FINAL REPORT

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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Table of contents

I EXECUTIVE SUMMARY: THE EUROPEAN AUDIT MARKET, ISSUES AND IMPLICATIONS FOR FUTURE REFORM ... 5

I.1 A HETEROGENEOUS EUROPEAN AUDIT MARKET, WITH DIVERSE MARKET CHARACTERISTICS AND TWO DIFFERENT MARKET SEGMENTS ... 5

I.2 MAIN ISSUES REGARDING THE CRITERIA TO ASSESS THE FUNCTIONING OF THE MARKET ... 6

I.2.1 A concentrated European market ... 6

I.2.2 Quality and independence issues ... 7

I.2.3 Potential risks regarding audit fees ... 7

I.3 OVERVIEW OF POSSIBLE MEASURES TO IMPROVE THE FUNCTIONING OF THE MARKET ... 8

I.3.1 No "magic bullet" ... 8

I.3.2 Joint audit, the priority step to tackle the concentration issue ... 8

I.3.3 Other measures aiming at opening the market to mid-tier firms ... 9

I.3.4 Measures for addressing the potential mistrust in the audit function ... 9

I.3.5 Implications for Future Reform ... 10

I.3.6 Sources and Limitations of the Study ... 10

II METHODOLOGY USED ... 12

II.1 OVERALL APPROACH ... 12

II.2 DETAILED METHODOLOGY PER MODULE ... 13

II.2.1 Module 1: Definition of the audit market and selection of relevant concentration indicators ... 13

II.2.2 Module 2: Analysis of the audit market based on desk research ... 23

II.2.3 Module 3: Key takeaways from relevant literature on audit ... 31

II.2.4 Module 4: Online survey ... 32

II.2.5 Module 5: Qualitative interviews with high-level representatives ... 47

II.2.6 Module 6: Focus groups confronting points of view of different stakeholders ... 50

II.2.7 Module 7: Key conclusions and action steps ... 51

III DESCRIPTION OF THE MARKET ... 52

III.1 OVERVIEW OF THE REGULATORY ENVIRONMENT FOR STATUTORY AUDIT IN EUROPE ... 52

III.1.1 Introduction ... 52

III.1.2 International Standards on Auditing ... 53

III.1.3 EU audit regulatory requirements ... 55

III.2 OVERVIEW OF THE AUDIT MARKET ENVIRONMENT IN EUROPE ... 65

III.2.1 Introduction ... 65

III.2.2 Size of the M69.2 market and historical evolution ... 68

III.2.3 Revenues of the top 10 audit firms ... 79

IV CRITERIA FOR ASSESSMENT OF THE FUNCTIONING OF THE MARKET ... 84

IV.1 FOCUS ON THE FIRST CRITERION: CHANGES TO NETWORK STRUCTURES FIRMS' CONSOLIDATION (2005-MID 2011) .. 85

IV.1.1 Objective and methodology ... 85

IV.1.2 Evolution of M&A activity ... 86

IV.1.3 Overview of M&A activity per sector ... 88

IV.2 FOCUS ON THE SECOND CRITERION: CURRENT CONCENTRATION LEVELS AND EVOLUTION OF THIS LEVEL OVER THE PAST FIVE YEARS ... 89

IV.2.1 Current concentration levels ... 89

IV.2.2 Evolution of concentration levels over the past five years ... 111

IV.3 FOCUS ON THE THIRD CRITERION: BARRIERS TO ENTRY AND DEVELOPMENT OF MID-TIER FIRMS ON THE OVERALL AND LISTED MARKET SEGMENTS 124
IV.3.1 Objective and methodology 124
IV.3.2 Analysis of the turnover growth of mid-tier firms 124
IV.3.3 Focus on the market position of mid-tier firms with listed companies 127
IV.3.4 Ranking barriers to entry 131
IV.3.5 Conclusion 136
IV.4 FOCUS ON THE FOURTH CRITERION: RISK OF THE DEMISE OF ONE OF THE BIG 4 137
IV.4.1 Objective and methodology 137
IV.4.2 Simulation 140
IV.4.3 Conclusion 145
IV.5 FOCUS ON THE FIFTH CRITERION: AUDIT PRICE LEVELS 146
IV.5.1 Objectives and methodology 146
IV.5.2 Price levels analysis 147
IV.5.3 Focus on the provision of non-audit services and potential impact on audit fees 150
IV.6 FOCUS ON THE SIXTH CRITERION: INDEPENDENCE OF AUDIT FIRMS 153
IV.6.1 Provision of non-audit services to audit clients 153
IV.6.2 Overfamiliarity between the auditors and their clients 170
IV.7 FOCUS ON THE SEVENTH CRITERION: AUDIT QUALITY 172
IV.7.1 Definition of audit quality 172
IV.7.2 Main audit quality challenges 179
IV.7.3 Review of the issues raised in terms of audit quality 184
IV.7.4 Conclusion 188

V POSSIBLE MEASURES IN ORDER TO BETTER MEET THE CRITERIA FOR ASSESSMENT OF THE FUNCTIONING OF THE AUDIT MARKET 189

V.1 LINK BETWEEN THE CRITERIA FOR ASSESSMENT OF THE FUNCTIONING OF THE MARKET AND POSSIBLE MEASURES 189
V.1.1 Criteria for the assessment of the functioning of the market 189
V.1.2 Overview of potential action steps 190
V.1.3 Link between the potential action steps and the criteria for assessment of the functioning of the market 192
V.1.4 Action steps prioritisation 195
V.2 DETAIL OF POSSIBLE MEASURES 198
V.2.1 Action step 1: Annually disclose date of initial appointment and reasons for keeping or changing auditor... 198
V.2.2 Action step 2: Ban the acquisition of audit players by the Big 4 198
V.2.3 Action step 3: Ban "Big 4-only" restrictive covenants 198
V.2.4 Action step 4: Ban the provision of non-audit services to all types of clients 199
V.2.5 Action step 5: Break up, dissolve or split the Big 4 firms 201
V.2.6 Action step 6: Cap the Big 4 firms' market share with listed companies 201
V.2.7 Action step 7: Create a European passport for audit firms 201
V.2.8 Action step 8: Create a European quality certification 201
V.2.9 Action step 9: Detail audit methodology and its risks 203
V.2.10 Action step 10: Encourage consolidation or specialisation among mid-tiers 209
V.2.11 Action step 11: Encourage consortia among mid-tiers 209
V.2.12 Action step 12: Encourage appointment of mid-tiers by the public sector 210
V.2.13 Action step 13: Introduce mandatory firm rotation 210
V.2.14 Action step 14: Introduce mandatory joint audit 226

V.2.15 Action step 15: Introduce mandatory joint audit with a ban on the appointment of two Big 4 .. 242
V.2.16 Action step 16: Introduce mandatory tendering 242
V.2.17 Action step 17: Implement ISAs 243
V.2.18 Action step 18: Limit the provision of non-audit services to statutory audit clients 244
V.2.19 Action step 19: Limit the proportion of fees an audit firm can receive from a single client 245
V.2.20 Action step 20: Establish contingency plans for the potential demise of a Big 4 audit firm (living will)....... 247
V.2.21 Action step 21: Publicly disclose loan agreement to regulators 247
V.2.22 Action step 22: Increase the number of public interest entities that need to be audited 248
V.2.23 Action step 23: Reinforce the role of the audit committee 249
V.2.24 Action step 24: Review audit firms ownership and partnership rules 263
V.2.25 Action step 25: Submit audit fees at AGMs (for approval) 263
V.2.26 Action step 26: Submit audit fees to regulators (for approval) 263
V.2.27 Action step 27: Limit liability 263
V.3 COMBINATION OF POSSIBLE MEASURES 264
V.3.1 Combination n°1: Mandatory rotation, mandatory joint audit and prohibition of certain non-audit services to audit clients 266
V.3.2 Combination n°2: Mandatory rotation, mandatory joint audit and pure audit firms 267
V.3.3 Combination n°3: Mandatory tendering, mandatory joint audit and prohibition of certain, but not all, non-audit services to audit client 268
V.3.4 Combination n°4: Mandatory tendering, mandatory rotation and prohibition of certain, but not all, non-audit services to audit client 269

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.

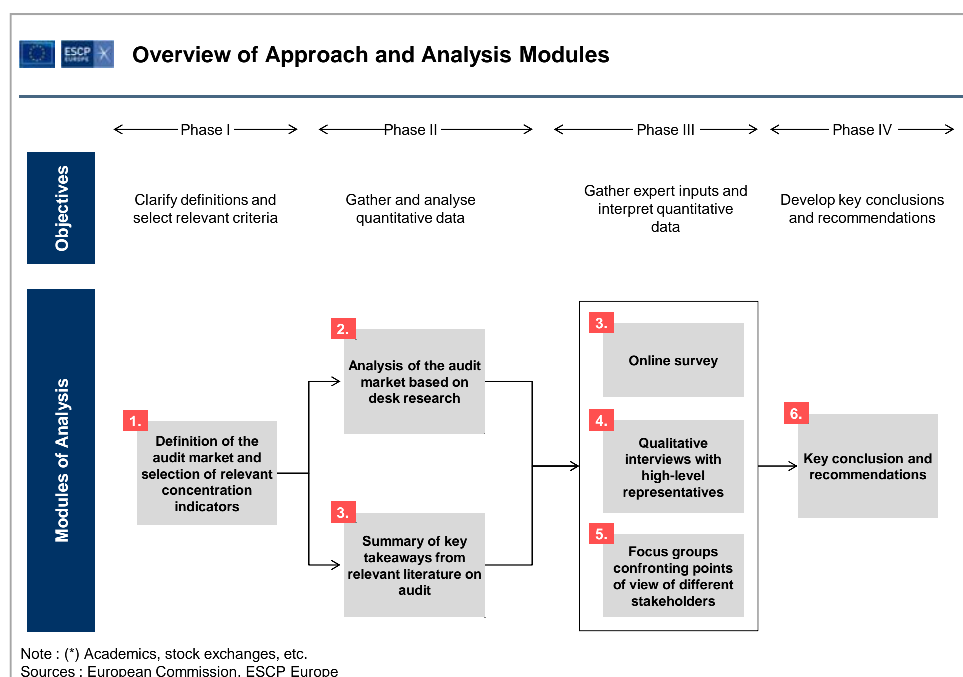
II METHODOLOGY USED

II.1 Overall approach

The first step of the approach was to identify which criteria needed to be used in order to describe and assess the functioning of the audit market (see details below).

Once identified, ESCP Europe structured an approach using six main types of analysis tools or "modules", as follows:

Figure 1: Overview of analysis modules



The overall rationale of this approach is the following:

- The first building block (module 1) aimed at gathering all relevant data to qualify the criteria used to describe and assess the functioning of the audit market;
- Modules 2 to 5 were used to complement and interpret the "rough data" that was collected during module 1, as well as to precisely assess how critical issues identified on the audit market were, and which action steps could be taken to tackle these issues.

Before outlining the objectives and key steps for each module, the following section details two preliminary methodological aspects before the analysis of the audit market environment and concentration levels:

- The definition of the reference or relevant audit market;
- A selection of the most relevant market concentration indicators (through the assessment of the most relevant indicators or ratios).

II.2 Detailed methodology per module

II.2.1 Module 1: Definition of the audit market and selection of relevant concentration indicators

II.2.1.1 Definition of the audit market

The audit market

The audit market falls within the NACE class M69.2[4] ("accounting, bookkeeping, auditing activities and tax consultancy"), which is a subclass of business services. This class also includes secondary activities such as business and management consultancy services. Activities can be provided to all types of clients, irrespective of their size.

A widely used breakdown of the types of services provided by audit firms includes four main categories of services[5]:

- Audit and accounting;
- Taxation and legal services;
- Corporate finance and business recovery;
- Business and management consultancy.

Examples of services per category

The following table presents a partial list of services commonly offered by audit firms per category:

Table 1: Examples of services typically offered by audit firms per category

Service category	Examples
Audit and accounting	- Statutory and non statutory audits - Other types of accounting services, such as: "general accounting services, systems assurance, business risks assessment, internal audit, transaction services […] and advice on international accounting standards, etc."[6]
Taxation and legal services	- Tax planning and compliance - Tax audits and appeal services - International tax advice and guiding - Etc.
Corporate finance and business recovery	- Share issues; stock-market flotations - Project and structured finance - Mergers and acquisitions - Debt management, insolvency - Etc.

[4] Class 74.12 before 2008.

[5] *Key Note, Accountancy Market Report, UK, 2008.*

[6] *Case COMP/M.2824 – Ernst & Young/Andersen Company, 2002.*

Business and management consultancy	- Strategy consulting - Operational and organizational consulting - IT consulting - Etc.

Sources: Key Note and Case COMP/M.2824 – Ernst & Young/Andersen Company, 2002.

Scope of the study

The scope of the audit market data that is provided in the study (size of the market in volume and value and historical growth over the past five years) is the overall audit market, including all four categories of above-mentioned services.

A breakdown of the audit market between audit and non-audit services is provided whenever possible (subject to availability of data in the different Member States).

II.2.1.2 Definition of the relevant audit market

EC definition of relevant market

The EC definition of market differs from common understandings of the concept, which refer either to a place where a demand meets an offer – i.e. any structure where buyers and sellers exchange goods or services for money – or to the industry or sector in which a company performs. For the EC, the definition of a relevant market is a necessary condition to the enforcement of the EU Competition Law, since it allows the evaluation of consistent market shares and levels of competition pressure, key indicators for merger regulation.

The concept of relevant market has been defined by the EC as the combination of a relevant product market with a relevant geographic market, each one being described as follows:

- "A relevant product market comprises all those products and services that are regarded as interchangeable or substitutable by the consumer, by reason of the products' characteristics, their prices and their intended use;
- A relevant geographic market comprises the area in which the undertakings concerned are involved in the supply and demand of products or services, in which the conditions of competition are sufficiently homogeneous and which can be distinguished from neighbouring areas because the conditions of competition are appreciably different in those areas".

Source: Commission Notice on the definition of relevant market for the purposes of Community competition law (Official Journal C 372 of 9.12.1997).

Definition of relevant audit markets for the study

Relevant product market of audit firms for the study:

- As mentioned in the London Economics Study[7], the EC Directorate General for Competition (EC DG Competition) stipulates in its regulations on mergers & acquisitions that the "audit and audit-related services to listed and large companies form a distinct product market" [8], which should be considered as a separate market from that of small and medium-sized companies. Indeed, EC DG Competition considers that in most EU Member States, the listed and large companies can only resort to one of the Big 4 audit firms (Big Five at the time of the quoted merger procedures), as they are the only ones able to provide them with the international network, the reputation on financial markets and the expertise on their respective sectors. In some Member States, a few top mid-tier firms also have a limited access to this market (e.g. Mazars in France). Services provided by the Big 4 are not fully substitutable for those provided by mid-tier or small audit firms.
- Consequently, definitions and analyses of market concentration levels must take into account the two different product or service categories: statutory audit and audit-related services for listed and large companies, secondly statutory audit and audit-related services for small and medium-sized companies;

Relevant geographic markets of audit firms for the study:

- European regulations on mergers and competition[9] recognize that the relevant product or service markets are national in scope, as the regulatory frameworks and required expertise vary widely between Member States.

Conclusion

The relevant audit markets retained for the study are therefore the following:

- Audit services for listed companies within national markets;
- Audit services for other companies within national markets (i.e. the rest of the market).

[7] *Study on the Economic Impact of Auditors' Liability Regimes (MARKT/2005/24/F), 2006.*

[8] *Case COMP/M.2810 – Deloitte & Touche/Andersen Company; Case COMP/M.2824 – Ernst & Young/Andersen Company, 2002; Case COMP/M.1016 – Pricewaterhouse Coopers/Lybrand, 1998.*

[9] *Case COMP/M.2810 – Deloitte & Touche/Andersen Company; Case COMP/M.2824 – Ernst & Young/Andersen Company, 2002; Case COMP/M.1016 – Pricewaterhouse Coopers/Lybrand, 1998.*

II.2.1.3 Selection of relevant concentration indicators

In a given market, there are different numbers of buyers and sellers. This situation creates competition in the marketplace and thus allows price changes in response to changes in supply and demand. Market structures are used to describe the intensity of competitive rivalry in a given market. There are basically five main market structures. Each of these structures corresponds to a specific combination of numbers of buyers and sellers and notably implies sellers' entry barriers.

Table 2: Stackelberg Table - Main Market Structure

	Seller Number	Buyer Number	Seller Entry Barriers
Perfect Competition	Many	Many	No
Monopoly	One	Many	Yes
Oligopoly	Few	Many	Yes
Oligopsony	Many	Few	No
Monopsony	Many	One	No

In addition to the strict number of sellers, the distribution of sellers can also influence the market structure. For instance, a market in which there are many sellers for many buyers, but with only a few sellers with significant market shares, could be described as oligopolistic. This particular distribution of sellers corresponds to a certain concentration level. Concentration refers to the extent to which a small number of firms or enterprises account for a large proportion of economic activity such as total sales, assets or employment.

There are many market concentration measures or indexes:

Table 3: Main Concentration Indexes

	Index	Formula	Comments
1	Concentration Ratio	$CR_k = \sum_{i=1}^{k} S_i$	• k: ranges from 1 to N (total number of firms) • S_i: market share of the firm i
2	Hirschman-Herfindahl Index	$HHI = \sum_{i=1}^{N} S_i^2$	• S_i: market share of the firm i • N: total number of firms
3	Numbers equivalent Herfindahl Index	$HHI_{NE} = \frac{1}{HHI}$	• HHI: Hirschman-Herfindahl Index

4	Hannah-Kay Index	$HK(\propto) = \sum_{i=1}^{N} S_i^{\propto}$	• S_i: market share of the firm i • $\propto$: integer to be chosen • N: total number of firms
5	Comprehensive Concentration Index	$CCI = S_1 + \sum_{i=2}^{N} S_i^2 (2 - S_i)$	• S_i: market share of the firm i • S_1: market share of the largest firm • N: total number of firms
6	Linda Index	$L = \frac{1}{k(k-1)} \sum_{i=1}^{k-1} Q_i$	• Q_i: ratio between the average share of the first i firms and the average share of the remaining k – i firms • k: number of firms in the selected sample
7	Gini Coefficient	$G = \frac{N + 1 - 2\sum_{i=1}^{N} iS_i}{N}$	• S_i: market share of the firm i • i: firm's rank position • N: total number of firms
8	Rosenbluth/Hall-Tideman Index	$RHT = \frac{1}{2\sum_i^N iS_i - 1}$	• S_i: market share of the firm i • i: firm's rank position • N: total number of firms
9	Entropy	$E = -\sum_{i=1}^{N} S_i \log(S_i)$	• S_i: market share of the firm i • i: firm's rank position • N: total number of firms

Sources: Glossary of Industrial Organisation Economics and Competition Law, OECD, 1993; Using Excel to Illustrate Hannah and Kay's Concentration Axioms, Paul L. Latreille and James Mackley, 2011; Indices de concentration et pouvoir de monopole, Alexis Jacquemin et David Encaoua, La Revue Economique, 1978; Market concentration measurement: example of food retail market in Belgrad, Dragan DjDjuri (PhD), Dragan Loncar (PhD) and Vesna Rajic (PhD), 2006.

1. Concentration ratio

- Concentration ratios are by far the most used measures in the economic literature (CR_4 and CR_8 being the most common ratios);
- Concentration ratios range from 0% to 100%:
  - CR_4 = 0% means perfect competition;
  - 0% < CR_4 < 50% ranges from perfect competition to oligopoly;
  - 50% < CR_4 < 80% means oligopoly;
  - 80% < CR_4 < 100% ranges from highly concentrated oligopoly to monopoly;
  - CR_4 = 100% means highly concentrated oligopoly and even monopoly (if CR_1 = 100%);
- Although concentration ratios are widely used and provide a good snapshot of how concentrated a market is, they fail to provide information on the number and size distribution of firms in the market. Basically, two markets with the same high CR_4 can be significantly different.

Table 4: Concentration ratios example

Firms	Market A (quasi monopolistic) Market Shares	Market B (oligopolistic) Market Shares
1	65%	20%
2	5%	20%
3	5%	20%
4	5%	20%
5	5%	10%
6	5%	5%
7	5%	5%
CR_4	80%	80%

2. Hirschman-Herfindahl Index (HHI)

- The HHI is also one of the most often used indexes. This measure is based on the total number and size distribution of firms. It ranges from 1/N to 1, with N the total number of firms in the market. For a more convenient reading HHI can be computed on a base of 10,000 (each market share is given on a base of 100);
- As the HHI is calculated by summing the squares of the individual firms' market shares, it gives proportionately greater weight to the larger market shares;
- The HHI is used by official bodies (United States Antitrust Division Merger Guidelines and European Union Guidelines on the assessment of horizontal mergers[10] both use this index two assess mergers impact on a particular market);
- In 2010, the USA revised their Horizontal Merger Guidelines and provided the following classification[11]:
    - Not concentrated Markets: HHI below 1,500;
    - Moderately Concentrated Markets: HHI between 1,500 and 2,500;
    - Highly Concentrated Markets: HHI above 2,500;
- The HHI computed on the previous example illustrates the HHI capability to render the size distribution of firms.

[10] *Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings, Official Journal C 031, (2004/C 31/03).*
[11] *Horizontal Merger Guidelines, U.S. Department of Justice and the Federal Trade Commission, April 2010.*

Table 5: HHI example

Firms	Market A (quasi monopolistic) Market Shares	Market B (oligopolistic) Market Shares
1	65%	20%
2	5%	20%
3	5%	20%
4	5%	20%
5	5%	10%
6	5%	5%
7	5%	5%
HHI	4,375	1,750

3. Numbers equivalent Herfindahl index (NEHI)

- The NEHI is simple variant of the HHI as it is its reciprocal. It indicates the "equivalent" number of firms in the market with identical market shares that would give the same HHI;
- For instance, a market with N companies with a HHI = 0.2 (on a base of 1) is equivalent to a market with five companies with identical shares (in this case 20% each).

4. Hannah-Kay index

- The Hannah-Kay index is another variant of the HHI (HK(2)=HHI) that gives greater weight to the larger market shares as α increases.

5. Comprehensive Concentration Index (CCI)

- The CCI is another variant of the HHI as it is a combination of the HHI and the Hannah-Kay index. It gives greater weight to the share of the largest firm.

6. Linda Index[12]

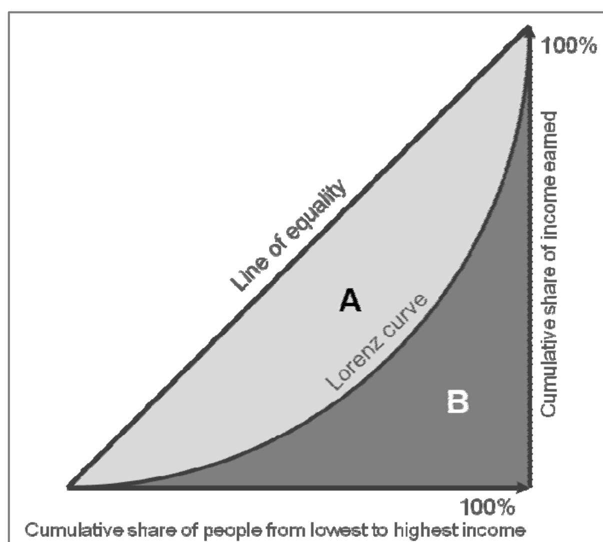
- The Linda Index is used to identify the oligopolistic players within a market;
- The Linda Index is calculated for a particular subset of (k) firms. Thus, the measure of concentration obtained depends on the subset;
- Accordingly, in order to identify the oligopoly threshold if it exists, a set of Linda indices must be computed: L2 (for k = 2), L3, L4, and so on. The first discontinuity identified in the computed values of the Linda index denotes the subset of firms operating in the oligopoly area.

[12] *Infra-industry spillovers and R&D cooperation: Theory and evidence, Luca Lambertini, Francesca Lotti and Enrico Santarelli, June 2004.*

7. Gini coefficient

- The Gini coefficient is a measure of the inequality of a distribution. It ranges from 0 (for perfect equality) to 1 (total inequality);
- The Gini coefficient is usually associated with the Lorenz curve, which plots the cumulative share of income earned by the population ranked from lowest to highest income. G = 2A;

Figure 2: Lorenz curve



- Although the Gini coefficient is a widely used measure for inequality, it is not the most suitable for market concentration as it does not reflect the number of firms in the market. Thus, the Gini index is called a relative measure[13];
- The following example illustrates how an oligopolistic four-player market with equal market shares is assessed as perfectly equal with the Gini coefficient.

