's characteristics and market situation.

I.3.2 Joint audit, the priority step to tackle the concentration issue

Joint audit appears as the key measure to lower concentration levels in the short term: France, the only Member State that currently enforces joint audit (for companies consolidating their accounts), has a lower than average concentration level and a mid-tier firm that is present on the "main index" market segment.

This would contribute to the growth of mid-tier firms, hence enabling them to reach critical size on a national basis. In France, joint audits contributed to the growth of Mazars and three other mid-tiers firms later acquired by Big 4 firms: Salustro Reyel (acquired by KPMG), BDO Marque et Gendrot (acquired by Deloitte) and Constantin (also acquired by Deloitte).

Increasing the presence of mid-tier firms at an international level, especially for those companies listed on the main indexes in the larger Member States, will take longer, given the geographical and capacity barriers. For example in France, mid-tiers carrying out joint audits with a Big 4 for companies listed on the SBF 250 index only have 28% of total audit fees on average. A balanced sharing of tasks, responsibilities and fees therefore needs to be found to maximise the potential of this measure.

I.3.3 Other measures aiming at opening the market to mid-tier firms

Other ways of opening the audit market of larger companies to mid-tier firms would consist in removing other specific barriers to entry:

- Bank covenants that request companies to be audited by a Big 4 (i.e. "Big 4-only" clauses) should be discouraged by publicly disclosing bank covenants (this type of clause could subsequently be banned);
- The role of audit committees in the appointment process of audit firms should be reinforced by increasing its transparency: they could be requested to report periodically on their decisions and reasons for changing or maintaining the existing auditors and to facilitate the involvement of investors;
- The year of the initial appointment of the auditor should be disclosed in the companies' financial statement so that shareholders may be aware of it and be able to eventually challenge the Board in case of long audit tenure;
- Member States could encourage the audit of public sector bodies which represents an opportunity to strengthen the non Big 4 firms' capacity to audit relatively large institutions and increase competition and choice in national audit markets.

Another potential issue aiming at opening the market to mid-tier firms is to limit liabilities of audit firms, which was extensively discussed in the study on the *"Economic impact of auditor's liability regime"* by London Economics (published in 2006). The Commission Recommendation[3] of June 2008 lists the measures to address this issue.

I.3.4 Measures for addressing the potential mistrust in the audit function

In order to address the potential mistrust of investors:

- Mandatory rotation could address the potential mistrust of some investors implied by the currently low switching rate and consequently long audit tenure, even if a risk on audit quality would have to be monitored;
- Tendering could be encouraged given that some auditors have been in place for decades, but could have a negative impact on quality according to stakeholders if it would become mandatory;
- A publicly disclosed long form audit report that would include audit methodology and its risks along with main findings on the going concern or risks facing the company;
- Limits could be fixed on the proportion of fees earned by an audit firm from one client: e.g. it could be fixed at a maximum of 15%;
- Stricter rules on the provision of non-audit services to audit clients could be introduced;

[3] Commission Recommendation of 5 June 2008 concerning the limitation of the civil liability of statutory auditors and audit firms.

- Non-audit assignments should be submitted to the audit committee for approval, when they exceed a defined threshold;
- ISAs could be implemented across Europe, since it would provide assurance that uniform audit processes are being applied and that they are in compliance with ISA standards.

I.3.5 Implications for Future Reform

Given the differences and complexities in national environments, future reforms relating to audit and financial reporting could be viewed on two levels – the listed company audit requirements at a European level, and the non-listed company audit requirements at a national level. Many of the specific issues and action steps studied in the report – concentration, non-audit services, joint audits, mandatory rotation of auditors, etc. – could be harmonised for listed company audits throughout Europe. More flexibility and options could exist for the non-listed, national audit markets.

Company reporting and audit requirements should also be tailored to each specific market in order to maximise the beneficial effects resulting from new regulatory measures.

The need to address such problems requires careful consideration: consultation is required amongst all stakeholders, coordination is required between the auditors, the oversight bodies, the regulatory authorities, the users of financial statements, at both national and European levels.

I.3.6 Sources and Limitations of the Study

The information provided in this report comes from a wide range of data sources, including:

- Extensive desk research and statistical analyses;
- A review of 96 academic articles, studies and reports from economic and accounting journals, regulators and other official bodies;
- 158 responses to an online survey with key stakeholders;
- 51 interviews with representatives from the different audit stakeholders;
- 5 focus groups meetings held in France, Germany, Italy, Spain and the United Kingdom, representing key interested parties.

The study involves some limits such as:

- Data collection was realised only for EU Member States for the market of accounting, bookkeeping, auditing activities and tax consultancy (NACE class M69.2), i.e. not specifically the audit market as such (as audit firms are the dominant players in this market, the trends distinguished for this market are considered to apply for the audit market);
- The data collected on audit fees always includes a portion of audit-related services;

- No investors contacted attended the focus groups. Therefore, for the views of investors on the issues discussed, ESCP focused on their replies to the Commission's Green Paper on Audit Policy;
- While only one regulator attended the focus groups, the views of regulators could be found in the replies to the Green Paper as well as for a number of regulators in their inspection reports;
- No data were available for years 2005-2008 to assess concentration levels on the listed companies market segment;
- No full data sets were available for 2010;
- Data were collected on the 27 Member States, but information can be missing (not available) for specific countries on specific data points.