Table 6: Gini coefficient example

Firms	Oligopolistic Market Market Shares
1	25%
2	25%
3	25%
4	25%
Gini coefficient	0
HHI	2500

8. Rosenbluth/Hall-Tideman Index (RHT)

[13] *Using Excel to Illustrate Hannah and Kay's Concentration Axioms, Paul L. Latreille and James Mackley, 2011.*

- The Rosenbluth/Hall-Tideman index is linked to the Gini coefficient by the following equality;

$$G = 1 - \frac{1}{N(RHT)}$$

- As for the Gini coefficient, though to a lesser extent, the RHT does not reflect enough the number of firms in the market as illustrated in the following example.

Table 7: Rosenbluth/Hall-Tideman Index example

Firms	Market A Market Shares	Market B Market Shares	
1	55%	40%	
2	15%	30%	
3	15%	20%	
4	15%	10%	Delta market A vs. market B
RHT	0,36	0,33	-19%
HHI	3700	3000	-7%

9. Entropy

- The Entropy Index ranges from 0 to 1/N;
- As for the Gini coefficient, the Entropy Index is used as a measure of the inequality of a distribution and thus is not the most suitable to assess a market concentration.

Conclusion

The HHI appears as the most suitable index to assess market concentration, while the popularity of the concentration ratios makes them a pre-requisite.

Applying these two indexes enabled us to compare our results with the 2006 London Economics study[14], as these two measures were retained in the report.

Furthermore, those two indexes are presented by the OECD as the most frequently used concentration measures[15].

In conclusion, the different indexes were selected on the basis of the following rationale:

Table 8: Concentration measures retained and rationale

	Index	Retained	Not retained	Rationale (reminder)
1	Concentration Ratio	✓		- Most frequently used index in economic literature - Allows comparison with the 2006 London Economics study
2	Hirschman-Herfindahl Index	✓		- Most relevant index for several regulators or professional bodies (US Justice Department, European Commission, OECD) - Allows comparison with the 2006 London Economics study
3	Numbers equivalent Herfindahl Index		×	- Simple variant of HHI
4	Hannah-Kay Index		×	- Simple variant of HHI
5	Comprehensive Concentration Index		×	- Variant of both HHI and Hannah-Kay Index, which gives greater weight to the share of the largest firm
6	Linda Index		×	- Used to identify the oligopolistic players within a market - Not the most suitable index when it comes to assess overall market concentration
7	Gini Coefficient		×	- Does not reflect the number of firms in the market
8	Rosenbluth/Hall-Tideman Index		×	- Does not reflect the number of firms in the market
9	Entropy		×	- Used to measure the inequality of a distribution, rather than to assess a market concentration

[14] *Study on the Economic Impact of Auditors' Liability Regimes (MARKT/2005/24/F), September 2006.*
[15] *Glossary of Industrial Organisation Economics and Competition Law, OECD, 1993.*

II.2.2 Module 2: Analysis of the audit market based on desk research

II.2.2.1 Objective of the module

This module provides a detailed overview of the audit market situation per Member State, and of its functioning, by collecting and analysing an extensive amount of data.

More specifically, module 1 provides, a detailed profile including (as far as possible and subject to availability of data in the 27 Member States) the specific measures described in the following pages.

II.2.2.2 Key steps

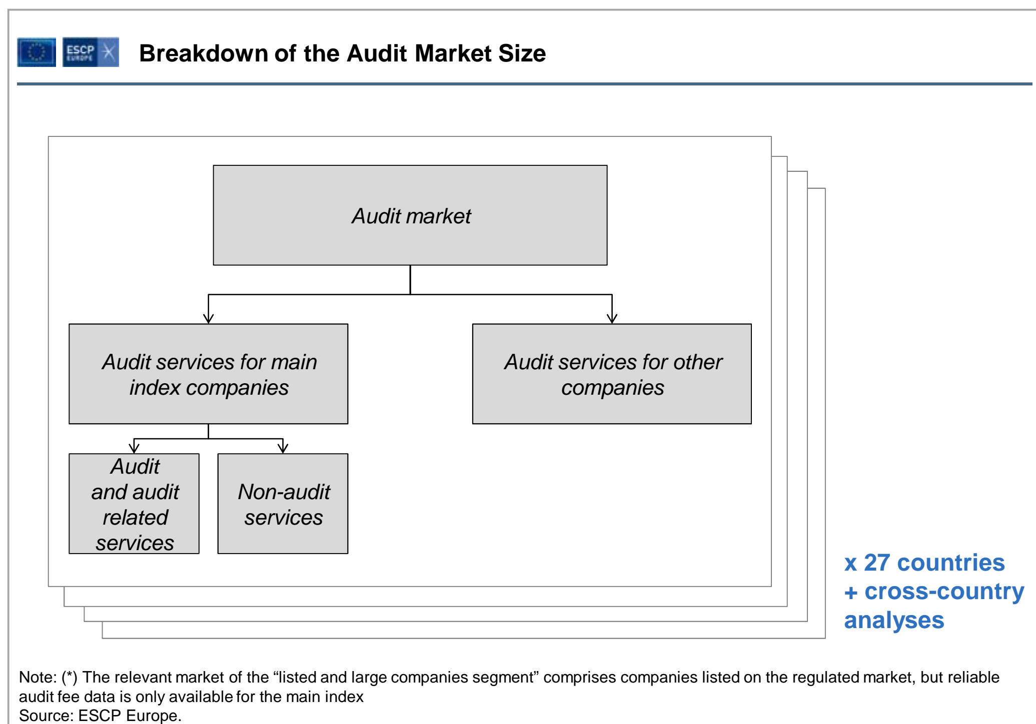
Module 2 followed under six main steps:

I. Definition of market segments on which concentration levels were to be assessed;
II. Identification of data to be collected (structured into reporting templates and analysis grids, in order to be able to analyse data gathered in specific and consistent reporting formats);
III. Desk research and data collection;
IV. Data processing;
V. Production of Member States profiles;
VI. Production of cross-country insights (including the identification of country clusters sharing similar market patterns).

I. *Definition of market segments*

The market segmentation carried out under module 1 aimed at identifying the segments under which audit market concentration would be assessed, as outlined below:

Figure 3: Different market segments on which concentration levels were assessed



Note: (*) The relevant market of the "listed and large companies segment" comprises companies listed on the regulated market, but reliable audit fee data is only available for the main index
Source: ESCP Europe.

II. *Identification of data to be collected*

The table below outlines the different measures that were used to describe and assess the functioning of the audit market. Each measure is fully described at the beginning of each core section in which it is analysed (including specific information sources and data availability).

Note: This list contains all main data that we tried to collect in each Member States; the availability of each measure can vary significantly between Member States.

Table 9: Measures that were used to describe and assess the functioning of the audit market in each Member State

Market description/ assessment category	List of criteria used	Comments on period and breakdowns covered (whenever available)
Size of the audit market	**Size of the audit market in number of audit firms**	- 2005-2010 evolution
	Size of the audit market in turnover of audit firms	- 2005-2010 evolution - Share of the audit market in the Member State's GDP

		- Average turnover per audit firm
	Revenues of the top 10 audit firms	- 2009
Development of market players	**Changes to audit market structure**	- Consolidation and M&A activity among statutory audit providers - Consolidation and M&A activity among non-audit services providers
	Main driving factors behind M&A activity	- Number of M&A transactions per type of target activity or service
Concentration levels	**Overall market concentration levels**	- 2005-2009 evolution - Market share of the Big 4 vs. mid-tiers vs. other smaller firms
	Concentration levels for listed companies	- Calculated by number of mandates and by turnover, using the HHI, CR1,CR4 and CR8 reference indicators - Considering different market segments: all listed companies, companies listed on the regulated market, companies listed on the main index - Breakdown by industry sector
Barriers to entry or development of mid-tier firms	**Analysis of the turnover growth of mid-tier firms vs. overall market growth**	- 2005-2009 evolution
	Focus on the market position of mid-tier firms with listed companies	- Number of mid-tier firms' with at least one mandate, on the listed market segment - Market share of mid-tier firms with listed companies by Member State, in number of mandates and in turnover
Independence of audit firms from their clients	**Share of non-audit revenues in auditors' turnover**	- 2005-2009 evolution - Breakdown by type of service (audit vs. other services)
	Share of non-audit services in main index companies' audit fees	- Audit and non-audit fees paid by companies listed on the main index, in 2009

III. Desk research and data collection

Main sources of information used

For the assessment of market size, different complementary sources of information were used:

- *Datamonitor;*
- *Euromonitor;*
- *Eurostat;*
- *London Economics;*

- *National statistics institutes[16].*

For the identification of the main mergers and acquisitions within the audit market (between audit service providers, but also between audit service providers and other service providers), three reference sources were used:

- *Bureau Van Dijk (Zephyr database);*
- *Mergermarket;*
- *Thomson One Banker – Deals.*

For the collection of financial data on listed companies, two databases were used to cross-check data and complete information:

- *Thomson Research, Thomson One Banker and Thomson Financial;*
- *Bureau Van Dijk (Amadeus and Osiris databases).*

Note: Considering the limited availability of earnings in the Thomson Research/One Banker/Financial and Bureau Van Dijk (Amadeus and Osiris) databases for 2010, 2009 was used as a reference year.

At the time when data searched, only a limited number of listed companies had announced their 2010 annual earnings, as outlined below:

[16] CBS Nederlands Statistics (Netherlands), Destatis (Germany), Insee (France), Instituto Nacional de Estadísticas (Spain), Istat (Italy), Statistics Denmark, Statistika Centralbyrån (Sweden), UK National Statistics, etc.

Table 10: Availability of turnover of listed companies for 2009 vs. 2010

Member State	Number of companies for which the **2009 earnings** were available (in %)	Number of companies for which the **2010 earnings** were available (in %)
Austria	100%	92%
Belgium	99%	78%
Bulgaria	100%	94%
Cyprus	95%	16%
Czech Republic	100%	83%
Denmark	94%	79%
Estonia	100%	100%
Finland	100%	91%
France	99%	68%
Germany	98%	77%
Greece	100%	86%
Hungary	100%	79%
Ireland	94%	92%
Italy	100%	72%
Latvia	100%	100%
Lithuania	100%	100%
Luxembourg	100%	60%
Malta	100%	90%
Netherlands	98%	71%
Poland	100%	71%
Portugal	100%	93%
Romania	76%	41%
Slovakia	100%	44%
Slovenia	100%	75%
Spain	99%	94%
Sweden	99%	29%
United Kingdom	88%	63%
Average	**98%**	**75%**

Sources: ESCP Europe analysis based on data from Thomson, Bureau Van Dijk and Annual Reports.

It should be noted that even in France, with a 68% coverage of listed companies, HHIs, CR1, CR4 and CR8 measures could be significantly distorted, since some very large companies (having a strong impact on concentration levels calculated by turnover) had not announced their earnings.

IV. Data processing

Analyses were then performed to describe the market, assess its functioning and determine the possible measures to improve its functioning, as outlined below:

Table 11: Key analyses performed on the basis of data collected

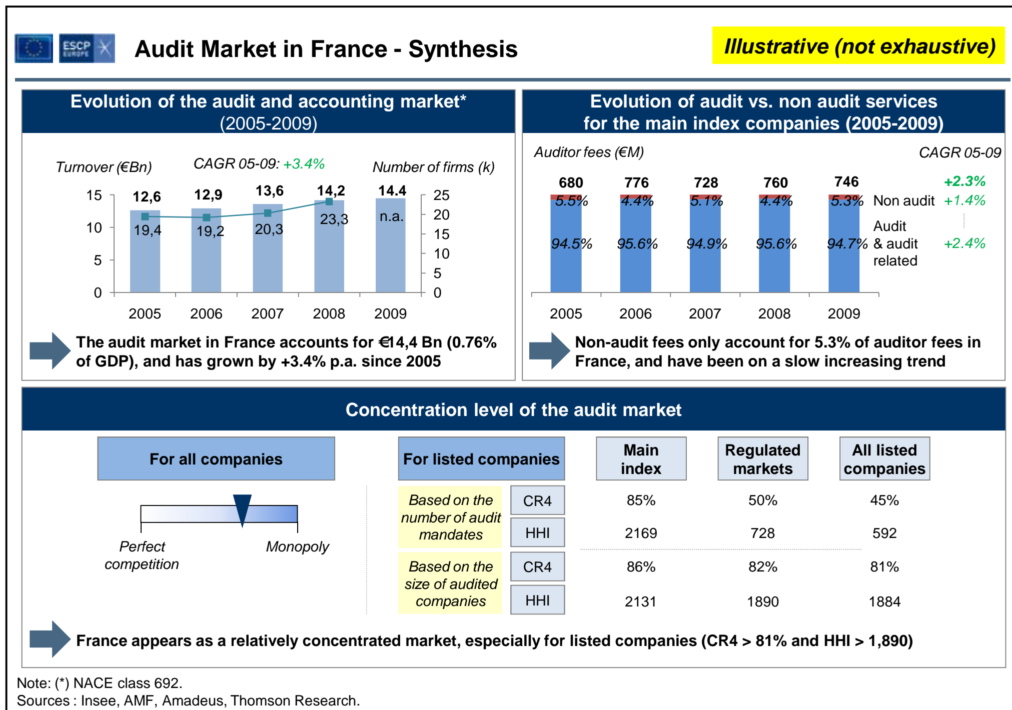
		Analysis performed
Description of the market	Overview of regulatory environment	ISA adoption status per Member State
		Scope of statutory audit by Member State
		Key regulatory characteristics by Member State
	Size and evolution of the market	Size of the audit market by Member State in value
		Total number of audit firms per Member State
		Total audit market share in percentage of GDP per Member State
		Average turnover per audit firm per Member State
		Historical evolution of the audit market size in value per Member State
		Historical evolution of the audit market share in percentage of GDP per Member State
		Historical evolution of the number of audit firms per Member State
		Correlation between market growth of the audit market and number of audit firms
		Big 10 audit firms revenues
Criteria to assess the functioning of the market	Changes to network structure	Compared number of M&A transactions per type of acquirer
		Key drivers for changes: analysis of the main targeted sectors through acquisitions
	Concentration levels	Overall market share of the Big 4
		Top 20 mid-tier breakthrough on overall audit market
		Concentration levels in EU statutory audit markets for all listed companies (by mandates and by turnover)
		Concentration levels in EU statutory audit markets for companies listed on the regulated market by mandates and by turnover)
		Average concentration ratios by category of industry
		Concentration levels in EU statutory audit markets for companies in main index of main national stock exchange (by number of mandates and turnover)
		Overall market share evolution for the Big 4 and the Top 20 mid-tier firms per Member States
		Evolution of concentration levels for all listed companies (by number of mandates and turnover) per Member States
		Evolution of concentration levels for companies listed on the main index of main national stock exchange (by number of mandates and turnover) per Member States
		Correlation between joint audit and concentration levels (included in section V.2.14.)
		Case study on joint audit in Denmark and France (included in section V.2.14.)
	Barriers to entry and	Compared annual growth for mid-tier firms, overall market and Big 4 in the European Union

	development of the mid-tier firms	Compared annual growth for mid-tier firms, overall market and Big 4 per Member State
		Number of mid-tier firms with at least one mandate on the listed market segment
		Market share of mid-tier firms on the listed market per Member State
		Mapping of current market share of mid-tier firms and their turnover growth
		Ranking of barriers to entry according to online survey respondents
		Ranking of purchasing criteria to select an audit firm according to online survey respondents
		Comparison between the share of non-audit fees and mid-tier firms market share
		Evolution of the non-audit services share in mid-tiers firms turnover
		Choice of auditors: role of the audit committee (developed in section V.2.23)
	Possible demise of a Big 4	Number one Big 4 per Member State on regulated market
		Ranking of the Big 4 firms on the EU market
		Impact of the demise of Pricewaterhouse Coopers (concentration ratio by number of mandates and by turnover)
		Impact of the demise of number one Big 4 in a Member State (concentration ratio by number of mandates and by turnover)
	Audit price levels	Comparison between audit fees and concentration levels
		Correlation between average fees per turnover and concentration levels
		Correlation between audit fees and share of the non-audit fees
		Comparison between the level of non-audit fees and the difference between audit fees for audit clients only and fees for clients of audit and non-audit services
	Independence: Provision of non-audit services to audit clients	Case studies on current regulations and guidelines on the share of non-audit services in France, the US and Switzerland
		Share of non-audit services in auditors' turnover per Member State
		Evolution of non-audit revenues in auditors' turnover per Member State
		Proportion of non-audit services in main index companies' audit fees
		Impact of the provision of non-audit services to audit clients on auditors' independence (online survey respondents' opinion, summary of key stakeholders' opinions from the Green Paper)
		Impact of a limitation of the proportion of fees audit firms can receive from a single client (included in sectionV.2.19)
	Independence: Overfamiliarity	Comparison of average switching rate of audit mandate for companies of the FTSE 100 and the FTSE 250 in the United Kingdom
	Audit quality	Satisfaction of the online survey respondents in respect of auditors
		Review of the IAASB perspective
		Case studies on detailed audit methodology and its risks in France and Germany (included in section V.2.9)
		Level of services provided
		Level of substantive testing (included in section V.2.13. in the literature review analysing this indicator))

V. *Production of Member States profiles*

Example of analyses

Figure 4: Illustrative example of different criteria used to assess the functioning of the audit market by Member State

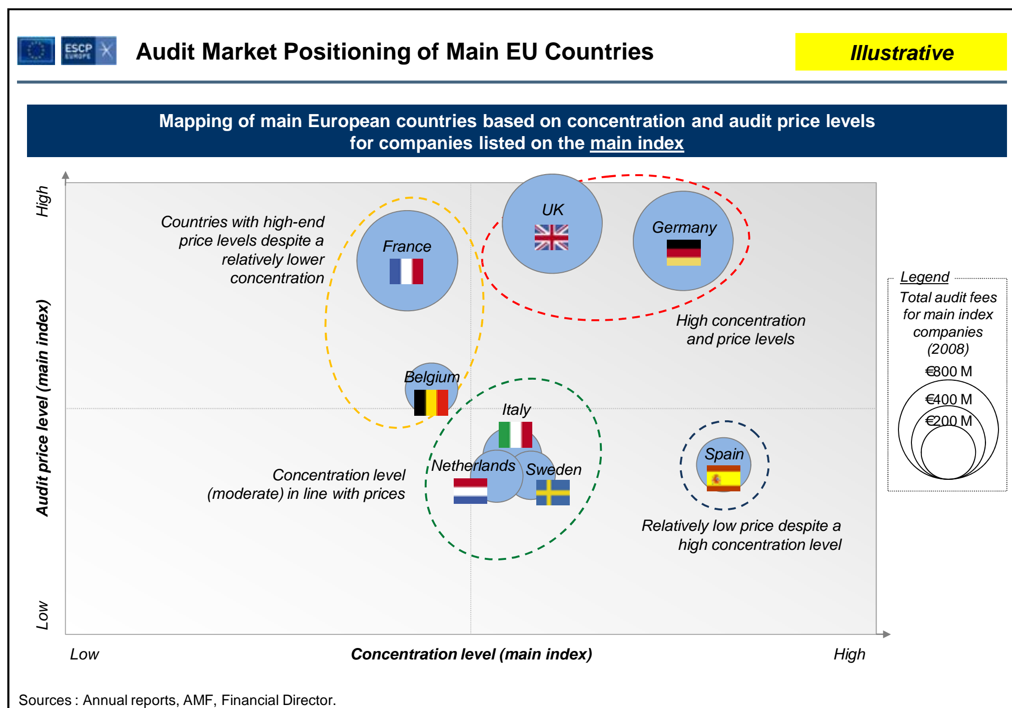


For listed companies		Main index	Regulated markets	All listed companies
Based on the number of audit mandates	CR4	85%	50%	45%
	HHI	2169	728	592
Based on the size of audited companies	CR4	86%	82%	81%
	HHI	2131	1890	1884

VI. *Production of Member States profiles*

Example of analysis:

Figure 5: Illustrative example of a cross-country analysis



II.2.2.3 Non-availability bias

As mentioned earlier, gathering exhaustive information is not possible in all 27 Member States.

In order to address this issue, the following steps were undertaken:

- Key missing information was added to country-specific interview guides, to be discussed during interviews of module 5 (e.g. evaluation of historical market growth, share of non-audit fees in total turnover of audit firms, turnover of main audit players, etc.);
- Whenever possible, data substitutes were sought or estimates were produced.

II.2.3 Module 3: Key takeaways from relevant literature on audit

II.2.3.1 Objective of the module

This module provides an overview of the main issues included in the literature on audit, contributing to a better understanding of the audit market situation in Europe, under all its dimensions.

Identifying and analysing academic or regulatory papers at the beginning of the project provided a clearer focus on the audit market, before launching other modules.

With this perspective, module 3 enabled us to fine tune the survey questionnaire/interview guide, and to identify:

- Key issues for the European audit market;
- Specific country specificities that could make good case studies;
- A first list of action steps, and their main advantages and drawbacks.

II.2.3.2 Key steps

Module 3 followed three main steps:

I. Identification of key academic papers published on:
   - The audit industry;
   - Its evolution over the past five years;
   - Potential steps to be taken in order to improve the current market situation;

II. Analysis of each paper and summary of key takeaways;

III. Formalization of:
   - Inputs for the survey, interviews and focus groups, i.e. areas of focus to be further discussed;
   - Preliminary action steps on evolutions for the audit industry and business.

105 different sources of information have been used. The exhaustive list can be found in appendix VI.2.

II.2.4 Module 4: Online survey

II.2.4.1 Objective of the module

The purpose of the online survey was to get a larger-scale insight from all types of stakeholders, in a cost-effective manner. More specifically, the online survey focused on the following issues:

- Overall effectiveness of audit services (quality, performance, etc.);
- Perception of different market practices (e.g. price levels);
- Potential recommendations regarding the evolution of the audit industry (e.g. auditor rotation or joint audit).

Table 12: Survey responses per type of stakeholder

Stakeholder	Expected number	Responses received	**Reason for gaps** (ECG members and companies)
Regulators and officials bodies	*43*	*53*	
Audit firms – ECG members	*57*	*30*	*Big 4 audit firm submitted only one questionnaire for the 27 Member States* *Other Big 4 audit firm has not responded yet*
Audit firms – EGIAN members and other mid-tier	*57*	*52*	
Companies	*55*	*11*	*Invitations sent on June 20th* *Lower than expected ramp-up* *Active follow-up emails and calls still being carried out*
Other stakeholders	*22*	*12*	
Total	***234***	***158***	

Source: Online Survey.

II.2.4.2 Key steps

The on-line survey followed four main steps:

I. Building the survey;
II. Testing the survey;
III. Conducting the survey;
IV. Analysing the results of the survey.

I. Building the survey

Our survey questionnaire had the following characteristics:

1. *A series of close-ended questions with a few open questions aimed at collecting additional qualitative information;*
2. *A specific version of the questionnaire for each category of stakeholder, including sections common to all versions for statistical purposes;*
3. *A balanced representation of the stakeholders and an adequate sample size to ensure the quality of the collected data.*

Building the survey consisted mainly in defining the appropriate questions. The main sources of information to do so were:

4. *Previous studies undertaken for DG Markt such as: London Economics – Study on the economic impact of Auditors' liability regimes (September 2006) and Oxera – Ownership rules of audit firms and their consequences for the audit market concentration (October 2007);*
5. *The Green Paper – Audit policy: lessons from the crisis (October 2010);*
6. *The Summary of responses to the Green Paper.*

The questionnaire was structured around the following issues:

- *Degree of satisfaction*
    - *Overall:*
        - *Stakeholders were invited to grade a list of various criteria such as quality of services, independence, technical knowledge, level of fees, range of information provided.*
    - *External communication:*
        - *This concerns the level of details that auditors should provide in their "public" reports regarding their methodology and their appreciation of the companies' use of accounting methods or material and sensitive accounting estimates.*
    - *Internal communication:*
        - *This relates to the formal communication between auditors and audit committees.*
    - *Scope of services:*

        - *Stakeholders were invited to state from a list of audit-related and non-audit services to which they expect from their auditor, providing that the service would not impair independence.*
- *Fair consideration paid for audit services:*
        - *This covers various topics such as pressure on audit fees, perceived level of audit fees compared to the finance services providers, etc.*
- *Choice of auditors:*
    - *Range and perceived size of the market:*
        - *Stakeholders were invited to indicate how many mid-tier audit firms in their respective Member State are in a position to provide audit services to large and/or multinational companies, large and/or complex financial institutions and to listed companies.*
    - *Criteria:*
        - *The aim of this question is to rank, from the most appropriate to the least appropriate, criteria used to select an audit firm, e.g. size of the audit firm, geographical coverage, degree of expertise, reputation, etc.*
    - *Barriers to entries:*
        - *The aim of this question was to rate various potential barriers to entries for audit firms other than the Big 4 in providing audit services to listed companies (e.g. lack of technical capacity in IFRS and/or certain area of expertise, lack of sector knowledge, client switching inertia, limited geographical coverage,…).*
    - *Independence:*
        - *This relates to how the auditors' appointment process could be improved in order to reinforce their independence.*
    - *Transparency:*
        - *This mainly related to whether audit committees should document their proposed choice of auditors and to whom they should report (shareholders, relevant regulators).*
    - *Decision maker:*
        - *This question sought to identify who, in practice, chooses the audit service providers, not in term of formal approval process but in term of influence.*
- *Rotation of auditors:*
    - *Frequency:*
        - *Various topics were covered such the number of years the current audit firm served as auditor for a company, and the maximum term of the auditors' mandate should the rotation become mandatory.*
    - *Tender process:*
        - *This question enquired whether a formal tender process had been run over the last 10 years and if not, the reasons.*
    - *Criteria for rotation:*

        - *Stakeholders were asked to provide the main reasons for changing its auditors, such as regulatory requirements, level of audit fees, audit quality issues, changing needs of the company, etc.*
    - *Criteria for lack of rotation:*
        - *Stakeholders were requested to provide the main reasons for not changing auditors, such as lack of choice, increase audit risk due to the new auditor's lack of knowledge of the company, red flag signal to investors, selection and support costs, practical difficulties, etc.*
- *Joint auditors:*
    - *Should the joint audit become mandatory? If the answer is yes, how should the rotation of the two auditors is organised?*
- *Audit firms' corporate governance:*
    - *Audit firms were requested to present the corporate governance measures they have implemented.*

The questionnaire was customised to each of the four stakeholder categories:

- *Audit and Financial Market regulators, ministry officials or governmental bodies, professional bodies ("Regulators and official bodies");*
- *Audit firms;*
- *Companies;*
- *Other stakeholders.*

II. Testing the survey

The aim of this step was to test the questionnaire with a limited number of respondents in order to assess the clarity of the questions and the quality of the information collected. Based upon the results of this test the content of the survey was amended.

Subsequent to the approval by DG Markt, the invitation to participate in the survey was sent out mid-May to a first selection of stakeholders who were chosen based on their interest in or knowledge of the subject and their independence from audit firms:

- *Regulators and official bodies:*
    - *Governmental bodies;*
    - *Audit regulators;*
    - *Financial Market regulators;*
- *Other stakeholders:*
    - *Corporate governance associations;*
    - *Minority shareholders associations;*
    - *Stock exchanges;*
    - *Banks.*

III. Conducting the survey

Once the testing step was achieved, the updated survey was transferred to "production" via the same secured website.

Online technology provided many advantages: respondents could quickly and easily complete and submit the questionnaire; it enabled a clear lay-out and a professional presentation of the survey, the results could be consulted online, which permitted a tracking of the status (response rate), etc.

Figure 6: Views from the web platform

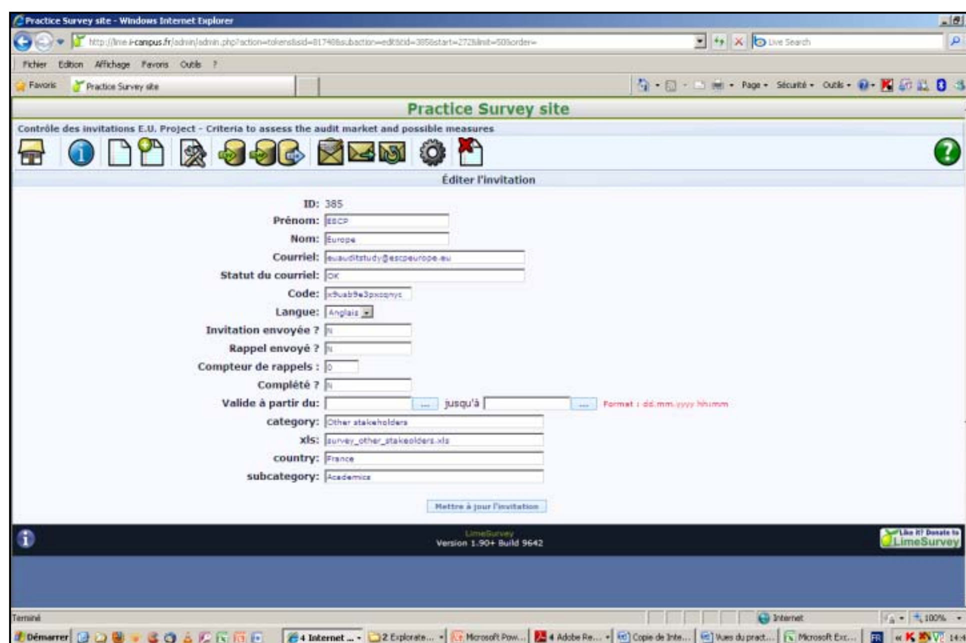
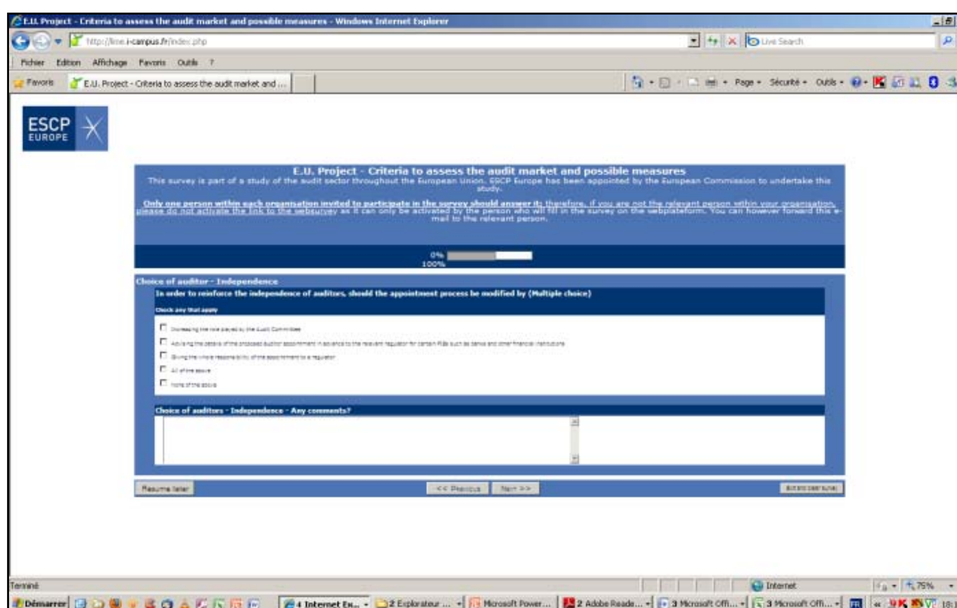
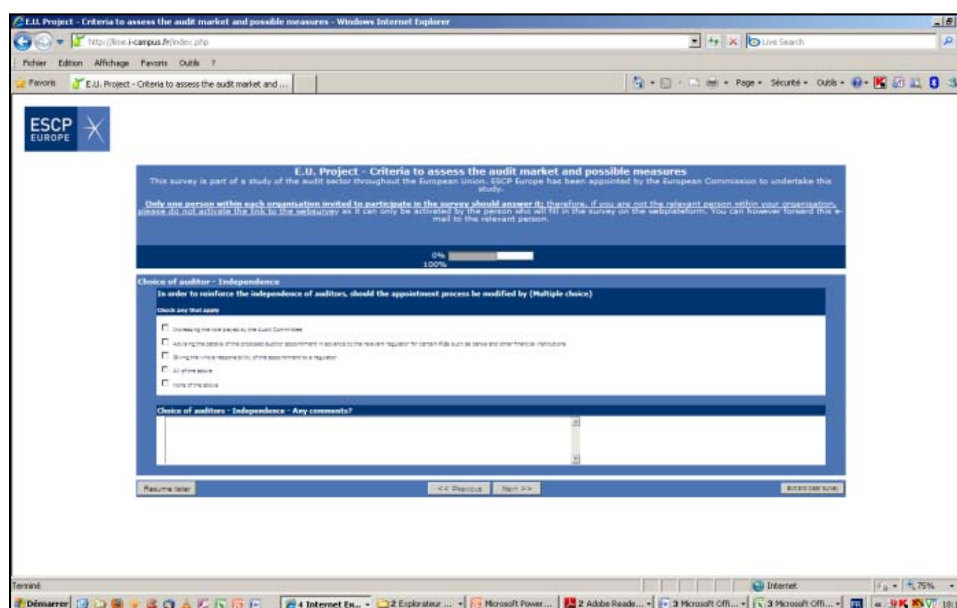


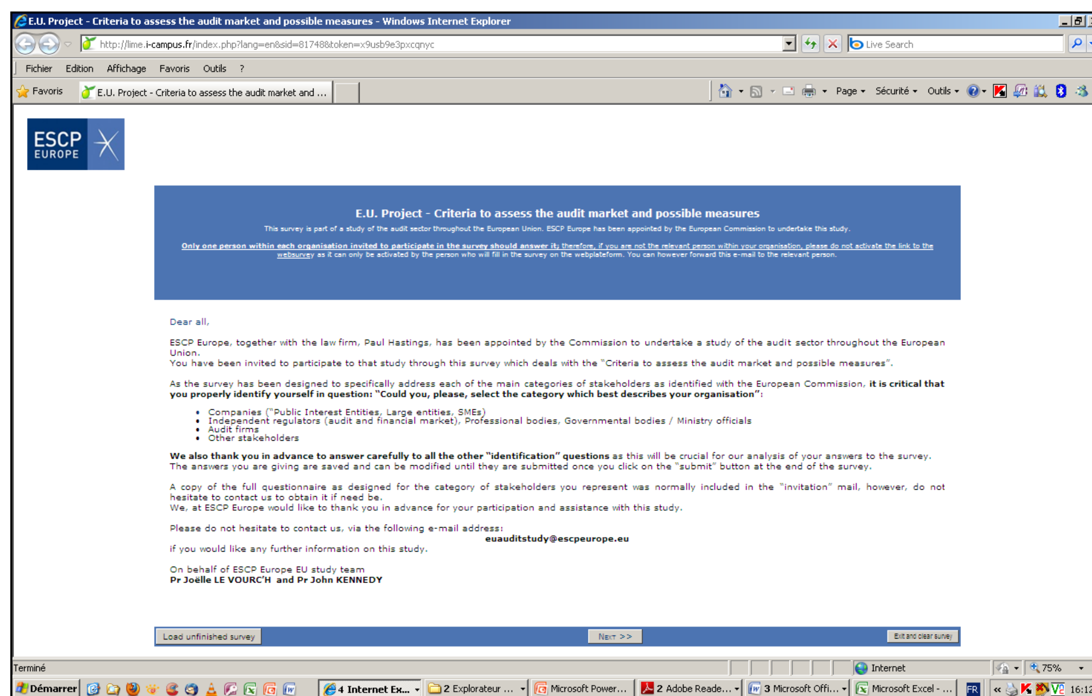
Figure 7: Views from the web survey





Whereas the access to the web survey was not restricted in the first run, invitations were then directly sent through the web platform. Each invitation was personal and encoded so that the link to the web survey could only be activated by one person.

Figure 8: Other views from the web survey

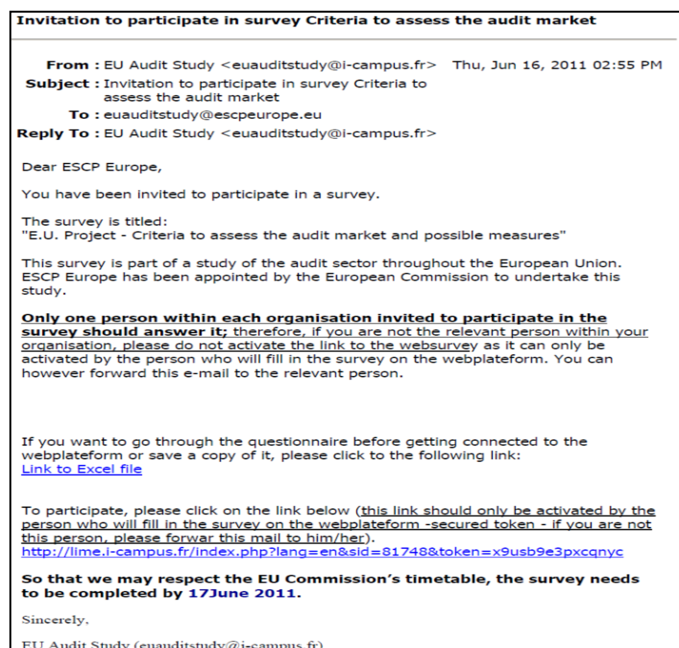


The communication protocol was the same for each category of stakeholders:

1. *First we sent a mail introducing the purpose of the study and including a copy of the survey so that respondents could go through it before getting connected to the platform;*

2. *Then, a personal invitation was sent through the web platform:*

Figure 9: Invitation email to the online survey



Invitation to participate in survey Criteria to assess the audit market

From : EU Audit Study <euauditstudy@i-campus.fr> Thu, Jun 16, 2011 02:55 PM
Subject : Invitation to participate in survey Criteria to assess the audit market
To : euauditstudy@escpeurope.eu
Reply To : EU Audit Study <euauditstudy@i-campus.fr>

Dear ESCP Europe,

You have been invited to participate in a survey.

The survey is titled:
"E.U. Project - Criteria to assess the audit market and possible measures"

This survey is part of a study of the audit sector throughout the European Union. ESCP Europe has been appointed by the European Commission to undertake this study.

Only one person within each organisation invited to participate in the survey should answer it; therefore, if you are not the relevant person within your organisation, please do not activate the link to the websurvey as it can only be activated by the person who will fill in the survey on the webplateform. You can however forward this e-mail to the relevant person.

If you want to go through the questionnaire before getting connected to the webplateform or save a copy of it, please click to the following link:
Link to Excel file

To participate, please click on the link below (this link should only be activated by the person who will fill in the survey on the webplateform -secured token - if you are not this person, please forwar this mail to him/her).
http://lime.i-campus.fr/index.php?lang=en&sid=81748&token=x9usb9e3pxcqnyc

So that we may respect the EU Commission's timetable, the survey needs to be completed by 17June 2011.

Sincerely,

EU Audit Study (euauditstudy@i-campus.fr)

3. *A reminder could also be sent directly through the web platform.*

To ensure an adequate statistical representation of stakeholders, the following sample size was used:

Table 13: Expected target sample and response rate per stakeholder category

Stakeholders	***Sample per EU member***	***Total sample***	***Expected response rate***	***Expected number***	***Expected representation***
Regulators and officials bodies	*4*27*	*108*	*40%*	*43*	*19%*
Audit firms – ECG members	*6*27*	*162*	*35%*	*57*	*24%*
Audit firms – EGIAN members and other mid-tier	*21*27*	*567*	*10%*	*57*	*24%*
Companies	*15*27 + 140*	*545*	*10%*	*55*	*23%*
Other stakeholders	*8*27*	*216*	*10%*	*22*	*19%*
Total		***1 598***	***14,56%***	***234***	***100%***

In order to maximise the response rate, the following actions were undertaken:

- *The most relevant persons were targeted by either contacting directly the organisations (phone & email) or searching their website;*

- *Mails were sent which introduced the purpose of the study and included a copy of the survey so that respondent could go through it before connecting to the platform;*
- *Representation letters, provided by the DG Internal Market and Services were sent out;*
- *Follow-up procedures (by phone, mail or email): automatic follow-up emails were sent directly through the web-platform;*
- *The targeting of companies, throughout the European Union, in which ESCP Europe alumni hold Financial and Executive positions.*

Other actions to address non-response bias included:

- *Using statistical adjustment techniques in order to adjust the allocation of respondents to the expected representation by giving more weight to under-represented categories of stakeholders;*
- *Modifying the representation in the interviews in order to mitigate any observed under-representation within responses to the survey.*

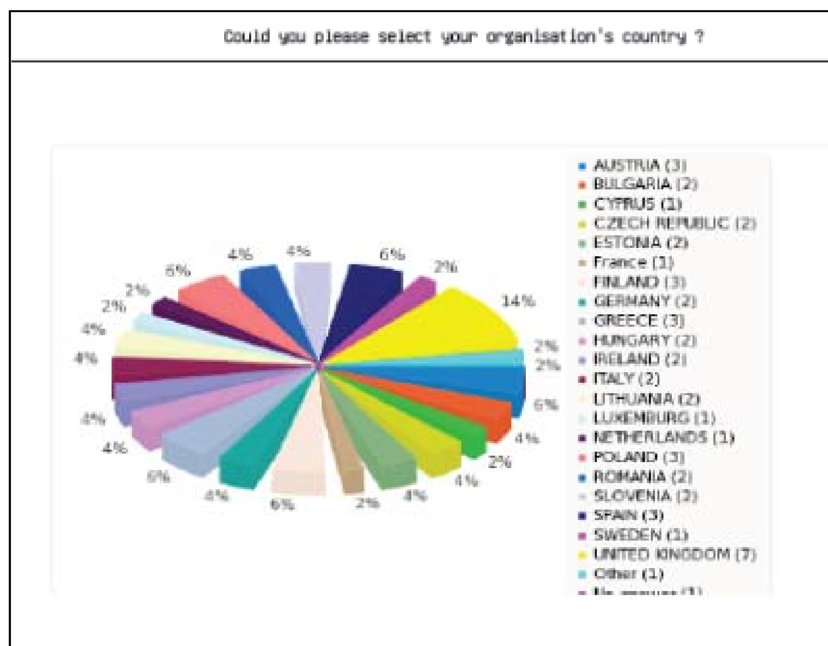
IV. Analysing the results of the survey

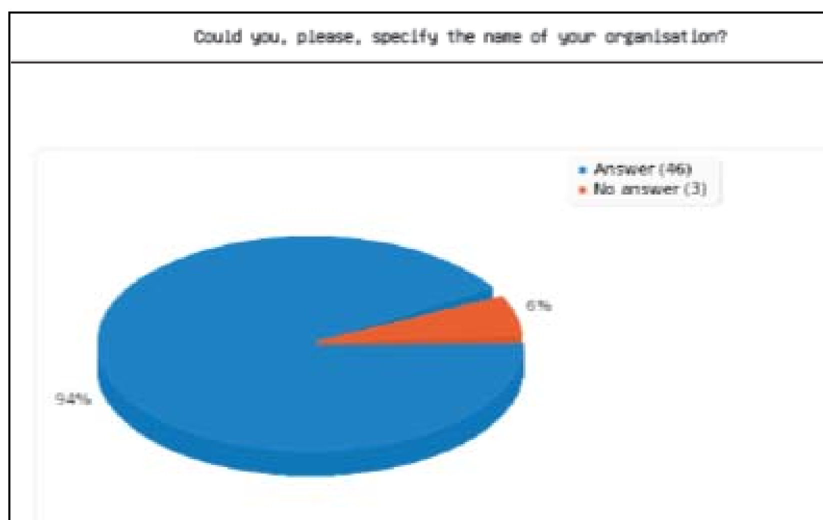
The results of the survey were analysed through various statistical methods. Depending on the type of questions, the results are presented:

- *Through percentages, averages, variances, standard deviations, minimum and maximum, allocation per quartiles;*
- *At overall, country and/or stakeholder levels.*

As previously mentioned, we also resorted to statistical adjustment techniques.

Figure 10: Views from the survey results - Generic identification questions



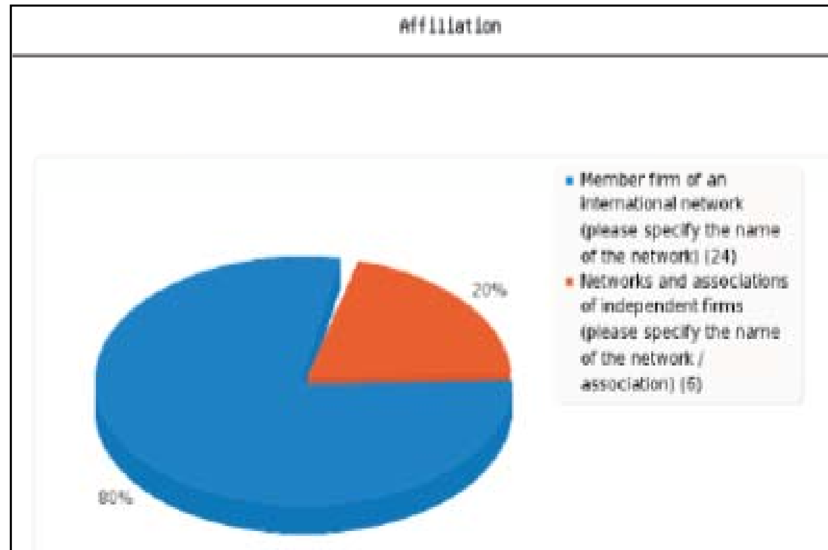


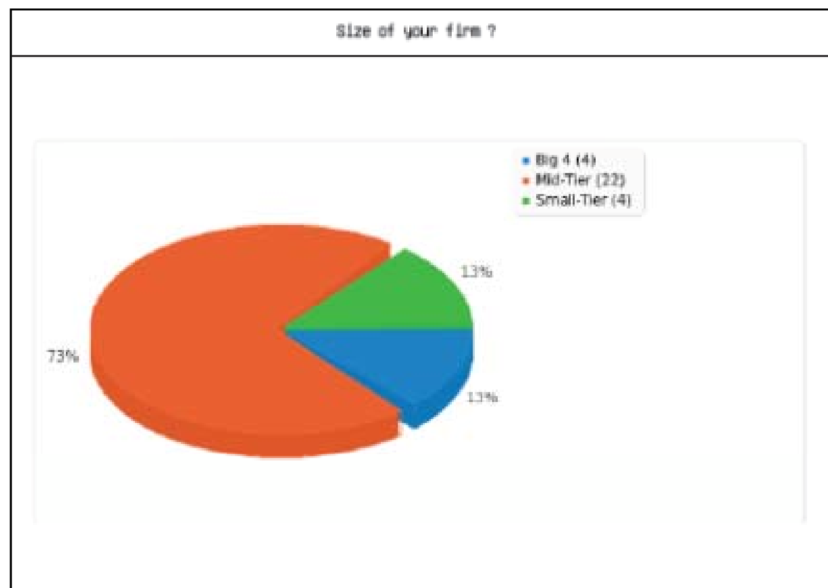
Based on the pre-defined attributes and the detailed and mandatory questions set up at the beginning of the survey to identify respondents, detailed analysis by category of stakeholders could be provided, e.g.:

- *Regulators and official bodies: Audit regulators;, Financial Market Regulators, Governmental bodies, Professional bodies;*
- *Audit firms: Big 4, Upper mid-tier networks, Mid-tier networks and Mid-tier association of independent firms;*
- *Companies: Big Caps, Mid-Caps, Small Caps, private;*

- *Other stakeholders: Corporate governance associations, Minority shareholders associations, Banks, Other institutional investors, Academics.*

Figure 11: Views from the results - Audit firm specific identification questions

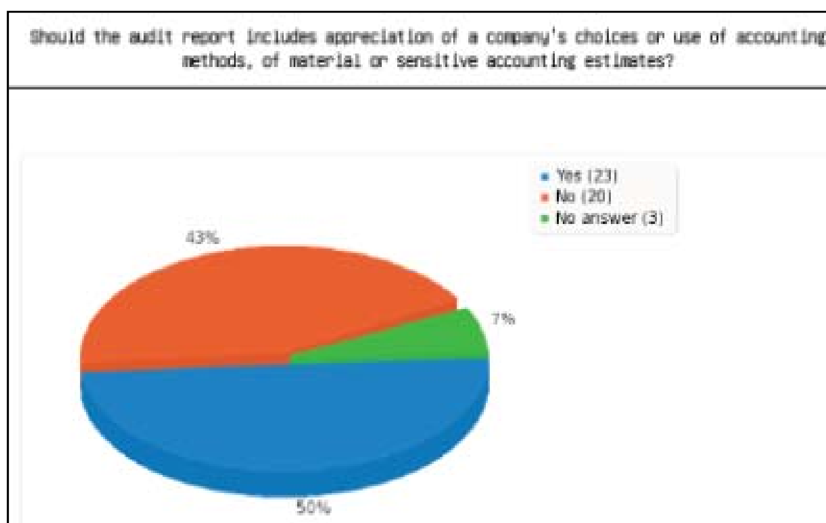




The diversity of the questions enabled us to collect both quantitative and qualitative data. Depending on criteria to be assessed, stakeholders were invited to:

- *Select one or several choices;*

Figure 12: Views from the results - Single choice questions



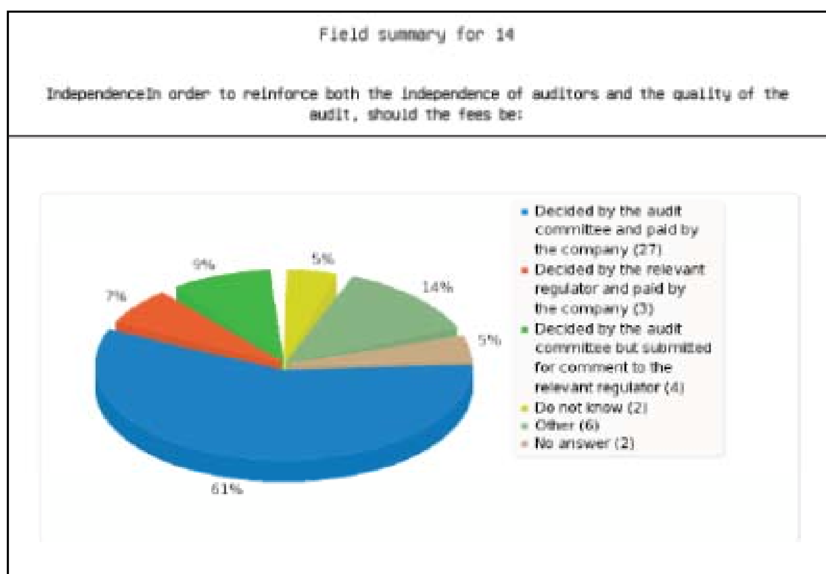
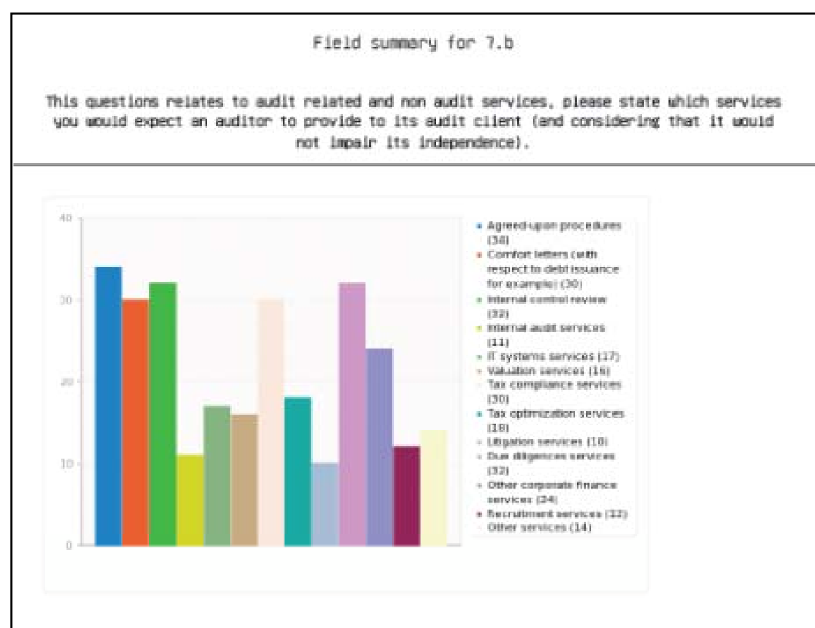


Figure 13: Views from the results - Multiple choice questions

Field summary for 7.b

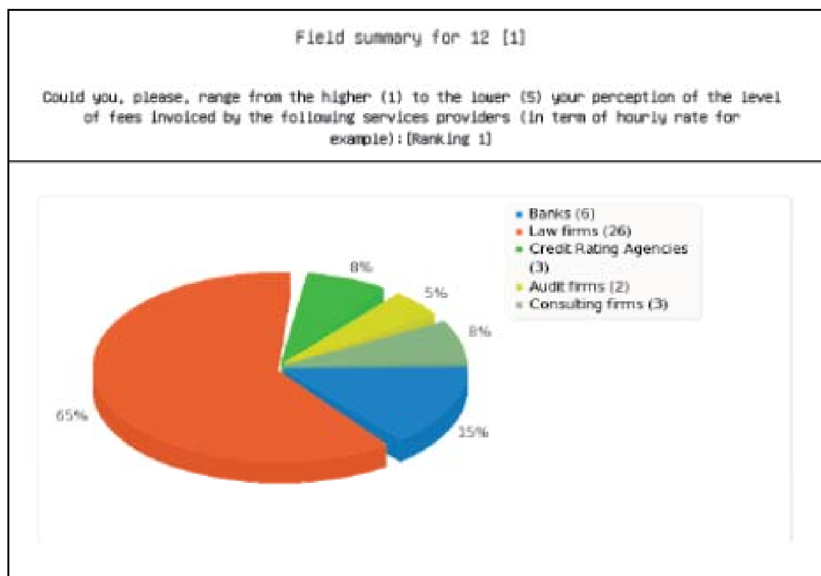
This questions relates to audit related and non audit services, please state which services you would expect an auditor to provide to its audit client (and considering that it would not impair its independence).

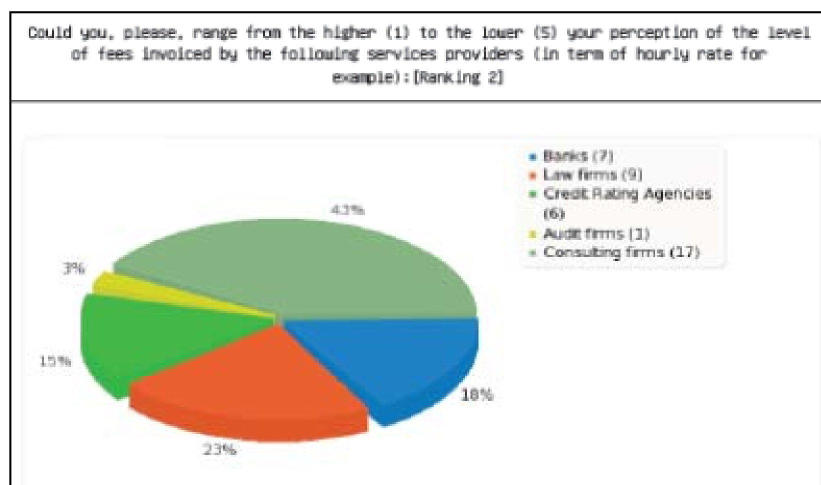
Answer	Count	Percentage
Agreed-upon procedures (SQ001)	34	69.39%
Comfort letters (with respect to debt issuance for example) (SQ002)	30	61.22%
Internal control review (SQ003)	32	65.31%
Internal audit services (SQ004)	11	22.45%
IT systems services (SQ005)	17	34.69%
Valuation services (SQ006)	16	32.65%
Tax compliance services (SQ007)	30	61.22%
Tax optimization services (SQ008)	18	36.73%
Litigation services (SQ009)	10	20.41%
Due diligences services (SQ010)	32	65.31%
Other corporate finance services (SQ011)	24	48.98%
Recruitment services (SQ012)	12	24.49%
Other services (SQ013)	14	28.57%



- *Rank various criteria against one another;*

Figure 14: Views from the results - Ranking questions





- *Give marks from 1 to 5 to proposed criteria.*

Figure 15: Views from the results - Rating questions

Field summary for 2.b [Level of fees]

How satisfied (on a scale of 1 (extremely unsatisfied) to 5 (extremely satisfied), 0 if you do not know) are you in respect of the following criteria in respect of auditors

Calculation	Result
Count	10
Sum	26
Standard deviation	1.36
Average	2.6
Minimum	0
1st quartile (Q1)	1.75
2nd quartile (Median)	2.5
3rd quartile (Q3)	4
Maximum	4

Null values are ignored in calculations
Q1 and Q3 calculated using minitab method

Field summary for 19 [Audit firm are too small and lack capacity to handle audit assignments undertaken typically by large audit firm]

How important (on a scale of 1 (least important) to 5 (most important), 0 if you do not know) do you rate the following factors as barriers for audit firms other than the Big 4 to provide audit services to listed companies usually audited by Big 4?

Calculation	Result
Count	38
Sum	131
Standard deviation	1.33
Average	3.45
Minimum	1
1st quartile (Q1)	2
2nd quartile (Median)	4
3rd quartile (Q3)	4.25
Maximum	5

The possibility for respondents to provide additional comments at the end of each sub-section also enabled us to gather further qualitative data.

II.2.5 Module 5: Qualitative interviews with high-level representatives

II.2.5.1 Objective of the module

This module consisted of qualitative interviews so as to:

- Get a deeper understanding of the audit market situation by Member State;
- Complete information gaps where specific quantitative data was not available (module 2), or not enough responses to the online survey were collected (module 4);
- Discuss the key issues that emerged from the European audit market overall, and at a Member State level;
- Discuss the potential steps to be taken in order to address these issues.

A total of 51 interviews were carried out. The contact list can be found in Appendix VI.2.3.

II.2.5.2 Key steps

Module 5 followed five main steps:

I. Identification of stakeholders to be targeted, and by direct email or phone contact;
   Note 1: the list of stakeholders contacted leveraged the online survey contacts, with a similar proportion of the four stakeholders
   Note 2: the list consisted of a relatively balanced mix of respondents and non-respondents to the survey
II. Production of an interview guide ("semi-structured") containing:
   a. A cross-country section, focusing on dimensions to be discussed in all Member States
   b. A country-specific section, with topics coming from analyses and conclusions from modules 1, 3 and 4;
III. Interviews of stakeholders:
   a. Mainly over the phone;
   b. Whenever appropriate, face-to-face;
IV. Production of a report summarising key takeaways from the interviews.

Focus on the second main step: Production of an interview guide

It should be noted that prior to each interview, the guide was customised to select appropriate questions depending on:

- *The type of stakeholder and their position in the market (e.g. with different questions when interviewing a mid-tier audit firm vs. a Big 4);*
- *The possible responses to the survey;*
- *The specific country context (analyses from module 1);*
- *The key information gaps to be completed.*

I. Key issues** (non exhaustive) **discussed with interviewees in all Member States

- *Audit market concentration:*
    - *Apart from the Big 4, how many mid-tier audit firms are able to provide services to large, multinational and/or listed corporations?*
    - *What (if any) barriers prevent mid-tier firms from providing audit services to listed corporations? (e.g. non-provision of non-audit services, a selection process favouring larger corporations, etc.)*
    - *What would be the impact of the failure of one of the Big 4?*
- *Audit price levels:*
    - *[Depending on level of concentration] To what extent does the currently high or relatively high concentration level contribute to above average audit fees?*
    - *[Not to be asked to audit firms] Do you think audit firms use the audit business as a loss leader to boost the sale of non-audit services?*
- *Overall effectiveness, quality and performance of audit organisations, practices and governance:*
    - *Relevance of audit key documents used or communication?*
    - *Relevance of the scope of services of audit firms?*
    - *Independence and transparency in the selection and choice of auditors:*
    - *Has your firm participated in a formal tender process to provide audit services to large, multinational corporations?*
    - *If not, was this due to not having been invited to tender, or to your firm's decision not to respond to the tender?*
    - *Does Big 4 dominance harm audit quality?*
- *Independence of audit firms from their clients:*
    - *How independent are audit firms from their clients?*
    - *Is the non-audit work significant with audit clients?*

Further follow-up questions were asked during the interview.

II. ***Potential steps to be taken to tackle these issues*** *(not exhaustive)*

- *Rotation of auditors:*
  - *What factors prevent more frequent rotation of audit firms?*
  - *Should rotation of audit firms become mandatory? If so, how long should the appointment be?*
- *Joint audits:*
  - *In respect of listed companies or entities with a public interest, should they appoint two or more auditors?*
    - *If the response is "no", why not?*
    - *If the response is "yes", should the joint audit appointments be for the same period, or should the appointments run for different periods?*
- *Other steps aiming at lowering the overall concentration level or tackling the issue of a potential price ring:*
  - *Create a European vehicle to provide financial assistance to a Big 4 that would be in economic difficulty (in conjunction with the IMF, as was done with the recent European Financial Stability Facility)? (ref. to Green Paper)*
  - *Limit the ability for the Big 4 to acquire any further audit competitor (e.g. above a specific threshold or with the help of national regulators)?*
  - *In specific Member States, force dominant players to break up into smaller companies or to sell specific activities to mid-tier firms?*
  - *Remove barriers to the development of mid-tier firms (e.g. a deregulation of non-audit activities in France, allowing mid-tier firms to provide non-audit services to audit clients; or on the contrary, limits on services audit firms would be allowed to provide to audit clients)?*
  - *Encourage consolidation among mid-tier firms?*
  - *Encourage a specialisation of mid-tier audit firms on specific sectors (to increase their overall level of expertise and to lower entry costs with new clients)?*
  - *Introduce some regulation on audit prices (e.g. target ranges per Member State)?*
- *Steps aiming at improving the overall effectiveness of audit:*
  - *Increase consistency of audit practices across Europe or enforce compulsory audit standards (ISA) at European level?*
  - *Impose systematic, standard and transparent calls for tenders to select an audit firm?*
- *Limit the non-audit activity to a maximum percentage of overall turnover or margin, or even prohibit the non-audit business with statutory audit clients?*
- *Have audit fees paid by a third party (e.g. by financing audit firms via a tax scheme)?*

Further follow-up questions were asked during the interview.

II.2.6 Module 6: Focus groups confronting points of view of different stakeholders

II.2.6.1 Objective of the module

This module consisted in organising five focus groups at ESCP Europe's campuses (i.e. Berlin, London, Madrid, Paris and Turin) so as to:

- Collect the views of key stakeholders on key issues identified under modules 1 to 5;
- Collectively brainstorm on potential action steps to be taken to address these issues;
- Have the different stakeholders confront their views on each key potential recommendation.

For this study, in seeking a qualitative analysis, the focus groups appeared to be an appropriate method to gain relevant insights and to support or enrich our conclusions and recommendations.

II.2.6.2 Key steps

Module 5 followed five main steps:

I. Identification of open issues from desk research, survey and interviews;
II. Identification and contact of key stakeholders;
III. Organisation and delivery of focus groups;
IV. Production of a report summarising key takeaways from each focus group;
V. Integration of key insights into the draft final report.

As regards step II, experts were chosen to represent all points of view, in a balanced and impartial way. They represented independent specialists, recognised in their domain (ref. to list of participants by functions in appendix VI.2.4.).

As regards step III, the five focus groups were held at the following dates:

- On July 19th in Spain;
- On July 25th in France;
- On July 26th in Germany and Italy;
- On July 27th in the UK.

As regards step IV, the report produced formulated conclusions and recommendations that were collectively accepted by the experts.

II.2.7 Module 7: Key conclusions and action steps

II.2.7.1 Objective of the module

The objective of this module was to:

- Summarise key issues on the European audit market, on the basis of all analyses undertaken in modules 2 to 6;
- Present action steps;
- Propose priority steps to be taken.

II.2.7.2 Key steps

This module followed five main steps:

I. Identification of key and priority issues to be tackled (with inputs from modules 2 to 6);
II. For each key issue and problem, identification of a list of potential action steps to be taken;
III. Analysis, for each action step, based on:
    - Attractiveness (impact on the four mains issues identified[17]);
    - Feasibility (complexity of implementation, potential timing and lead time before implementation, acceptability for stakeholders and scalability in the 27 Member States);
IV. Prioritisation of key steps to be taken;
V. For each priority step, identification of:
    - Main conditions of implementation, and potential prerequisites;
    - Possible timing;
    - Main risks for key stakeholders;
    - A preliminary assessment of whether these steps appear compatible with current evolutions for audit outside Europe (e.g. in the US).

[17] High concentration levels (including the risk of demise of a Big 4), barriers to entry for the mid-tiers, quality of audit and independence of audit firms.

III DESCRIPTION OF THE MARKET

In this part, we will give an overview of the implementation of the statutory audit requirements as defined in EU legislation in the different Member States. The data on the market of accounting, bookkeeping, auditing activities and taxconsultancy (NACE class M69.2) is dominated by the audit firms and therefore gives an indication on how audit firms performed over the last five years. In all Member States, audit firms followed the evolution of GDP or outperformed GDP.

III.1 Overview of the regulatory environment for statutory audit in Europe

III.1.1 Introduction

The progressive adoption of International Standards on Auditing (ISAs) should lead to a higher convergence of national audit standards within the EU. Yet current national specificities regarding the scope of statutory audit and other regulatory characteristics must still be taken into account when analysing national markets, since they directly impact the number of statutory audit mandates (i.e. volumes of statutory audit market) and the price levels of audit services. This section will therefore focus on:

- EU audit regulatory requirements: possible adoption of ISAs at an EU level and analyses of the implementation of the amendments of the EU 4th Company Law Directive on "the annual accounts of certain types of companies"[18];
- National definitions of scope for statutory audit and national regulatory characteristics. The impact of specific regulatory measures mentioned in this section will be further analysed in sections 5 and 6 of this report.

Our review on key regulatory specificities per Member State will help understand the functioning of national audit markets but will not, by itself, allow a comprehensive understanding of all market components.

[18] 78/660/EEC.

III.1.2 International Standards on Auditing

ISAs contain *"basic principles and essential procedures [...] together with related guidance in the form of explanatory and other material, including appendices"*[19]. The final set of clarified standards, as published in the "*Handbook of International Quality Control, Auditing, Review, Other Assurance, and related Services Pronouncement* – 2010 Edition" and effective for audits of financial statements for periods beginning on or after December 15th 2009, comprise:

- 36 International Standards on Auditing (ISAs) organised under 6 major categories: (1) general principles and responsibilities (ISA200-299); (2) risk assessment and response to assessed risks (ISA300-499); (3) audit evidence (ISA500-599); (4) using work of others (ISA600-699); (5) audit conclusions and audit reports (ISA700-799); and (6) specialised areas (ISA800-899);
- International Standard on Quality Control (ISQC), which deals with a company's responsibilities[20].

ISAs are currently based on national voluntary adoption. The respective ISAs adoption status for each one of the 27 analysed Member States is outlined below:

Table 14: ISAs adoption process per Member State (2009-2010)

Member State	Required by law or regulation	ISAs adopted	Nationals standards are ISAs	Other
Austria				✓
Belgium				✓
Bulgaria	✓			
Cyprus	✓			
Czech Republic		✓		
Denmark			✓	
Estonia	✓			
Finland			✓	
France			✓	

[19] *Preface to the International Standards on quality control, auditing, review, other assurance and related services – IAASB, December 2009.*

[20] ISA 220.2 allows alternative standards if equal quality as ISQC1: the ISA is premised on the basis that the firm is subject to ISQC1 or national requirements that are at least as demanding.

Germany			✓	
Greece				✓
Hungary		✓		
Ireland		✓		
Italy			✓	
Latvia	✓			
Lithuania				✓
Luxembourg		✓		
Malta	✓			
Netherlands			✓	
Poland			✓	
Portugal			✓	
Romania	✓			
Slovakia	✓			
Slovenia	✓			
Spain				✓
Sweden			✓	
United Kingdom		✓		

Source: IFAC.

Required by Law or Regulation: national legislation or regulation requires the use of ISAs as issued by the International Auditing and Assurances Standards Board (IAASB) in the auditing of general purpose financial statements;

ISA adopted: a national standard-setter has adopted ISAs as the audit standard to be used in the Member State (there are no separate national auditing standards);

National standards are the ISAs: while ISAs have generally been adopted as the national standards, and there may be national modifications to them but changes, if any, are stated to be in line with the spirit of the IAASB Modifications Policy;

Other: In some circumstances, available information is not adequate to evaluate whether the local adoption process, including the translation of ISAs into the national language(s), is reasonably up to date with translation lags of a year. In other cases, where a jurisdiction indicates that the national generally accepted auditing standards is "based on" or "similar to" the ISAs, it is not clear whether modifications to or other differences from the ISAs meet the requirements of the IAASB

Modifications Policy. Finally, there are some Member States which have declared convergence with ISAs as an objective but still have a way to go in achieving this objective.

In their response to the EC *Green Paper – Audit policy: lessons from the crisis,* professional bodies and audit firms generally support the mandatory adoption of ISAs. Companies and investors, on the other hand, express reservations mainly linked with the IAASB governance (IFAC is funded by large audit firms and professional audit bodies), which could, in their opinion, lead to conflicts of interest[21]. More than 100 countries worldwide have either adopted ISAs or declared their intent to do so in the future, including all EU Member States.

All analysed Member States are in a quite advanced stage of adoption, with some amendments to adjust ISAs to national regulatory requirements.

The harmonization of the different national audit standards that could result from Member States adopting ISAs as national auditing standards should benefit mid-tier and smaller-sized firms, which should be more easily able to work outside national borders. Indeed, contrary to the largest audit firms, mid-tier and smaller auditors do not have the geographical reach to have developed an expertise on the audit standards of each of the 27 Member States. Although audit quality and independence should be enhanced by ongoing implementations of ISAs requirements, some stakeholders wonder if ISAs will be sufficient, given their inherent limitations: regulation measures such as audit firm rotation, joint audit or other possible statutory audit requirements are outside the scope of ISAs.

III.1.3 EU audit regulatory requirements

III.1.3.1 EU thresholds for statutory audit exemption

According to the EU 4th Company Law Directive on *"the annual accounts of certain types of companies"* [22], Member States shall approve persons in charge of statutory audits, and can exempt companies from audits below specific thresholds.

Regarding the approval of auditors, article 51 outlines the following:

"1. The annual accounts of companies shall be audited by one or more persons approved by Member States to carry out statutory audits on the basis of the Eighth Council Directive 84/253/EEC of 10 April 1984 on the approval of persons responsible for carrying out the statutory audits of accounting documents (1). The statutory auditors shall also express an opinion concerning the consistency or otherwise of the annual report with the annual accounts for the same tax year.

2. The Member States may relieve the companies referred to in Article 11 from the obligation imposed by paragraph 1. Article 12 shall apply.

[21] Summary of responses to the EC *Green Paper – Audit policy: lessons from the crisis.*
[22] 78/660/EEC.

3. Where the exemption provided for in paragraph 2 is granted the Member States shall introduce appropriate sanctions into their laws for cases in which the annual accounts or the annual reports of such drawn up in accordance with the requirements of this Directive."

Moreover, article 11 of the EU 4th Company Law Directive and its 2006 amendments[23] set maximum thresholds:

"The Member States may permit companies which on their balance sheet dates do not exceed the limits of two of the three following criteria:

- *Balance sheet total: €4,400,000;*
- *Net turnover: €8,800,000;*
- *Average number of employees during the tax year: 50.*

to draw up abridged balance sheets showing only those items preceded by letters and roman numerals in Articles 9 and 10, disclosing separately the information required in brackets in D (II) under 'Assets' and C under 'Liabilities' in Article 9 and in D (II) in Article 10, but in total for each."

Article 12 also outlines the conditions of exemptions:

"Where on its balance sheet date, a company exceeds or ceases to exceed the limits of two of the three criteria indicated in Article 11, that fact shall affect the application of the derogation provided for in that Article only if it occurs in two consecutive tax years."

Therefore, audit exemption thresholds are not mandatory. Member States can freely set thresholds on the three above-mentioned criteria, leading to very different scopes and shares of the corporate landscape that must be audited across Europe.

III.1.3.2 Scope of statutory audit by Member State

The following table outlines the scope of statutory audit for each Member State according to two types of criteria:

- Their legal status or the sector they operate in (left-hand column);
- Their size, depending on the threshold levels defined for statutory audit exemption (right-hand column).

[23] 2006/46/EC.

Table 15: Scope of statutory audit by Member State

	Company legal status	Company size
Austria	• Listed companies; • Private companies; • Not-for-profit.	All companies that meet at least two of the three following criteria for two years running: • Total balance sheet over €4.84 M; • Net turnover over €9.68 M; • Number of employees over 50.
Belgium	• Listed companies; • Private companies.	All companies that meet at least one of the two following criteria for two years running: • Total balance sheet over €3.6 M; • Net turnover over €7.3 M; • Number of employees over 50.
Bulgaria	• Listed entities; • Private companies; • Not-for-profit.	All companies that meet at least two of the three following criteria for two years running: • Total balance sheet over BGN1.5 M (€0.8 M); • Net turnover over BGN1 M (€511 k); • Number of employees over 50.
Cyprus	• Listed companies; • Private companies; • Governmental; • Not-for-profit.	All companies that meet at least two of the three following criteria for two years running: • Total balance sheet over C£2 M (€3.4 M); • Net turnover over C£4.1 M (€7 M); • Number of employees over 50.
Czech Republic	• Joint-stock and listed companies that meet at least one of three criteria; • Private companies; • Other entities required to prepare their annual statutory financial statements (if they meet at least two of the three criteria); • Public sector entities (if these are governmental entities) must have their activities checked either by the auditor or the state officer; • Not-for-profit: certain entities after meeting required limits.	All companies that meet at least two of the three following criteria for two years running: • Total balance sheet over CZK 40 M (€1.6 M); • Net turnover over CZK 80 M (€3.2 M); • Number of employees over 50.
Denmark	• Listed companies; • Private companies.	All companies that meet at least two of the three following criteria for two years running: • Total balance sheet over DKK36 M (€4.8 M); • Net turnover over DKK3 M (€400 k); • Number of employees over 50.

Estonia	• Listed entities; • Private companies; • Governmental companies; • Not-for-profit companies.	All companies that meet at least two of the three following criteria for two years running: • Total balance sheet over EEK5 M (€320 k); • Net turnover over EEK10 M (€640 k); • Number of employees over 10.
Finland	• Listed entities; • Private companies; • Governmental; • Not-for-profit; • Co-operatives • Partnerships and other entities subject to bookkeeping requirements.	All companies that meet one of the three following criteria: • Total balance sheet over €3.65 M; • Net turnover over €7.3 M; • Number of employees over 50.
France	• Listed entities; • Private companies; • Not-for-profit.	All companies that meet one of the three following criteria: • Total balance sheet over €0.267 M; • Net turnover over €0.534 M; • Number of employees over 10.
Germany	• Listed entities; • Private companies; • Governmental; • Not-for-profit.	All companies that meet at least two of the following criteria for two years running: • Total balance sheet over € 4.015.000; • Net turnover over € 8.030.000; • Number of employees over 50.
Greece	• Listed companies; • Private companies; • Banks; • Insurance companies • Some specialised companies.	All companies that meet at least two of the three following criteria for two years running: • Total balance sheet over €2.5 M; • Net turnover over €5 M; • Number of employees over 50.
Hungary	• Listed companies; • Private companies; • Governmental; • Not-for-profit.	All companies that meet one of the three following criteria: • Total balance sheet over HUF 500 M (€1.7 M); • Net turnover over HUF1,000 M (€3.4 M); • Number of employees over 50.
Ireland	• Listed companies; • Private companies; • Governmental; • Not-for-profit.	All companies that meet at least two of the three following criteria for two years running: • Total balance sheet over €1.9 M; • Net turnover over €3.81 M; • Number of employees over 50.

Italy	• Listed companies; • Private companies; • Governmental; • A few other, specific company forms.	All companies that meet at least two of the three following criteria for two years running: • Total balance sheet over €4.4 M; • Net turnover over €8.8 M; • Number of employees over 50.
Latvia	• Listed companies; • Private companies; • Governmental: only municipalities.	All companies for which at least two of the following three criteria exceeded the limits on the last day of the reporting period: • Total balance sheet over LVL0.25 M (€0.35 M); • Net turnover over LVL12 M (€711 k); • Number of employees over 25.
Lithuania	• Listed companies; • Private companies; • Governmental; • Not-for-profit; • Financial institutions; • Insurance companies.	All companies for which at least two of the following three criteria exceeded the limits on the last day of the reporting period: • Total balance sheet over LTL5.9 M (€1.7 M); • Net turnover over LTL10 M (€2.9 M); • Number of employees over 15.
Luxembourg	• Listed companies; • Private companies; • Not-for-profit.	All companies that meet at least two of the three following criteria for two years running: • Total balance sheet over €3.125 M; • Net turnover over €6.25 M; • Number of employees over 50.
Malta	• All companies.	All companies that meet at least one of the two following criteria: • Total balance sheet over €2.6 M; • Net turnover over €5.1 M.
Netherlands	• Listed companies; • Private companies; • Governmental; • Not-for-profit: if their commercial activities exceed €3.5 M or if required by the articles of association.	All companies that meet at least two of the following criteria for two years running: • Balance sheet over €4.4 M; • Net turnover over €8.8 M; • Number of employees over 50.
Poland	• Listed companies; • Private companies; • Governmental; • Not-for-profit; • Banks; • Insurance companies; • Other financial institutions.	All companies that meet at least two of the three following criteria for two years running: • Total balance sheet over €2 M; • Net turnover over €4 M; • Number of employees over 50.

Portugal	• Listed companies; • Private companies; • Governmental; • Not-for-profit.	All companies that meet at least two of the three following criteria for two years running: • Total balance sheet over €0.5 M; • Net turnover over €1 M; • Number of employees over 20.
Romania	• Listed companies; • Private companies; • Governmental; • Not-for-profit.	All companies that meet at least two of the three following criteria for two years running: • Total balance sheet over €3.65 M; • Net turnover over €7.3 M; • Number of employees over 50.
Slovakia	• Listed companies; • Private companies; • Governmental; • Not-for-profit; • Joint-stock companies.	All companies that meet at least two of the three following criteria for two years running: • Total balance sheet over €1 M; • Net turnover over SKK40 M (€1.2 M); • Number of employees over 30.
Slovenia	• Listed companies; • Private companies.	All companies that meet at least two of the three following criteria for two years running: • Total balance sheet over €4.4 M; • Net turnover over SIT1.7 bn (€7 M); • Number of employees over 50.
Spain	• Listed entities; • Private companies; • Governmental; • Not-for-profit; • Credit and Insurance companies; • Companies receiving grants from the Government; • Exchange offices; • Sport companies; • Real estate investment funds; • Mutual guarantees companies; • Social work entities.	All companies that meet at least two of the following criteria for two years running: • Total balance sheet over €2.85 M; • Net turnover over €5.7 M; • Number of employees over 50.
Sweden	• Listed entities; • Private companies.	All companies that meet at least two of the following criteria for two years running: • Total balance sheet over SEK25 M (ca. €2.7 M); • Net turnover over SEK3 M (ca. €0.3 M); • Number of employees over 3.
United Kingdom	• Listed entities; • Private companies; • Not-for-profit.	All companies that meet at least two of the following criteria for two years running: • Total balance sheet over £3.26 M (ca. €3.6 M); • Net turnover over £6.5 M (ca. €7.2 M); • Number of employees over 50.

Sources: EC Consultation of Accounting Regulatory Committee Members[24], IFAC and September 2011 EU report on the responses received to the consultation of accounting regulatory committee members on the use of options within the accounting directives.
Exchange rates as of October, 1st 2011.

Considering the type of companies that have to be audited, it can be noted that in every Member State, auditing is mandatory for listed companies and for private companies depending on their legal form.

Thresholds for statutory audits are also heterogeneous: as of July 1st, 2010, the net turnover threshold ranged from €534 k in France to €9.7 M in Austria, Denmark and Germany. Overall, three Member States (Italy, the Netherlands and Slovenia) strictly implement thresholds defined in the EU 4th Company Law Directive on "the annual accounts of certain types of companies"[25] and eight Member States (Austria, Belgium, Cyprus, Denmark, Finland, Germany, Romania and the United Kingdom) implement thresholds relatively close to those defined by the EC.

Finally the current trend towards a threshold increase, which implies a reduction of companies subject to statutory audit, would not necessarily lead to a decrease in market turnover. The recent threshold implementation in Sweden show that many companies continue to have their financial statements audited on a voluntary basis.

III.1.3.3 Regulatory characteristics by Member State

In addition to the different requirements for statutory audits, Member States also have different regulatory characteristics that impact the functioning of the audit market. The following table details some key regulatory characteristics and recent regulation changes. It does not cover legislation related to capped liabilities for audit firms (with, for instance, liabilities capped on the basis of a fixed amount in Austria (€4 M) or Germany (€1 M for non-listed companies, €4 M for listed companies) or multiples of audit fees in Cyprus (7 times audit fees) or Slovakia (20 times audit fees for PIEs and 10 times for other companies)). Member States have implemented the European Commission's Recommendation in different ways and some Member States introduced mechanisms to limit liabilities without capping them.

[24] Consultation of Accounting Regulatory Committee Members on the Use of Options within the Accounting Directives, September 2011 (answers accurate as of July 1st, 2010).
[25] Thresholds defined in the 2006 amendments to the EU 4th Company Law Directive: Net turnover under €8.8 M; Total balance sheet under €4.4 M; Number of employees under 50 (for two years running).

Table 16: Key regulatory characteristics per Member State

	Maximum audit mandate duration*	Mandatory audit partner rotation	Other specific regulations	Recent changes in regulation
Austria	1 year	5 years for partners and other key personnel (all persons who are important for the audit team)		
Belgium	3 years	6 years (for listed companies, credit institutions and insurance companies)		Since 2005, additional types of entities or activities have been subject to statutory audit (e.g. non-profit making organisations, public health institutions, etc.)
Bulgaria	1 year	5 years for Public Interest Entities	• Restrictions on the provision of non-audit services to audit clients	
Cyprus	1 year	7 years	• Restrictions on the provision of non-audit services to audit clients	
Czech Republic	No	7 years		
Denmark	1 year	7 years	• An audit firm must not have a share of more than 20% of its turnover with the same customer for five consecutive years • Restrictions on the provision of non-audit services to audit clients	
Estonia	No	7 years	• Restrictions on the provision of non-audit services to audit clients • Banks and insurance companies are required to perform ISA-compliant audit	
Finland	No	7 years	• Restrictions on the provision of non-audit services to audit clients	

France	6 years	6 years (for listed companies, credit institutions and insurance companies)	• Mandatory joint audit for: o Companies that need to consolidate o Credit institutions o Certain political parties or associations • Severe restriction on the provision of non-audit services to audit clients: it is prohibited for audit clients and restricted for the subsidiaries of audit clients.	Successive regulation changes have increased the overall number of mandates, by broadening the scope of statutory audit to structures such as universities, work councils and public health institutions. On the other hand, since 2009 and under certain conditions, SAS[26] have been exempted from statutory audit requirements
Germany	1 year	7 years		Recent restriction on the provision of non-audit services to audit clients
Greece	1 year	7 years	• Restrictions on the provision of non-audit services to audit clients	
Hungary	5 years	5 years for Public Interest Entities	• Restrictions on the provision of non-audit services to audit clients	
Ireland	1 year	7 years	• Rotation for selected other personnel in addition to the key partners	
Italy	3 years	Mandatory rotation of audit firm after a maximum of 9 years (3 mandates) for listed companies and some other companies identified by law		
Latvia	1 year	7 years	• Restrictions on the provision of non-audit services to audit clients	
Lithuania	N.A.	• 5 years for Public Interest Entities • 7 years for other entities	• Restrictions on the provision of non-audit services to audit clients	
Luxembourg	1 year	7 years	• Rotation for other key personnel in addition to the key partners	

[26] Simplified corporate structures under French law.

Malta	1 year	7 years	• Restrictions on the provision of non-audit services to audit clients	
Netherlands	1 year	7 years		Since 2006, no statutory audit of a company incorporated in the Netherlands can be performed without a license granted by the Netherlands Authority for the Financial Markets
Poland	1 year	5 years for Public Interest Entities, no obligation for other companies	• Restrictions on the provision of non-audit services to audit clients	
Portugal	4 years	7 years for Public Interest Entities	• Restrictions on the provision of non-audit services to audit clients	
Romania	1 year	7 years for Public Interest Entities and key partners	• Restriction on the provision of non-audit services to audit clients	
Slovakia	No	5 years	• Restrictions on the provision of non-audit services to audit clients	
Slovenia	1 year	7 years	• Restrictions on the provision of non-audit services to audit clients	
Spain[27]	9 years	7 years		
Sweden	4 years	7 years (for listed companies, credit institutions and insurance companies)	Restriction on the provision of non-audit services to audit clients (limited companies)	Audit exemption thresholds for small companies have been implemented very recently (November 2010)
United Kingdom	1 year	5 years[28]		

**Maximum mandate duration allows for the reappointment of the same auditor and retendering is not required.*

Sources: Financial Standards Foundation, audit firms websites and National audit standard setters.

The above analysis highlights:

- The statutory Audit Directive is a minimum harmonisation directive, and situations can be very different across the 27 Member States:

[27] In 1989, Spain adopted mandatory audit firm rotation after a maximum of 9 years, which included a mandatory retention of 3 years. This system was dropped in 1995.

[28] Up to two years extension when approved by the Audit Committee.

    - Maximum audit mandate durations vary from one year in at least seven Member States to nine years in Italy;
- Strict regulations in certain Member States on Audit practices:
    - France is the only Member State to require joint audits, and the strict restriction of the provision of non-audit services to statutory audit clients;
    - Italy is the only Member State to require audit firm rotation on termination of a 9 years mandate;
- The absence of any uniform trend across Europe in audit regulation.

III.2 Overview of the audit market environment in Europe

III.2.1 Introduction

Two different sources are used in this section:

- Data provided by the national statistics institutes, considering all firms referenced under NACE class M69.2[29] ("accounting, bookkeeping, auditing activities and tax consultancy"), which is a subclass of business services;
- Data from audit regulators and financial authorities, which estimate the number of audit firms and statutory auditors in 26 Member States.

Concerning the first source:

- It gives the number of firms and the turnover of firms referenced under NACE class M69.2 for each Member States between 2005 and 2010 (some data for certain Member States or certain years may not be available though);
- It also includes secondary activities such as business and management consultancy services. As a result, the number of audit firms presented with this source is overstated, as it includes companies performing other activities than audit;
- The number of audit firms registered with national audit regulators (see table 18) is lower than the number of firms included in NACE class M69.2 (see table 21). However, as shown in following analyses, the data of NACE class M69.2 and the resulting analysis and conclusions can be used to discuss the market of audit firms.
- The market represented by NACE class M69.2 will be referred to in this chapter as M69.2 market.

Concerning the second source:

- It is an estimate from each national audit regulators or financial authorities;
- No historical evolution was available;
- It does not give any information neither on the total value of the market nor on the turnover of the audit firms considered.

[29] Class 74.12 before the nomenclature revision of 2008.

As a result, the first source, relying on national statistics institutes data which are comparable in the 27 Member States, was used in priority. Data from the second source is also detailed in table 18.

To be convinced on the fact that conclusions drawn on the M69.2 market could be extrapolated to the audit market, we demonstrated that the registered audit firms (according to local audit regulators and financial authorities) appear to be dominant within the NACE class M69.2, based on calculations for the largest 10 Member States in M69.2 turnover:

- The average turnover of registered audit firms can be estimated above €1.43 M while the average turnover per M69.2 firm equals €0.29 M, i.e. +390% (meaning that audit firms are about five times larger in turnover compared to average M69.2 firms);
- The registered audit firm account for 6% of M69.2 firms (19,950 registered audit firms vs. 341,600 M69.2 firms);
- Therefore, the conclusions drawn from the evolution of the market represented by NACE class M69.2 is also representative for the market of audit firms and the reasons explaining this evolution will highly depend on evolutions in the market of audit firms.

This is outlined below:

Member States	Total turnover of firms within M69.2 (in €M)	*Corresponding number of firms within M69.2*	*Average turnover per M69.2 firm*	Total turnover of top 10 audit firms (in €M)	*Corresponding number of firms*	*Average turnover per top 10 audit firm*	Total number of registered audit firms (according to local audit regulators and financial authorities)	*Average turnover per registered audit firm (assuming that the top 10 audit firms account for the whole audit market*
Germany	€ 23 800 M	*45 040*	*€ 0,53 M*	€ 5 297 M	*10*	*€ 530 M*	*2 631*	*€ 2,01 M*
UK&Ireland	€ 17 900 M	*33 270*	*€ 0,54 M*	€ 7 963 M	*10*	*€ 796 M*	*7 843*	*€ 1,02 M*
France	€ 14 400 M	*23 309*	*€ 0,62 M*	€ 4 372 M	*10*	*€ 437 M*	*4 500*	*€ 0,97 M*
Italy	€ 10 900 M	*104 177*	*€ 0,10 M*	€ 1 389 M	*10*	*€ 139 M*	*321*	*€ 4,33 M*
Spain	€ 11 000 M	*58 063*	*€ 0,19 M*	€ 1 694 M	*10*	*€ 169 M*	*1 354*	*€ 1,25 M*
Netherlands	€ 9 800 M	*18 400*	*€ 0,53 M*	€ 3 484 M	*10*	*€ 348 M*	*481*	*€ 7,24 M*
Belgium	€ 3 800 M	*12 902*	*€ 0,29 M*	€ 828 M	*5*	*€ 166 M*	*513*	*€ 1,61 M*
Sweden	€ 2 700 M	*17 587*	*€ 0,15 M*	€ 1 278 M	*10*	*€ 128 M*	*125*	*€ 10,22 M*
Poland	€ 2 700 M	*22 158*	*€ 0,12 M*	€ 1 815 M	*10*	*€ 182 M*	*1 804*	*€ 1,01 M*
Austria	€ 2 700 M	*6 694*	*€ 0,40 M*	€ 389 M	*5*	*€ 78 M*	*378*	*€ 1,03 M*

More specifically on how data was pulled out and collected from national statistics institutes:

- The data request was made for NACE class M69.2, or the equivalent code in each national industry nomenclature (no nomenclature mismatch was detected).
- To get the relevant data and comments on their coverage or scope, all national institutes were contacted;
- For Member States or years not provided by National statistics, we applied the growth rate of Datamonitor “Accountancy” industry profiles to the data available from national statistics;
- Eurostat was used as a complementary source of information when neither national statistics institute nor Datamonitor was available.

The following table shows the national statistics sources used and the data available per Member State:

Table 17: Market size - Sources and available data for companies under NACE class M69.2

Member state	Sources	Number of companies						Total turnover of the audit market					
		2005	2006	2007	2008	2009	2010	2005	2006	2007	2008	2009	2010
Austria	Statistik Austria	✓	✓	✓	✓	✓	✗	✓	✓	✓	✓	✓	✗
Belgium	Statbel	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Bulgaria	Eurostat	✗	✗	✗	✓	✗	✗	✗	✗	✗	✓	✗	✗
Cyprus	Statistical Service of Cyprus	✓	✓	✓	✓	✓	✗	✓	✓	✓	✓	✓	✗
Czech Republic	Czech Statistical Office	✗	✗	✗	✗	✗	✗	✓	✓	✓	✓	✓	✓
Denmark	Denmark statistics	✓	✓	✓	✓	✗	✗	✓	✓	✓	✓	✓	✗
Estonia	Eurostat	✗	✗	✗	✓	✗	✗	✗	✗	✗	✓	✗	✗
Finland	Statistic Centralen	✓	✓	✓	✓	✓	✗	✓	✓	✓	✓	✓	✗
France	Insee	✓	✓	✓	✓	✗	✗	✓	✓	✓	✓	✓	✓
Germany	Destatis	✓	✓	✓	✓	✗	✗	✓	✓	✓	✓	✓	✓
Greece	-	✗	✗	✗	✗	✗	✗	✗	✗	✗	✗	✗	✗
Hungary	Central Statistical Office	✓	✓	✓	✓	✓	✗	✓	✓	✓	✓	✗	✗
Ireland	CSO Ireland	✗	✓	✓	✓	✓	✗	✓	✓	✓	✓	✗	✗
Italy	Istat	✓	✓	✓	✗	✗	✗	✓	✓	✓	✓	✓	✓
Latvia	Statistika Latvijas	✓	✓	✓	✓	✗	✗	✓	✓	✓	✓	✗	✗
Lithuania	Statistics Lithuania	✓	✓	✓	✓	✗	✗	✓	✓	✓	✓	✗	✗
Luxembourg	Statec	✓	✓	✓	✓	✗	✗	✓	✓	✓	✓	✗	✗
Malta	-	✗	✗	✗	✗	✗	✗	✗	✗	✗	✗	✗	✗
Netherlands	CBS Netherlands	✗	✓	✓	✓	✓	✓	✗	✓	✓	✓	✓	✓
Poland	Eurostat	✗	✗	✗	✓	✗	✗	✗	✗	✗	✓	✗	✗
Portugal	Statistics Portugal	✓	✓	✓	✓	✓	✗	✓	✓	✓	✓	✓	✗
Romania	Eurostat	✗	✗	✓	✓	✗	✗	✗	✗	✓	✓	✗	✗
Slovakia	Slovstat	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Slovenia	Statistical Office Slovenia	✓	✓	✓	✓	✗	✗	✗	✗	✗	✓	✗	✗
Spain	INE[30]	✓	✓	✓	✓	✓	✗	✓	✓	✓	✓	✓	✓
Sweden	Statistika Centralbyrån	✓	✓	✓	✓	✓	✗	✓	✓	✓	✓	✓	✗
UK	National Statistics	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓

Market sizes were cross-checked with available data from Eurostat, Datamonitor[31], Key Note (UK)[32] and Xerfi (France)[33]. After comparing different sources and, in particular, talking with survey authors from Datamonitor, we concluded that market data from national statistics institutes were the most reliable, since 1) the scope of Datamonitor surveys excludes certain audit activities (e.g. corporate finance or insolvency), and 2) Datamonitor turnovers for 2009 are based on partial-year data.

<u>Note:</u> considering the significantly higher data availability for 2009 compared to 2010, the reference year selected is 2009.

[30] Instituto Nacional de Estadística.
[31] *Datamonitor, Audit and Accountancy in Belgium/France/Germany/Italy/Netherlands/Spain/UK, 2010.*
[32] *Key Note, Accountancy Market Report, UK, 2010.*
[33] *Xerfi, Cabinets d'Audit et d'Expertise Comptable, France, 2011.*

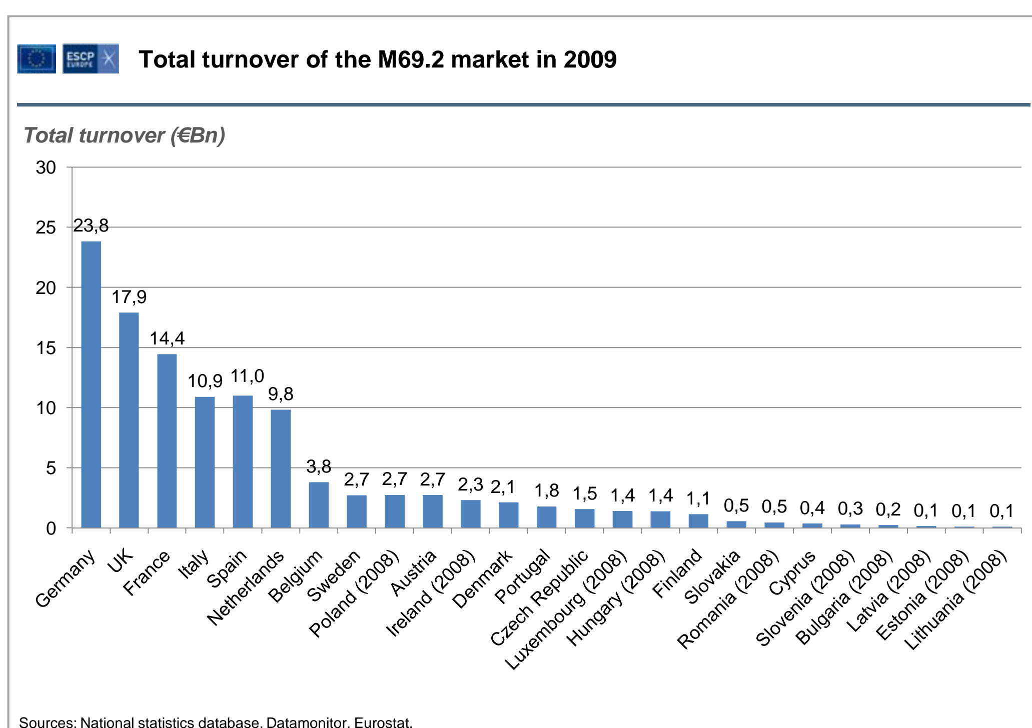
III.2.2 Size of the M69.2 market and historical evolution

Note: national statistics institutes register the number of firms reporting VAT, with the exception of the UK, where from 2008 onwards datasets have been VAT- and/or PAYE-[34] based (PAYE-based companies are usually companies with an annual turnover under £70 k, i.e. exempt from VAT), whereas they were VAT-based only up to 2007.

As a consequence, the evolution in number of firms for the UK must be taken with caution (the strong increase in number of firms between 2007 and 2008 is due to this change of scope) and cannot be used directly for cross-country comparisons.

III.2.2.1 Size of the M69.2 market

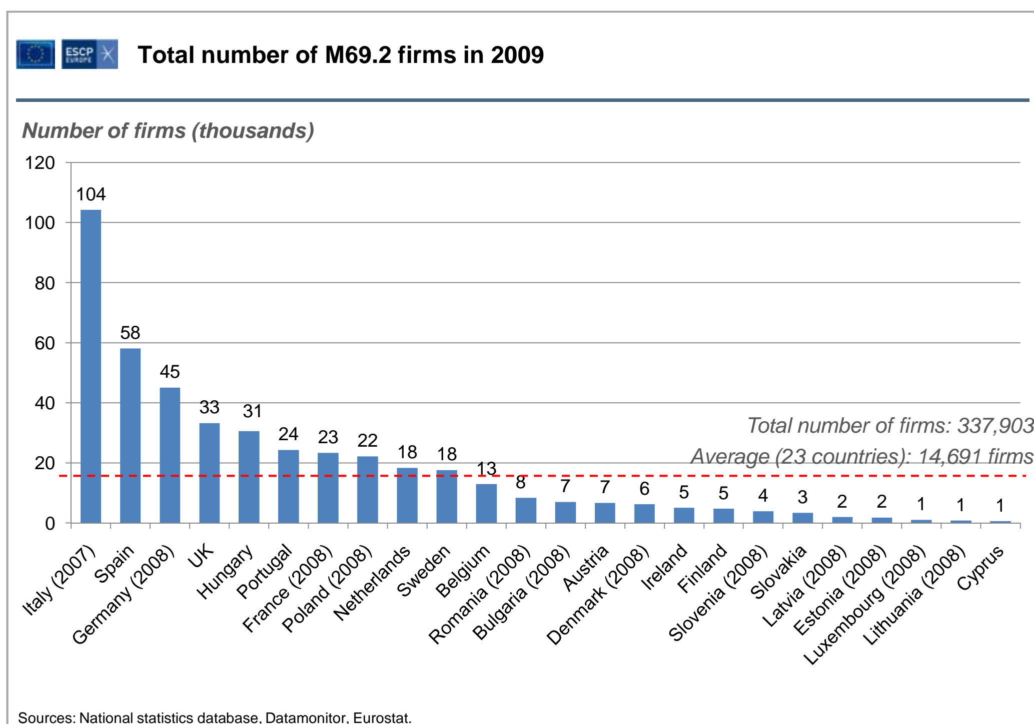
Figure 16: Size of the M69.2 market per Member State (2009)



Caveat: Size of the M69.2 market as defined under NACE class M69.2[35] ("accounting, bookkeeping, auditing activities and tax consultancy").

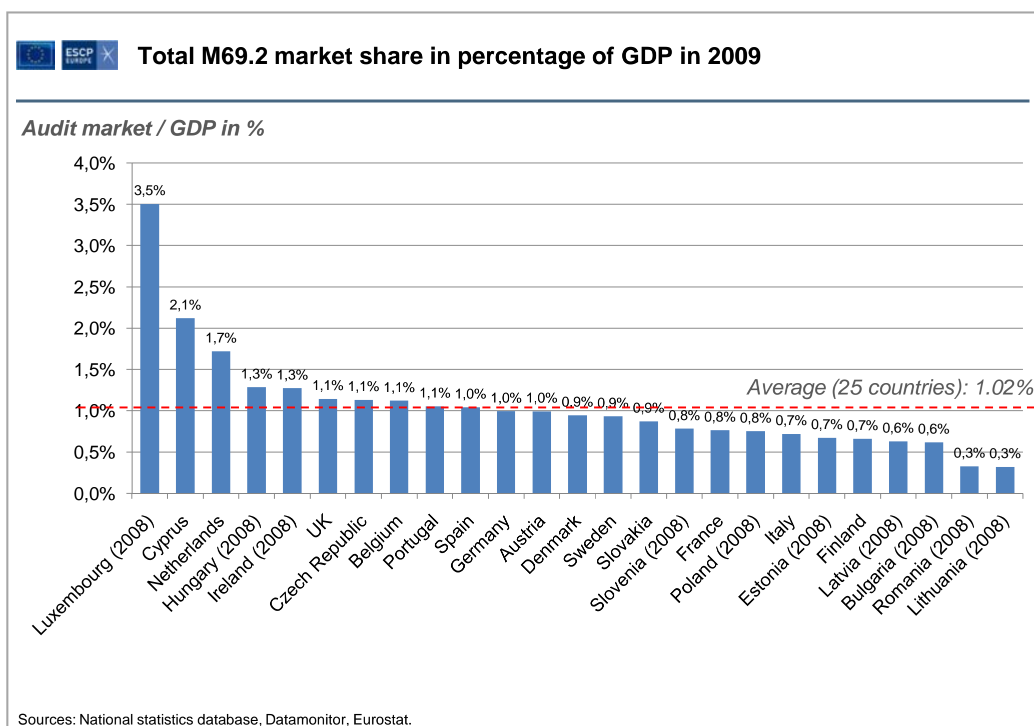
[34] Pay as you earn: payment method for which an employer is required by law to deduct income tax from an employee's taxable wages or salary.
[35] Class 74.12 before the nomenclature revision of 2008.

Figure 17: Total number of M69.2 firms per Member State (2009)



Caveat: Total number of firms as defined under NACE class M69.2[36] ("accounting, bookkeeping, auditing activities and tax consultancy").

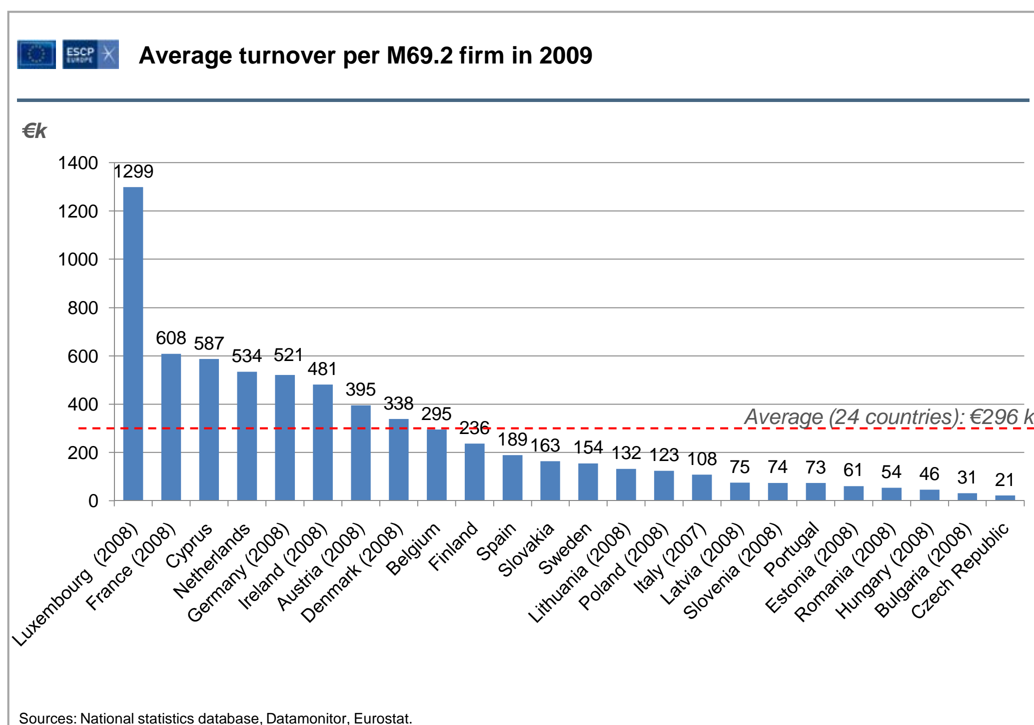
Figure 18: Total M69.2 market share in percentage of the GDP (2009)



[36] Class 74.12 before the nomenclature revision of 2008.

Caveat: Total market share in percentage of GDP as defined under NACE class M69.2[37] ("accounting, bookkeeping, auditing activities and tax consultancy").

Figure 19: Average turnover per M69.2 firm per Member State (2009)



Caveat: Average turnover per firm as defined under NACE class M69.2[38] ("accounting, bookkeeping, auditing activities and tax consultancy".)

The M69.2 market varies significantly from one Member State to another:

- Germany, the UK, France, Italy, Spain and the Netherlands are the largest markets by far:
  - Germany and the United Kingdom stand out as the largest markets, with respective sizes of €23.8 Bn and €18.2 Bn, and a relatively high number of firms. The higher risk of legal action by shareholders in the United Kingdom is often quoted as a reason for high audit fees, which partly explains the large size of the British market compared to similar size Member States such as France;
  - The relatively smaller size of the French market in turnover is the result of different factors. As regards turnover of audit firms traditionally lower audit prices, and the strict regulation regarding the provision of non-audit services to statutory audit clients contributes to the lower turnover;

[37] Class 74.12 before the nomenclature revision of 2008.
[38] Class 74.12 before the nomenclature revision of 2008.

- Seven Member States are in line with the European average in terms of size compared to their GDP and number of firms, even if they are small in terms of total turnover: Belgium, Sweden, Poland, Denmark, Finland, Slovakia and Slovenia;
- In Lithuania, Estonia, Latvia, Bulgaria and Romania, the size of the M69.2 market is small compared to other Member States and to the share of the M69.2 market in GDP. M69.2 markets in these Member States are mainly composed of numerous small-sized firms;
- Finally, the high share of the M69.2 market in percentage of GDP in Luxembourg and Cyprus (3.50% in Luxembourg and 2.12% in Cyprus vs. 1.02% on average in Europe) can be explained by the high share of financial intermediation among foreign investments (financial intermediation represents for example 56% of total Foreign Direct Investment in 2009 in Cyprus[39]), which requires more audit work. The high volume of foreign investment and foreign companies established is also a contributing factor.

The consolidated M69.2 market share of total GDP of the 27 Member States reached 1.02% in 2008 (based on 25 Member States) and 1.08% in 2009 (based on 15 Member States). This compares with the US M69.2 market share of GDP which indicated 0.63% in 2009[40]. One of the apparent reasons why the M69.2 market share in GDP is higher in the eight largest Member States is the level of audit and audit-related fees: the average cost of audit and audit-related fees per €1 M turnover in the main index of the eight largest Member States was €559 in 2009, vs. only €409 in the US[41] (data to be taken with caution since the US survey provides audit fees paid by accelerated filers).

[39] "Foreign Investments in Cyprus", Department of Trade Ministry of Commerce, Industry and Tourism.
[40] Source: Bureau of Economic Analysis, US Department of Commerce.
[41] Audit Analytics, *Audit fees and non-audit fees, an eight year trend,* May 2011. Scope of the survey: audit fees paid by accelerated filers (companies *"whose public float (as opposed to market capitalization) exceeds $75 million as of the last day of their second quarter").*

Table 18: Number of audit firms according to local audit regulators and financial authorities

Member State	Number of audit firms	Sources	Year
Austria	378	QKB	2010
Belgium	513	Belgian public oversight authority	2011
Bulgaria	94	Bulgarian Commission for Public Oversight of Statutory Auditors (CPOSA)	2011
Cyprus	250	FEE	2011
Czech Republic	357	Ministry of Finance	2011
Denmark	1835	Danish Commerce and Companies Agency	2010
Estonia	200	Estonian Auditors Activities Register	2011
Finland	74	AB3C	2009
France	4500	CNCC	2010
Germany	2631	WPK	2011
Greece	24	Greek oversight body	2011
Hungary	2000	Chamber of Auditors	2011
Italy	321*	CNDCEC	2006
Latvia	160	LACA	2011
Lithuania	189	Chamber of Auditors (LCA)	2011
Luxembourg	100	CSSF	2011
Malta	36	Ministry of Finance	2011
Netherlands	481**	AFM	2011
Poland	1804	Ministry of Finance	2011
Portugal	189	CMVM & Ordem dos Revisores Oficiais de Contas	2011
Romania	851	Chamber of Auditors	2010
Slovakia	237	FEE Udva	2009
Slovenia	52	Anr.si	2011
Spain	1354	Spanish Registry	2009
Sweden	125	Supervisory Board of Public Accountants	2009
United Kingdom and Ireland	7843	Auditregister.org.uk	2011
Average per country	985		

**21 audit firms registered with CONSOB and approximately 300 firms registered with CCRC.*

*** 15 audit firms registered with AFM for audits of PIEs and 466 auditors or firms registered with AFM.*

As can be seen on the above table, the number of audit firms according to audit regulators and financial authorities varies significantly from one Member State to another:

- Denmark, France, Germany, Hungary, Poland, Spain, United Kingdom and Ireland have a high number of firms compared to the EU average, with above 1,300 firms;
- Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Estonia, Finland, Greece, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia and Sweden have a small number of audit firms operating compared to the European average, the lowest number being 24 firms in Greece;
- Romania is the only Member State with a number of audit firms close to the European average.

This analysis outlines how different in terms of size and structure the national M69.2 markets are.

III.2.2.2 Historical evolution of the M69.2 market size (2005-2010)

III.2.2.2.1 *Historical evolution of the M69.2 market turnover (2005-2010)*

Table 19: Historical evolution of the M69.2 market size in turnover per Member State (2005-2010)

	2005	2006	2007	2008	2009	2010	05-08 CAGR	05-09 CAGR	05-10 CAGR
Austria	2,094	2,201	2,339	2,602	2,716	n.a.	7.5%	6.7%	n.a.
Belgium	2,763	2,873	3,128	3,343	3,803	3,176	6.6%	8.3%	2.8%
Bulgaria	n.a.	n.a.	n.a.	219	n.a.	n.a.	n.a.	n.a.	n.a.
Cyprus	176	208	260	341	359	n.a.	24.6%	19.5%	n.a.
Czech Republic	1,159	1,271	1,401	1,611	1,550	1,626	11.6%	7.5%	7.0%
Denmark	1,587	1,968	2,145	2,118	2,104	n.a.	10.1%	7.3%	n.a.
Estonia	n.a.	n.a.	n.a.	108	n.a.	n.a.	n.a.	n.a.	n.a.
Finland	787	918	980	1,075	1,130	n.a.	11.0%	9.5%	n.a.
France	12,647	12,930	13,619	14,165	14,443	14,454	3.8%	3.4%	2.7%
Germany	17,471	19,585	21,664	23,463	23,830	24,075	10.3%	8.1%	6.6%
Greece	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Hungary	944	1,035	1,227	1,366	n.a.	n.a.	13.1%	n.a.	n.a.
Ireland	1,529	1,799	2,070	2,290	n.a.	n.a.	14.4%	n.a.	n.a.
Italy	10,349	14,791	11,225	11,456	10,890	11,081	3.4%	1.3%	1.4%
Latvia	77	95	131	145	n.a.	n.a.	23.7%	n.a.	n.a.
Lithuania	47	57	80	103	n.a.	n.a.	30.0%	n.a.	n.a.
Luxembourg	737	866	1,142	1,389	n.a.	n.a.	23.5%	n.a.	n.a.

Malta	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Netherlands	n.a.	8,288	8,988	9,635	9,828	9,710	n.a.	n.a.	4,0%[42]
Poland	n.a.	n.a.	n.a.	2,730	n.a.	n.a.	n.a.	n.a.	n.a.
Portugal	1,470	1,830	1,843	1,836	1,774	n.a.	7.7%	4.8%	n.a.
Romania	n.a.	n.a.	350	455	n.a.	n.a.	n.a.	n.a.	n.a.
Slovenia	n.a.	n.a.	n.a.	291	n.a.	n.a.	n.a.	n.a.	n.a.
Slovakia	306	398	497	548	549	591	21.4%	15.7%	14.0%
Spain	9,084	10,465	10,794	11,201	10,983	10,965	7.2%	4.9%	3.8%
Sweden	2,449	2,604	2,849	2,988	2,712	n.a.	6.9%	2.6%	n.a.
UK	17,245	18,999	20,155	18,231	17,907	18,351	1.9%	0.9%	1.3%

Sources: ESCP Europe analysis based on data from National statistics databases, Datamonitor and Eurostat.

Caveat: Turnover as defined under NACE class M69.2[43] ("accounting, bookkeeping, auditing activities and tax consultancy".)

Table 20: Historical evolution of the M69.2 market share in GDP per Member State (2005-2010)

	2005	2006	2007	2008	2009	2010	Evolution	Period
Austria	0.91%	0.90%	0.93%	0.97%	1.12%	0.90%	- 1 pt	05-10
Belgium	0.74%	0.72%	0.72%	0.73%	0.76%	0.75%	+ 1 pt	05-10
Bulgaria	0.78%	0.84%	0.89%	0.95%	0.99%	0.96%	+18 pts	05-10
Cyprus	0.72%	1.00%	0.73%	0.73%	0.72%	0.72%	- 1 pt	05-10
Czech Republic	n.a.	1.53%	1.57%	1.62%	1.72%	1.64%	+ 11 pts	05-10
Denmark	1.00%	1.06%	1.02%	1.03%	1.04%	1.03%	+ 3 pts	05-10
Estonia	0.82%	0.82%	0.84%	0.90%	0.93%	n.a.	+ 11 pts	05-09
Finland	0.94%	0.98%	0.98%	1.00%	1.14%	1.08%	+ 14 pts	05-08
France	0.86%	0.86%	0.86%	0.92%	0.99%	n.a.	+ 13 pts	05-09
Germany	0.77%	0.90%	0.94%	0.91%	0.95%	n.a.	+18 pts	05-09
Greece	0.50%	0.55%	0.55%	0.58%	0.66%	n.a.	+16 pts	05-09
Hungary	1.29%	1.42%	1.63%	1.97%	2.12%	n.a.	+ 83 pts	05-09
Ireland	0.94%	1.01%	1.09%	1.27%	n.a.	n.a.	+ 33 pts	05-08
Italy	0.22%	0.24%	0.28%	0.32%	n.a.	n.a.	+9 pts	05-08
Latvia	0.96%	1.14%	1.09%	1.07%	1.05%	n.a.	+10 pts	05-09
Lithuania	2.43%	2.55%	3.05%	3.50%	n.a.	n.a.	+107 pts	05-08
Luxembourg	0.59%	0.59%	0.62%	0.63%	n.a.	n.a.	+4 pts	05-08

[42] 2006-2010 CAGR.
[43] Class 74.12 before the nomenclature revision of 2008.

Malta	0.80%	0.89%	0.91%	0.85%	0.87%	0.90%	+10pts	05-10
Netherlands	n.a.	n.a.	n.a.	0.78%	n.a.	n.a.	n.a.	08
Poland	n.a.	n.a.	n.a.	0.62%	n.a.	n.a.	n.a.	08
Portugal	1.16%	1.12%	1.10%	1.09%	1.13%	1.12%	-4 pts	05-10
Romania	n.a.	n.a.	n.a.	0.67%	n.a.	n.a.	n.a.	08
Slovenia	1.07%	1.15%	1.22%	1.28%	n.a.	n.a.	+ 21 pts	05-08
Slovakia	n.a.	n.a.	0.28%	0.33%	n.a.	n.a.	+5 pts	07-08
Spain	n.a.	n.a.	n.a.	0.75%	n.a.	n.a.	n.a.	08
Sweden	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
UK	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: ESCP Europe analysis based on National statistics databases, Datamonitor and Eurostat. Caveat: M69.2 market share in percentage of GDP as defined under NACE class M69.2[44] ("accounting, bookkeeping, auditing activities and tax consultancy".)

Over the period 2005-2009, the M69.2 market in the 14 Member States, where data is are fully available, has grown by an average 7.2% p.a. Over the same period, overall GDP of these Member States has grown by an average of 3.2% p.a. The M69.2 market in these 14 Member States has thus outperformed GDP.

At a country level, three groups can be formed:

- In Belgium, Cyprus, Germany, Hungary, Ireland, Lithuania, Luxembourg and Spain, M69.2 activities were very dynamic with growth rates between 7% and 30% p.a., strongly outperforming their GDP growth for the period:
  - The increase in foreign investments in Cyprus (according to Eurostat, the average of inward and outward Foreign Direct Investment flows as a percentage of GDP grew from 5.1% in 2005 to 22.9% in 2009) and Luxembourg (from 319.7% in 2005 to 394.7% in 2009, with a peak at 445.4% in 2007) contributed to this boom: international companies establishing in these Member States require audits;
  - In Ireland, the important number of M&A transactions across all sectors and industries (Mergermarket tracked an average of 165 deals per year from 2000 to 2009) raised the average size of firms, mechanically increasing the need for audit work;
- In Austria, Denmark, Finland, Italy, Latvia, the Netherlands, Portugal, Romania, Slovakia and Sweden, the M69.2 market grew steadily, outperforming the GDP growth;
- In the Czech Republic, France, and the UK, the M69.2 market grew moderately, in line with the GDP growth.

The evolution of the average M69.2 market share of GDP can be compared with the evolution of the

[44] Class 74.12 before the nomenclature revision of 2008.

consultancy management market: according to a FEACO survey[45], the weight of management consultancy firms in EU-27's GDP has increased from 0.61% to 0.68% over 2005-2009: the weighted average turnover of audit firms in GDP has grown faster than the average turnover of consultancy management firms (+1.1 pt vs. +0.7 pt), which reflects the impact of the economic crisis on consultancy management firms.

It should also be added that Big 4 firms acquired consultancy firms over the period (as detailed in table 32) and developed the provision of non-audit services, explaining thus part of the increase of the weighted average turnover of audit firms in GDP.

However, the increase in the share of consulting in audit firms cannot be compared to the growth of the management consultancy market, as management consultancy activities of the auditors represent a minor part of the total consultancy market (less than 5% in France, Germany, the UK and Spain in 2009[39]).

III.2.2.2.2 *Historical evolution of the number of M69.2 firms (2005-2010)*

The following table details the evolution of the number of M69.2 firms over 2005-2010, our objective being to understand whether the M69.2 market grew at the same speed as the number of M69.2 firms.

Table 21: Historical evolution of the number of M69.2 firms per Member State (2005-2010)

	2005	2006	2007	2008	2009	2010	05-08 CAGR	05-09 CAGR	05-10 CAGR
Austria	5,745	6,031	6,275	6,591	6,694	n.a.	4.7%	3.9%	n.a.
Belgium	12,992	13,141	13,213	13,244	12,902	12,269	0.6%	-0.2%	-1.1%
Bulgaria	n.a.	n.a.	n.a.	6,959	-	n.a.	n.a.	n.a.	n.a.
Cyprus	450	462	472	504	612	n.a.	3.8%	8.0%	n.a.
Czech Republic	n.r.	n.r.	n.r.	n.r.	n.r	n.r.	n.a.	n.a.	n.a.
Denmark	5,847	5,974	6,161	6,274	n.a.	n.a.	2.4%	n.a.	n.a.
Estonia	n.a.	n.a.	n.a.	1,778	n.a.	n.a.	n.a.	n.a.	n.a.
Finland	4,449	4,541	4,639	4,715	4,780	n.a.	2.0%	1.8%	n.a.
France	19,437	19,233	20,338	23,309	n.a.	n.a.	6.2%	n.a.	n.a.
Germany	43,572	44,564	45,771	45,040	n.a.	n.a.	1.1%	n.a.	n.a.
Greece	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Hungary	28,846	28,686	29,306	29,551	30,567	n.a.	0.8%	1.5%	n.a.
Ireland	n.r.	4,533	4,684	4,760	5,019	n.a.	n.a.	n.a.	n.a.
Italy	99,418	101,587	104,177	n.a.	n.a.	n.a.	2.4%	n.a.	n.a.
Latvia	1,003	1,285	1,569	1,936	n.a.	n.a.	24.5%	n.a.	n.a.
Lithuania	506	563	689	780	n.a.	n.a.	15.5%	n.a.	n.a.
Luxembourg	928	986	1,045	1,069	n.a.	n.a.	4.8%	n.a.	n.a.
Malta	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

[45] Survey of the European Management Consultancy – Feaco, 2009-2010. Consultancy management services include business consulting, IT consulting, development & integration, outsourcing and other services. The survey covers around 80% of the EU-27 management consultancy market.

Netherlands	n.a.	15,710	16,745	17,820	18,400	19,365	n.a.	n.a.	n.a.
Poland	n.a.	n.a.	n.a.	22,158	n.a.	n.a.	n.a.	n.a.	n.a.
Portugal	29,913	31,075	29,371	24,922	24,302	n.a.	**-5.9%**	**-5.1%**	n.a.
Romania	n.a.	n.a.	7,627	8,399	n.a.	n.a.	n.a.	n.a.	n.a.
Slovenia	3,322	3,482	3,616	3,937	n.a.	n.a.	**5.8%**	n.a.	n.a.
Slovakia	1,783	2,061	2,430	3,003	3,363	3,870	**19.0%**	**17.2%**	**16.8%**
Spain	48,251	52,187	52,314	59,139	58,063	n.a.	**7.0%**	**4.7%**	n.a.
Sweden	15,918	16,612	16,782	17,200	17,587	n.a.	**2.6%**	**2.5%**	n.a.
UK	21,815	22,485	23,080	34,815	33,270	32,980	**2.9%**	n.r.*	**8.6%**

Sources: ESCP Europe analysis based on National statistics databases, Datamonitor and Eurostat.

(*) 2005-2007 CAGR. For the UK, the strong increase in the number of UK firms between 2007 and 2008 is due to the change in company scope of National Statistics (ref. to earlier note), making CAGR not relevant after 2007.

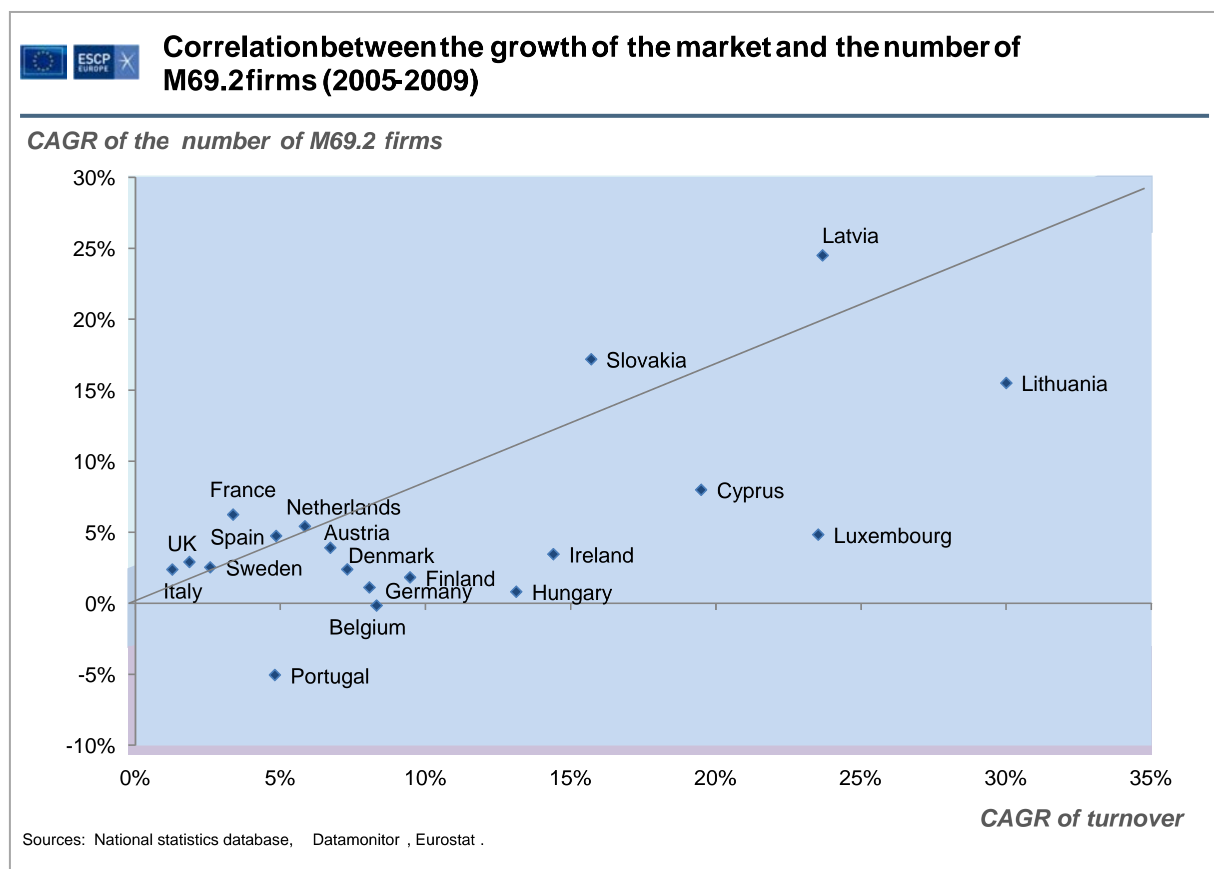
Between 2005 and 2009[46], the number of M69.2 firms increased in all analysed Member States, with the exception of Belgium and Portugal. Four groups of Member States can be distinguished:

- In Latvia, Lithuania and Slovakia, the number of M69.2 firms boomed over the period, with growth rates from 15% to 25% p.a.;
- Austria, France, the Netherlands, Slovenia and Spain have had average growth rates from +5% to +6% p.a.;
- Bulgaria, Cyprus, the Czech Republic, Denmark, Estonia, Finland, Germany, Hungary, Ireland, Italy, Luxembourg, Sweden and the UK have had more moderate growth rates from +0% to +3% p.a.;
- In Belgium the number of firms decreased slightly. Portugal is the only Member State with a significant decrease in the number of firms between 2005 and 2009 (-5.1% p.a.): according to market experts interviewed, this is mainly explained by the economic crisis and the severe decrease in prices over the period.

[46] When 2009 data was not available, the 2005-2008 period was taken as year of reference.

III.2.2.2.3 *Correlation between market growth and number of market players*

Figure 20: Correlation between growth of the M69.2 market and number of M69.2 firms (2005-2009)



Caveat: This correlation analysis is based on averages and on too small a sample to be considered as statistically representative.

Three clusters of Member State can be identified:

- In Portugal (where the number of firm decreased on the period) Belgium, Germany, Finland, Hungary, Ireland, Cyprus, Luxembourg and Lithuania, market growth appears to have benefited existing market players;
- In France, Slovakia and Latvia, the number of market players grew significantly faster than market growth;
- In the other Member States, market growth and number of new players are relatively in line.

III.2.3 Revenues of the top 10 audit firms

The only source to get relevant and exhaustive data on the revenue of the top 10 audit firms in Member States is the International Accounting Bulletin (IAB). However, data is only available for nine Member States, and only for the year 2009.

In the other available databases (Thomson Research/One Banker/Financial and Bureau Van Dijk), most audit firms do not disclose their sales figures, or disclose figures that are inconsistent from one firm to another (e.g. taking into account only audit revenues vs. audit and non-audit).

For the 14 Member States where IAB data is missing, we chose to present the turnover of the Big 4 in each Member State.

The 2009 revenues of the top 10 audit firms per Member State are presented in the following tables:

2009 total revenues of the top 10 audit firms in 10 MS

Member States	Revenue (in €M) top 10 firms (top 5 for Belgium and Austria)
Germany	5 297
UK	7 963
France	4 372
Italy	1 389
Spain	1 694
Netherlands	3 484
Belgium	828
Sweden	1 278
Poland	1 815
Austria	389

Table 22: 2009 revenues of the top 10 audit firms in France, Germany and Italy

	France		Germany		Italy	
	Firm	Turnover 2009 (€M)	Firm	Turnover 2009 (€M)	Firm	Turnover 2009 (€M)
1st	Deloitte	801	PwC	1378	KPMG	406
2nd	KPMG	790	KPMG	1250	PwC	350
3rd	Ernst & Young	765	Ernst & Young	1124	Deloitte	311
4th	PwC	628	Deloitte	716	Ernst & Young	199
5th	Fiducial	394	BDO	186	Praxity	32
6th	Praxity	262	Nexia International	154	Mazars	32
7th	Mazars	262	Grant Thornton	134	BDO	18
8th	Eurus / BKR International	195	Rödl & Partner	126	PKF Italy	16
9th	Kreston International	156	Moor Stephens Deutschland	124	INPACT Group	13
10th	Grant Thornton	119	RSM Germany	105	Crowe Horwath	12

Source: IAB.

Table 23: 2009 revenues of the top 10 audit firms in the Netherlands, Spain and Sweden

	Netherlands		Spain		Sweden	
	Firm	Turnover 2009 (€M)	Firm	Turnover 2009 (€M)	Firm	Turnover 2008 (€M)
1st	PwC	757	Deloitte	437	PwC	421
2nd	Deloitte	709	PwC	410	Ernst & Young	278
3rd	KPMG	676	KPMG	307	KPMG	213
4th	Ernst & Young	672	Ernst & Young	278	Deloitte	143
5th	BDO	216	BDO	86	Grant Thornton	85
6th	Moore Stephens	107	Grant Thornton	58	BDO	48
7th	Praxity	90	Praxity	33	Praxity	31
8th	Mazars	90	Mazars	33	Set Revision	30
9th	Baker Tilly	90	Horwath	28	Baker Tilly	16
10th	Nexia International	77	Moore Stephens	24	Horwath	13

Source: IAB.

Table 24: 2009 revenues of the top 10 audit firms in Ireland, Poland and the United Kingdom

	Ireland		Poland		United Kingdom	
	Firm	Turnover 2009 (€M)	Firm	Turnover 2009 (€M)	Firm	Turnover 2009 (€M)
1st	PwC	332	Ernst & Young	444	PwC	2248
2nd	KPMG	276	KPMG	409	Deloitte	1969
3rd	Deloitte	160	PwC	400	KPMG	1626
4th	Ernst & Young	144	Deloitte	351	Ernst & Young	1383
5th	BDO	69	Rödl & Partner	71,2	IAPA	255
6th	Grant Thornton	56	BDO	52	EuraAudit	220
7th	Mazars	26	Grant Thornton	35	Vantis/HLB International	90
8th	Horwath	17	Mazars	30	IGAF Worldwide	70
9th	Oliver Freaney & Co	11	PKF Consult	14	DFK UK	57
10th	Baker Tilly	9	KR Audyt	9	UHY Hacker Young Group	45

Source: IAB.

Table 25: 2009 revenues of the Big 4 in Belgium, Austria and Greece

	Belgium		Austria		Greece	
	Firm	Turnover 2009 (€M)	Firm	Turnover 2009 (€M)	Firm	Turnover 2009 (€M)
1st	Deloitte	317	KPMG	153	Ernst & Young	43
2nd	Ernst & Young	196	Deloitte	112	PwC	29
3rd	PwC	195	Ernst & Young	64	Deloitte	20
4th	KPMG	120	PwC	60	KPMG	15

Sources: Annual Reports.

Table 26: 2009 revenues of the Big 4 in Denmark, Finland and Portugal

	Denmark		Finland		Portugal	
	Firm	Turnover 2009 (€M)	Firm	Turnover 2009 (€M)	Firm	Turnover 2009 (€M)
1st	Deloitte	309	PwC	87	Deloitte	70*
2nd	PwC	217	KPMG	83	KPMG	67
3rd	KPMG	213	Ernst & Young	76	PwC	52
4th	Ernst & Young	109	Deloitte	47	Ernst & Young	N.A.

Sources: Annual Reports.

*2010 Revenue

Table 27: 2009 revenues of the Big 4 in Czech Republic, Romania and Hungary

	Czech Republic		Romania		Hungary	
	Firm	Turnover 2009 (€M)	Firm	Turnover 2009 (€M)	Firm	Turnover 2009 (€M)
1st	Ernst & Young	51	KPMG	36	PwC	46
2nd	KPMG	28	PwC	16	Ernst & Young	37
3rd	PwC	N.A.	Deloitte	11*	KPMG	32
4th	Deloitte	N.A.	Ernst & Young	N.A.	Deloitte	13*

Sources: Annual Reports.

Table 28: 2009 revenues of the Big 4 in Slovakia, Luxembourg and Slovenia

	Slovakia		Luxembourg		Slovenia	
	Firm	Turnover 2009 (€M)	Firm	Turnover 2009 (€M)	Firm	Turnover 2009 (€M)
1st	KPMG	25	PwC	233	KPMG	7
2nd	PwC	17*	Deloitte	135	Ernst & Young	6
3rd	Ernst & Young	16	Ernst & Young	125	PwC	N.A.
4th	Deloitte	12*	KPMG	116*	Deloitte	N.A.

Sources: Annual Reports.

Table 29: 2009 revenues of the Big 4 in Bulgaria, Lithuania and Latvia

	Bulgaria		Lithuania		Latvia	
	Firm	**Turnover 2009 (€M)**	**Firm**	**Turnover 2009 (€M)**	**Firm**	**Turnover 2009 (€M)**
1st	KPMG	13	Ernst & Young	14	Ernst & Young	9
2nd	Ernst & Young	10	PwC	7	KPMG	6
3rd	Deloitte	6	KPMG	5	PwC	5
4th	PwC	N.A.	Deloitte	N.A.	Deloitte	2*

Sources: Annual Reports.

Table 30: 2009 revenues of the Big 4 in Malta, Cyprus and Estonia

	Malta		Cyprus		Estonia	
	Firm	**Turnover 2009 (€M)**	**Firm**	**Turnover 2009 (€M)**	**Firm**	**Turnover 2009 (€M)**
1st	PwC	15**	PwC	72	PwC	7
2nd	KPMG	13	Ernst & Young	N.A.	KPMG	N.A.
3rd	Ernst & Young	6	KPMG	N.A.	Ernst & Young	N.A.
4th	Deloitte	N.A.	Deloitte	N.A.	Deloitte	N.A.

Sources: Annual Reports.

*2010 Revenue; **2008 Revenue.

IV CRITERIA FOR ASSESSMENT OF THE FUNCTIONING OF THE MARKET

In this part we will discuss that the majority of acquisistions by Big 4 audit firms over the period 2005-2011 regarded companies offering non-audit services. Mid-tier audit firms and smaller audit firms are focussing more on acquiring other audit firms.

We will discuss how the audit market has different concentration levels when looking at non-listed and listed companies. As for listed companies, concentration levels are different when looking at the number of mandates as compared to turnover. Even for markets with moderate concentration levels such as the market for all listed companies, there is a high concentration of the market when we consider this market by turnover. The concentration on the market of the largest companies is the highest. When considering the audit market of companies listed on main indexes, almost all Member States have a highly concentrated market dominated by the Big 4. When considering the audit market of companies listed on regulated markets and the market of companies listed on the main index, we will see that even though a majority of Member States had a decrease of concentration levels since 2004, their markets are still highly to very highly concentrated.

We will discuss how mid-tier audit firms still find it difficult to enter the audit market of the largest companies. The two biggest barriers to entry of this market are the mid-tier firms lack of size and capacity to carry out the audits of the largest companies and the reputation of Big 4 audit firms.

We will demonstrate that there is a need to address a possible demise by a Big 4 audit firm which stakeholders view as possible on a national level (though less likely on an European scale).

Stakeholders and academics hold the view that there exists cross-subsidisation between audit fees and the fees for non-audit services. As non-audit services account for a substantial part of the turnover of audit firms, increasing the independence of audit firms could be considered.

Finally, we will discuss audit quality. While we will show that it is very difficult to measure audit quality, a number of EU regulators which have carried out inspections of audit firms have indicated that this is an issue that needs to be addressed.

IV.1 Focus on the first criterion: changes to network structures firms' consolidation (2005-mid 2011)

IV.1.1 Objective and methodology

This section analyses the changes to network structures from 2005 until mid 2011 relative to the period mid 1998-2004:

- During phase 1 (mid 1998-2004) the two biggest changes to network structures were the merger of Coopers & Lybrand with Price Waterhouse into Price Waterhouse Coopers and the demise of Arthur Andersen;
- During phase 2 (2005-2011), consolidation continued without major changes in the competitive landscape.

The types of transactions considered are mergers and acquisitions between audit firms and between audit firms and other service providers.

Data from three different databases have been combined:

- Bureau Van Dijk (Zephyr database);
- Mergermarket;
- Thomson One Banker – Deals.

The data requests were made for NACE class M69.2 and the equivalent industry code for "accounting, bookkeeping, auditing activities and tax consultancy" in the case of Thomson One Banker – Deals (no nomenclature mismatch was detected). The combined data base thus obtained may not be 100% exhaustive, but the comparison between two periods makes the analysis relevant.

While not providing data focused only on the audit market, audit firms provide all services included in the NACE class M69.2. As such, the data provided regard the market in which audit firms are active.

Considering that amounts regarding mergers and acquisistions are seldom disclosed and that acquired firms do not always publish their revenues, the comparison of M&A activity between phase 1 and phase 2 has been approximated by the overall number of acquisitions of a majority stake and mergers.

IV.1.2 Evolution of M&A activity

Table 31 shows the number of M&A over the period 1998-2011 and allows to distinguish possible differences in M&A activity between Big 4 audit firms, mid-tier audit firms and other audit firms.

Table 31: Comparison of number of M&A transactions per type of acquirer (mid 1998-2004, 2005-mid 2011)

	1998-2004				2005-2011				Total
	Total	Big 4	Mid-tier	Others	Total	Big 4	Mid-tier	Others	*%*
Austria	**0**	0	0	0	**7**	1	5	1	*1%*
Belgium	**6**	2	3	1	**6**	1	2	3	*2%*
Bulgaria	**0**	0	0	0	**0**	0	0	0	*0%*
Cyprus	**0**	0	0	0	**0**	0	0	0	*0%*
Czech Republic	**0**	0	0	0	**0**	0	0	0	*0%*
Denmark	**6**	1	1	4	**6**	3	3	0	*2%*
Estonia	**0**	0	0	0	**2**	0	1	1	*0%*
Finland	**24**	7	3	14	**62**	7	20	35	*14%*
France	**6**	2	3	1	**41**	11	8	22	*8%*
Germany	**5**	1	0	4	**11**	3	7	1	*2%*
Greece	**1**	1	0	0	**0**	0	0	0	*0%*
Hungary	**0**	0	0	0	**1**	0	1	0	*0%*
Ireland	**9**	0	5	4	**6**	0	4	2	*2%*
Italy	**2**	0	1	1	**3**	0	3	0	*1%*
Latvia	**0**	0	0	0	**0**	0	0	0	*0%*
Lithuania	**0**	0	0	0	**0**	0	0	0	*0%*
Luxembourg	**0**	0	0	0	**1**	1	0	0	*0%*
Malta	**0**	0	0	0	**0**	0	0	0	*0%*
Netherlands	**10**	3	0	7	**48**	2	13	33	*10%*
Poland	**1**	1	0	0	**6**	0	1	5	*1%*
Portugal	**1**	1	0	0	**0**	0	0	0	*0%*
Romania	**0**	0	0	0	**0**	0	0	0	*0%*
Slovakia	**0**	0	0	0	**0**	0	0	0	*0%*
Slovenia	**0**	0	0	0	**0**	0	0	0	*0%*
Spain	**4**	0	2	2	**3**	0	2	1	*1%*
Sweden	**2**	1	0	1	**9**	5	0	4	*2%*
UK	**143**	19	43	81	**172**	14	50	108	*52%*
Total	**220**	**39**	**59**	**122**	**384**	**48**	**120**	**216**	**602**
%	***100%***	***18%***	***27%***	***55%***	***100%***	***13%***	***31%***	***56%***	***100%***

Sources: ESCP Europe analysis based on data from Bureau Van Dijk, Mergermarket and Thomson One Banker.

Between phase 1 and phase 2, the overall number of M&A transactions in the 27 analysed Member States increased by ca. 75%, from 220 to 384 transactions. Other transactions were concluded, but of a lower value since there were no major upheavals, such as the Andersen dissolution, during the 2005-2011 period.

- Over both phases, the UK was the Member State with the highest number of M&A transactions: 52% of all M&A activity. This is mainly due to the historically intense M&A activity of mid-tier and smaller-sized audit firms (category Others) in their core activity;
- Toghether with UK, Finland, the Netherlands and France contributed to the strong increase in the number of M&A transactions in phase 2. In these Member States, the activity was driven by smaller-sized firms:
  - In the Netherlands, since 2006, audit firms have been required to hold a license granted by the Netherlands Authority for the Financial Markets to perform statutory audits. The difficulty for smaller-sized firms to reach the quality requirements to obtain the license led many of them to either merge with larger firms or give up their audit clients[47];
  - In France, medium-sized independent firms such as Strego (€52 M turnover in 2010) developed through external growth, mainly in non-statutory audit.
- In the other 13 Member States (Austria, Belgium, Denmark, Estonia, Germany, Hungary, Ireland, Italy, Luxembourg, Poland, Portugal, Spain and Sweden), the M&A activity was much more limited;
- Finally, there are ten Member States (Bulgaria, Cyprus, Czech Republic, Greece, Latvia, Lithuania, Malta, Romania, Slovakia, and Slovenia) where no significant M&A operations were identified.

The evolution of the M&A activity per type of acquirer is relatively homogeneous across Member States:

- The overall number of acquisitions by the Big 4 remained more or less constant, the decrease in the United Kingdom being offset by an increase in France (including large transactions such as the acquisition of RSM Salustro Reydel by KPMG, and Constantin and BDO Marque & Gendrot by Deloitte). The overall share of operations led by Big 4 decreased between 1998-2004 and 2005-2011 (from 17% to 12% of total acquisitions);
- Mid-tier activity increased in almost all Member States. This included a few large transactions, such as the acquisition in 2009 by the Dutch mid-tier firm Berk (affiliated to Baker Tilly International) of a PwC office, as a consequence of PwC's announced strategy to leave the regional SME market[48];
- The main contributors to the increase in the number of transactions are smaller-sized firms, whose activity increased in most Member States.

[47] IAB July 2009.

[48] Accounting Intelligence, *Berk acquires a PwC office in Holland, September* 2009.

IV.1.3 Overview of M&A activity per sector

Tables 32 and 33 allow distinguishing to what extent Big 4 audit firms, mid-tier audit firms and smaller audit firms target different sectors for M&A.

Table 32: Comparison of number of M&A per type of target activity (mid 1998-2004)

Phase 1 (mid 1998-2004)	Audit & accounting services*	Management consultancy services	Tax consultancy services	Financial advisory services	Others**
Big 4	62%	18%	2%	5%	13%
Mid-tier	78%	0%	0%	7%	15%
Others	81%	1%	3%	3%	12%
Total	**77%**	**4%**	**2%**	**4%**	**13%**

Sources: ESCP Europe analysis based on data from Bureau Van Dijk, Mergermarket and Thomson One Banker.

Total by audit firm type may not be equal to 100% since figures were rounded up to the nearest integer.

* Establishments primarily engaged in furnishing accounting, bookkeeping, and auditing services.
** Legal services, process outsourcing services, environmental advisory services, etc.

Table 33: Comparison of number of M&A per type of target activity (2005-mid 2011)

Phase 2 (2005-mid 2011)	Audit & accounting services*	Management consultancy services	Tax consultancy services	Financial advisory services	Others**
Big 4	44%	15%	6%	0%	35%
Mid-tier	73%	5%	4%	9%	9%
Others	89%	3%	1%	1%	6%
Total	**78%**	**5%**	**3%**	**3%**	**11%**

Sources: ESCP Europe analysis based on data from Bureau Van Dijk, Mergermarket and Thomson One Banker.

Total by audit firm type may not be equal to 100% since figures were rounded up to the nearest integer.

* Establishments primarily engaged in furnishing accounting, bookkeeping, and auditing services.
** Legal services, process outsourcing services, environmental advisory services, etc.

Audit firms mainly target audit and accounting firms, but different driving factors can be noticed depending on the type of acquirer.

The Big 4 audit firms appear to be more interested in diversifying towards non-audit and non-accounting activities than non-Big 4 audit firms. Non-Big 4 audit firms mainly try to reach critical size and gain market share in their core activity. Table 33 shows that over the period 2005-mid 2011:

- For Big 4 audit firms, audit & accounting services account for 44% of their acquisitions;
- For mid-tier audit firms, audit & accounting services account for 73% of their acquisitions;
- For "Other audit firms", audit & accounting services account for 89% of their acquisitions.

IV.2 Focus on the second criterion: current concentration levels and evolution of this level over the past five years

IV.2.1 Current concentration levels

IV.2.1.1 Reminder on methodology used

IV.2.1.1.1 *Definitions of overall market, all listed market, regulated market, main index and relation to each other*

"Overall market" is the market share of audit firms composed of the total turnover all audit firms generate from audit and non-audit services in four different business categories49 (audit and accounting, taxation and legal services, corporate finance and business recovery and business and management consultancy).

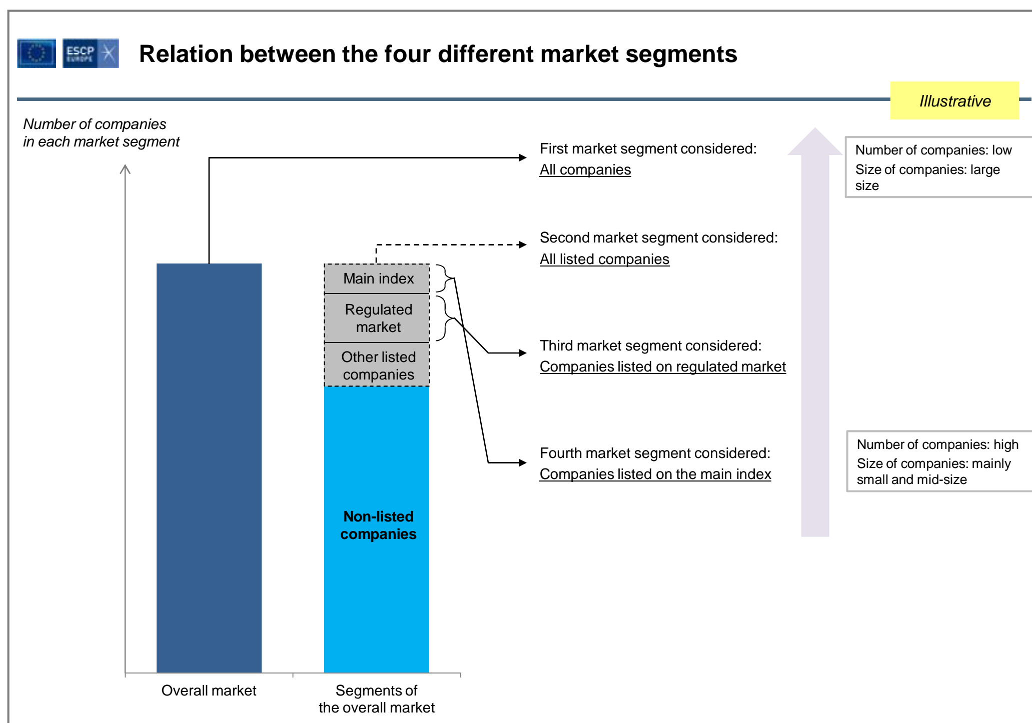
The "all listed companies' market" segment is composed of the audit market of all companies listed on the national stock exchange.

The "regulated market" is composed of the audit market of all companies listed on the regulated national stock exchange (regulated as defined by the European legislation in the Directive 2004/39/EC).

The "main index" is composed of the audit market of all companies listed on the main index of each national stock exchange.

[49] See Table 1 for detail.

Figure 21: Relation between the different market segments studied: overall market, all listed companies, regulated market and companies listed on the main index



IV.2.1.1.2 *Overall market*

Overall market concentration levels have been approximated through the calculation of market share (computed for each Member State by dividing audit firms' total revenues by the total market size of the audit and non-audit services). The data comes from:

- The International Accounting Bulletin (published by VRL Financial News) and the Big 4's transparency reports for audit firms' revenues;
- Local statistics offices of each Member State for market sizes.

The data for Big 4 and mid-tier audit firms can be isolated from the International Accounting Bulletins (IAB). The Big 4 market share and the top 20 mid-tier firms' market share have been computed for each Member State covered by the IAB in 2009 (or in 2008 when not available in 2009). Only the Big 4's market share in 2009 have been computed for Member States not covered by the IAB.

IV.2.1.1.3 *Listed companies*

Analysed populations

Concentration levels have been analysed for four different audited populations:

- All listed companies;
- All companies listed on regulated national stock exchange (regulated as defined by the European legislation in the Directive 2004/39/EC of the European Parliament and of the Council[50]);
- All companies listed on regulated national stock exchange by industry;
- All companies listed in main index of main national stock exchange.

Concentration indexes and thresholds

Four indexes have been selected to assess market concentration levels:

- Three concentration ratios: CR1 (market share of the largest audit firm), CR4 (market share of the four largest audit firms) and CR8 (market share of the eight largest audit firms);
- The Hirschman-Herfindahl Index (or HHI) which is the sum of the squares of the market shares of all audit firms in the market.

These indexes, and more specifically the HHI, are the reference measures of a market concentration level.

In 2010, the USA revised their Horizontal Merger Guidelines and provided the following classifications[51]:

- Not concentrated markets: HHI below 1,500 (formerly below 1,000);
- Moderately concentrated markets: HHI between 1,500 and 2,500 (formerly between 1,000 and 1,800);
- Highly concentrated markets: HHI above 2,500 (formerly above 1,800).

The European legislation uses the HHI to assess horizontal mergers[52] and thus isolates three ranges of post-merger HHI levels giving the following classifications:

- Not concentrated markets: HHI below 1,000;
- Moderately concentrated markets: HHI between 1,000 and 2,000;
- Highly concentrated markets: HHI above 2,000.

The EU legislation thresholds have been retained to characterise the various markets.

[50] Article 4, paragraph 1, point 14 of Directive 2004/39/EC defines a "regulated market" as a multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments — in the system and in accordance with its non-discretionary — rules in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorised and functions regularly and in accordance with the provisions of Title III of Directive 2004/39/EC.

[51] *Horizontal Merger Guidelines, U.S. Department of Justice and the Federal Trade Commission, April 2010.*

[52] *Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings, Official Journal C 031, (2004/C 31/03).*

Sources

The financial data used to compute these indexes were extracted from two reference databases: Thomson Research/One Banker/Financial and Bureau Van Dijk (Amadeus and Osiris databases).

In order to circumvent the absence of reliable and exhaustive audit fee information, we have chosen two proxy variables to compute the market shares of the various firms:

- Number of audit mandates of a firm;
- Aggregated turnover of companies audited by a firm (this variable gives more weight to the audit of large companies than the first variable).

Differences between concentration ratios by number of mandates and by turnover come from the fact that the companies audited by the 4 or 8 largest audit firms usually account for a very significant share of the total turnover of audited companies in a given category. As a consequence, even when CR4 or CR8 does not equal 100% by number of mandates, it can equal 100% by turnover, i.e. amount to more than 99.5%, since CR were rounded up to the nearest integer.

As detailed in table 10 in the methodology section, considering the limited availability of earnings in Thomson Research/One Banker/Financial and Bureau Van Dijk (Amadeus and Osiris databases) for 2010, we decided to use 2009 as a reference year.

Comparisons

The different concentration ratios calculated for 2009 for each Member State have been compared with the 2009 average concentration ratios at the European Union level[53].

The following table shows the availability of data for each Member State:

Table 34: Data available per Member State

Member States	Number of mandates	Turnover	2009 concentration ratios		
			All listed	Regulated market	Main index
Austria	✓	✓	✓	✓	✓
Belgium	✓	✓	✓	✓	✓
Bulgaria	✓	✓	✓	×	✓
Cyprus	✓	✓	✓	×	✓
Czech Republic	✓	✓	×	✓	✓
Denmark	✓	✓	✓	✓	✓
Estonia	✓	✓	×	×	✓
Finland	✓	✓	×	✓	✓
France	✓	✓	✓	✓	✓
Germany	✓	✓	✓	✓	✓
Greece	✓	✓	×	✓	✓
Hungary	✓	✓	×	✓	✓
Ireland	✓	✓	✓	✓	✓
Italy	✓	✓	✓	✓	✓

[53] CR8 have not been calculated on the main index as only 4 out of 27 Member States have 8 or more audit firms operating on this category.

Latvia	✓	✓	✗	✗	✓
Lithuania	✓	✓	✗	✓	✓
Luxembourg	✓	✓	✗	✓	✓
Malta	✓	✓	✗	✓	✓
Netherlands		✓	✓	✓	✓
Poland	✓	✓	✗	✓	✓
Portugal	✓	✓	✗	✓	✓
Romania	✓	✗	✓	✗	✓
Slovakia	✓	✓	✗	✓	✓
Slovenia	✓	✗	✗	✓	✓
Spain	✓	✓	✓	✓	✓
Sweden	✓	✓	✓	✓	✓
United Kingdom	✓	✓	✓	✓	✓

Sources: ESCP Europe analysis based on data from Thomson, Bureau Van Dijk and Annual Reports.

- Latvia, Malta, Slovakia and Slovenia, which have a relatively low number of companies, do not have a non-regulated market (i.e. all listed companies and companies listed on a regulated market are identical in these Member States). Thus, in order to allow relevant comparison with other Member States (where the average of all listed companies is about 400 per Member State), only the regulated market has been considered;
- Only companies listed on a regulated market were available in some Member States (e.g. Greece, Finland, Poland);
- No turnover information was available in the reference databases for Romania and Slovenia.

Industry concentration levels

Concentration levels have been calculated in compliance with the Global Industry Classification Standard[54] which is structured as follows:

- Consumer Discretionary (Automobiles and Components, Consumer Durables and Apparel, Consumer Services, Media, Retailing);
- Consumer Staples (Food & Staples Retailing, Food, Beverage & Tobacco, Household & Personal Products);
- Energy;
- Financials (Banks, Diversified Financials, Insurance, Real Estate);
- Health Care (Health Care Equipment & Services, Pharmaceuticals, Biotechnology & Life Sciences);
- Industrials (Capital Goods, Commercial & Professional Services, Transportation);
- Information Technology (Software & Services, Technology Hardware & Equipment, Semiconductors & Semiconductor Equipment);
- Materials;
- Telecommunication Services;
- Utilities.

[54] The Gl obal Industry Classification Standard (GICS®) was developed by, and is the exclusive property of, Standard & Poor's and MSCI. "GICS" is the trademark of Standard & Poor's and MSCI.

Industry concentration ratios have been calculated both by number of mandates and by turnover for each category of industry (10 categories). In order to maximize coverage of Member States, the ratios have been calculated on companies listed on regulated markets.

While it should be noted that for specific categories in a number of Member States the concentration ratios are based on only a small number of companies, it is possible to calculate industry concentration ratios on a European level by averaging concentration ratios of each Member State.

Caveat:

- Industry concentration ratios could not be calculated for Estonia, Latvia and Romania due to a lack of available data on industry classifications;
- Data for the market "all listed companies" have been considered for Bulgaria and Cyprus, as data regarding companies listed on their regulated exchanges are not available;
- Concentration ratios could not be calculated by turnover in Slovenia due to lack of available data.

IV.2.1.2 Overall concentration levels

Table 35 allows to distinguish for groups of Member States when considering the market shares of Big 4 audit firms for the overall market:

- Group n°1 (share of Big 4 < 10%): Czech Republic, Estonia, Hungary, Poland and Slovenia;
- Group n°2 (share of Big 4 between 10% and 20%): Austria, Bulgaria, Germany, Italy, Latvia, Portugal, Romania and Spain;
- Group n°3 (share of Big 4 between 20% and 30%): Belgium, Cyprus, Finland, France, Ireland, Lithuania, Netherlands and Slovakia;
- Group n°4 (share of Big 4 above 30%): Denmark, Luxembourg, Sweden and United Kingdom.

Table 35: Overall market share of the Big 4 in 2009

Member States	Big 4 market shares (Turnover)
Austria	14%
Belgium	22%
Bulgaria[55]	14%
Cyprus	20%
Czech Republic	5%
Denmark	40%
Estonia[55]	6%
Finland	26%
France	21%
Germany	19%
Greece	N.A.
Hungary[55]	9%
Ireland[55]	25%
Italy	12%
Latvia[55]	15%
Lithuania[55]	25%
Luxembourg[55]	44%
Malta	N.A.
Netherlands	29%
Poland	7%
Portugal	11%
Romania[55]	14%
Slovakia[55]	24%
Slovenia	2%
Spain	13%
Sweden[55][56]	35%
United Kingdom[55]	40%

Sources: ESCP Europe analysis based on data from Thomson, Bureau Van Dijk and Annual Reports.

[55] 2008 data.
[56] The latest data provided by the International Accounting Bulletins for Sweden refer to audit fees for the Big 4 and the top 13 mid-tier firms in 2008.

The overall market share for the Big 4 are rather heterogeneous among the different EU Member States and depend on local specificities and local legislations. For instance:

- Italy has a comparatively low overall market concentration due to a large number of audit firms (which can be explained by the limited M&A activity since 2005 with only 3 consolidations ref. to earlier section);
- Spain has a relatively high number of audit firms and consolidation has been relatively modest over 2005-2009 with only 5 acquisitions (ref. to earlier section).

Focus on mid-tier firms

The top 20 mid-tier firms' market share on the overall market is available for 9 out of 27 Member States.

- The market share of the top mid-tier firms depend on each Member State's structure in terms of classification as small, medium sized and large companies;
- To assess the mid-tier firms market share, looking at their relative market share compared with the Big 4's is the most appropriate method in order to minimize the varied economic structures in certain Member States.

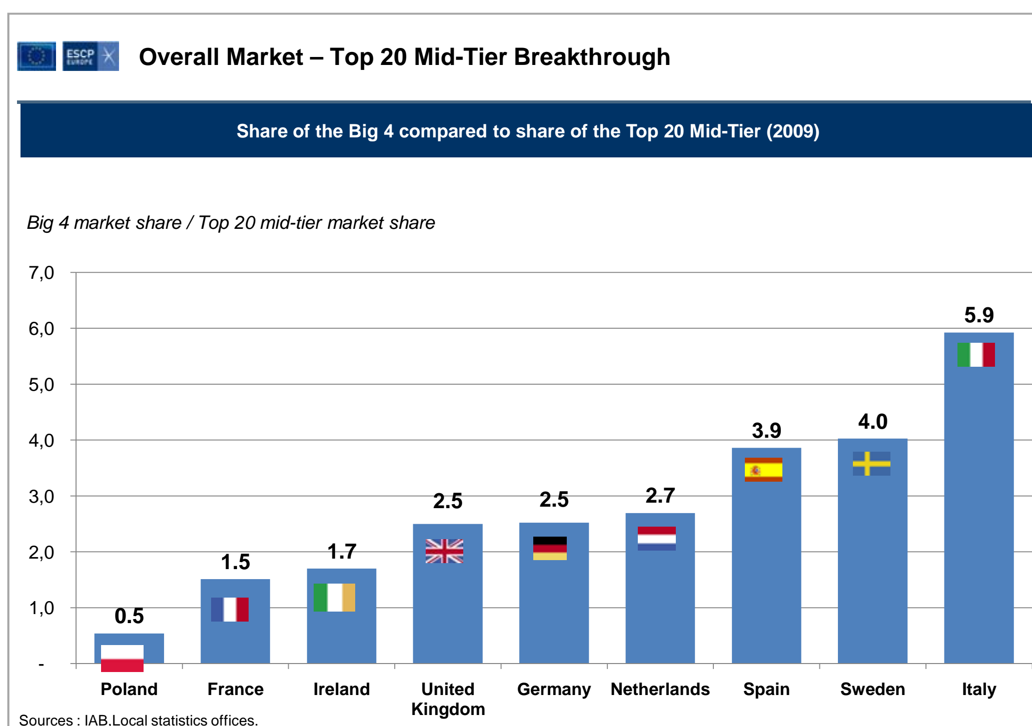
Table 36: Top 20 mid-tier breakthrough on the overall market

Member State	Share of the Big 4*	Share of the top 20 mid-tier firms*	Share of the Big 4 / share of the top 20 mid-tier firms
France	21%	14%	1.5
Germany	19%	7%	2.5
Ireland	25%	15%	1.7
Italy	12%	2%	5.9
Netherlands	29%	11%	2.7
Poland	7%	14%	0.5
Spain	13%	3%	3.9
Sweden	35%	9%	4.0
United Kingdom	40%	16%	2.5

Sources: ESCP Europe analysis based on data from IAB and local statistics offices.

**Market share in turnover*

Figure 22: Top 20 mid-tier breakthrough on the overall market (in turnover)



Member States can be divided in four groups when looking at the mid-tier market share compared to the market share of Big 4 audit firms:

- Group n°1 - mid-tier market share exceeds Big 4 market share: Poland is the only Member State where the top 20 mid-tier market share exceeds the one of the Big 4;
- Group n°2 – mid-tier market share between 50% and 100% of Big 4 market share : France and Ireland, the top 20 mid-tier market share is close to the Big 4's. In these Member States the mid-tier breakthrough is real;
- Group n°3 – mid-tier market share between 25% and 50% of Big 4 market share: the United Kingdom, the Netherlands, Germany, Sweden and Spain, the Big 4's market shares are two to four times higher than the top 20 mid-tier ones. In these Member States, the mid-tier breakthrough is moderate;
- Group n°4- mid-tier market share below 25% of Big 4 market share: In Italy, the Big 4's market share is almost six times higher than the market share of the mid-tier audit firms.

IV.2.1.3 Concentration levels on listed companies

Concentration levels on listed companies are very different from overall market concentration levels. Listed company clients are very large companies resulting in individual auditors in general not competing for these mandates.

IV.2.1.3.1 *Concentration levels on listed companies*

Table 37 shows the different concentration levels when considering the number of mandates for 14 Member States.
Notes:

- Concentration ratios by number of mandates are calculated based on the number of mandates, that can be higher than the number of companies since some companies have several audit firms.
- Differences between concentration ratios by number of mandates and by turnover come from the fact that the companies audited by the 4 or 8 largest audit firms usually account for a very significant share of the total turnover of audited companies in a given category. As a consequence, even when CR4 or CR8 does not equal 100% by number of mandates, it can equal 100% by turnover, i.e. amount to more than 99.5%, since CR were rounded up to the nearest integer.

Table 37: Concentration levels in EU statutory audit markets for all listed companies in 2009 (by number of mandates)

Member State	Number of companies	Concentration ratios for 2009 by number of mandates			
		CR1	CR4	CR8	HHI
Austria	75	35%	75%	91%	1884
Belgium	151	24%	55%	75%	1044
Bulgaria	218	5%	19%	28%	170
Cyprus	112	38%	77%	88%	2178
Denmark	167	27%	76%	94%	1786
France	761	14%	46%	58%	599
Germany	781	17%	50%	63%	744
Ireland	40	46%	88%	100%	2957
Italy	269	28%	86%	97%	2047
Netherlands	135	25%	87%	100%	2007
Romania	157	10%	28%	38%	290

Spain	155	36%	80%	88%	2033
Sweden	391	33%	85%	97%	2163
United Kingdom	2061	16%	55%	80%	969
EU Average	391	25%	65%	78%	1491

Sources: ESCP Europe analysis based on data from Thomson, Bureau Van Dijk and Annual Reports.

Underlined figures: there were less than four audit firms or less than eight audit firms on this audited population.

Caveat: Data were not available in reference databases for Czech Republic, Estonia, Finland, Greece, Hungary, Lithuania, Luxembourg, Malta, Poland and Portugal for all listed companies.

Three categories of audit market concentration levels can be distinguished:

- Cyprus, Ireland, Italy, Netherlands, Spain and Sweden are highly concentrated with HHI above 2,000;
- Austria, Belgium, Denmark and the United Kingdom[57] are moderately concentrated with HHI between 1,000 and 2,000;
- Bulgaria, France, Germany and Romania are not concentrated with HHI below 1,000.

The different levels of concentration reflect local legislation or specificities:

- In Italy for instance, one of the explanations for the high concentration level was the low number of firms that fulfilled the criteria to obtain the license to audit listed companies: "Only 21 audit firms have been licensed as listed company auditors";
- The joint audit system in France and the limited auditors' liability in Belgium and Germany contribute to low concentration levels in these Member States;
- The absence of consolidation activity in Bulgaria over 1998-2011 is one the reasons for the very low concentration level in this Member State.

Table 38 shows the different concentration levels when considering turnover for 14 Member States.

[57] The United Kingdom has a higher number of listed companies (respectively 2.6 to 2.7 times more than in France and in Germany for instance). Therefore, to compare the United Kingdom to other Member States, the "all listed" segment in any given country should be compared to the "regulated" segment in the United Kingdom, composed of 1,023 listed companies. When this indicator is considered, the HHI (1,394) confirms the United Kingdom as a moderately concentrated market (ref. to earlier section).

Table 38: Concentration levels in EU statutory audit markets for all listed companies in 2009 (by turnover)

Member State	Number of companies	Concentration ratios for 2009 by turnover			
		CR1	CR4	CR8	HHI
Austria	75	36%	83%	99%	2281
Belgium	151	32%	88%	100%	2256
Bulgaria	218	18%	50%	76%	873
Cyprus	112	32%	94%	98%	2737
Denmark	167	53%	96%	100%	3493
France	761	24%	81%	97%	1831
Germany	781	40%	97%	98%	3244
Ireland	40	40%	98%	<u>100%</u>	2995
Italy	269	40%	98%	100%	2786
Netherlands	135	34%	91%	100%	2353
Spain	155	58%	99%	100%	4050
Sweden	391	48%	99%	100%	3437
United Kingdom	2061	43%	98%	100%	2884
EU Average	391	38%	90%	98%	2709

Sources: ESCP Europe analysis based on data from Thomson, Bureau Van Dijk and Annual Reports.

Underlined figures: there were less than four audit firms or less than eight audit firms on this audited population.

Caveat: Data on turnover for the market of "all listed companies" are not available in reference databases for Czech Republic, Estonia, Finland, Greece, Hungary, Latvia, Lithuania, Luxembourg, Malta, Poland, Portugal, Romania, Slovakia and Slovenia for all listed companies.

Concentration ratios calculated by turnover indicate a high concentration with an average HHI for all Member States considered of 2709.

The market of all listed companies is highly concentrated for 11 out of 13 Member States.with an HHI above 2000.

The market of all listed companies is moderately concentrated in France with HHI between 1000 and 2000.

The market of all listed companies is not concentrated for Bulgaria with HHI below 1000.

IV.2.1.3.2 *Focus on companies listed on regulated national stock exchanges*

Table 39 shows the different concentration levels for the market of companies listed on regulated national stock exchanges by mandates.

Table 39: Concentration levels in EU statutory audit markets for companies listed on regulated national stock exchanges in 2009 (by number of mandates)

Member State	Number of companies	Concentration ratios for 2009 by number of mandates			
		CR1	CR4	CR8	HHI
Austria	67	38%	77%	91%	2044
Belgium	125	28%	65%	82%	1363
Czech Republic	18	26%	74%	95%	1634
Denmark	159	27%	79%	96%	1876
Finland	117	32%	93%	96%	2690
France	550	15%	51%	65%	740
Germany	527	22%	61%	75%	1110
Greece	256	30%	68%	91%	1563
Hungary	44	16%	45%	57%	702
Ireland	28	41%	93%	100%	3127
Italy	260	29%	87%	97%	2064
Lithuania	34	30%	86%	97%	2053
Luxembourg	19	25%	75%	95%	1600
Malta	19	32%	95%	100%	2742
Netherlands	131	26%	88%	100%	2019
Poland	138	18%	57%	76%	1010
Portugal	51	35%	71%	84%	1821
Slovakia	20	15%	45%	70%	850
Slovenia	41	34%	66%	88%	1672
Spain	154	36%	80%	88%	2040
Sweden	260	36%	93%	100%	2463
United Kingdom	1023	22%	72%	86%	1394
EU Average	184	28%	74%	88%	1754

Sources: ESCP Europe analysis based on data from Thomson, Bureau Van Dijk and Annual Reports.

Underlined figures: there were less than four audit firms or less than eight audit firms on this audited population.

Caveat: Data were not available on reference databases for Cyprus, Bulgaria, Estonia, Latvia and Romania.

For companies listed on regulated national stock exchanges, the audit market is more concentrated then the market for all listed companies when considering the number of mandates. The average HHI when considering all companies listed on regulated markets is 1,748 versus an average HHI of 1,491 when considering all listed companies).

When considering the audit mandates for companies listed on regulated national stock exchanges, Member States can be divided in three groups

- 9 Member States are highly concentrated with an HHI above 2000: Austria, Finland, Ireland, Italy, Lithuania, Malta, the Netherlands, Spain and Sweden;
- 10 Member States are moderately concentrated with an HHI between 1000 and 2000: Belgium, Czech Republic, Denmark, Germany, Greece, Luxembourg, Poland, Portugal, Slovenia and the United Kingdom;
- 3 Member States are not concentrated with an HHI below 1000: France, Hungary and Slovakia.

Table 40 shows the different concentration levels for the market of companies listed on regulated national stock exchanges by turnover.

Table 40: Concentration levels in EU statutory audit markets for companies listed on regulated national stock exchange in 2009 (by turnover)

Member State	Number of companies	Concentration ratios for 2009 by turnover			
		CR1	CR4	CR8	HHI
Austria	67	36%	83%	99%	2283
Belgium	125	32%	89%	100%	2260
Czech Republic	18	33%	90%	100%	2402
Denmark	159	53%	96%	100%	3495
Finland	117	58%	99%	100%	4000
France	550	24%	81%	97%	1840
Germany	527	42%	97%	99%	3294
Greece	256	30%	73%	98%	1734
Hungary	44	55%	98%	99%	3912
Ireland	28	40%	98%	100%	3002
Italy	260	40%	98%	100%	2787
Lithuania	34	41%	95%	100%	3080
Luxembourg	19	63%	99%	100%	4474
Malta	19	32%	100%	100%	2808
Netherlands	131	34%	91%	100%	2353
Poland	138	35%	88%	97%	2272
Portugal	51	47%	94%	99%	3246
Slovakia	20	71%	97%	99%	5302
Spain	154	58%	99%	100%	4050
Sweden	260	48%	100%	100%	3457
United Kingdom	1023	43%	99%	100%	2926
EU Average	184	44%	94%	99%	3094

Sources: ESCP Europe analysis based on data from Thomson, Bureau Van Dijk and Annual Reports.

Underlined figures: there were less than four audit firms or less than eight audit firms on this audited population.

Caveat: Data were not available on reference databases in Cyprus, Bulgaria, Estonia, Latvia, Slovenia and Romania.

When considering the concentration ratios calculated by turnover, the audit market for companies listed on regulated markets is highly concentrated with an average HHI of 3092.

For the 21 Member States analysed in table 40:

- 19 Member States are highly concentrated with an HHI above 2000: Austria, Belgium, Czech Republic, Denmark, Finland, Germany, Hungary, Ireland, Italy, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Slovakia, Spain, Sweden and the United Kingdom;
- 2 Member States are moderately concentrated with an HHI between 1000 and 2000: France and Greece.

IV.2.1.3.3 *Industry concentration levels on companies listed on regulated national stock exchange*

Table 41 shows the number and list of countries with no available data regarding concentration levels and the market share of the biggest audit firm by category of industry.

Table 41: Number and list of countries with no available data by category of industry

Industry	Number of countries with no available data	List of countries without available data
Energy	7	Bulgaria, Cyprus, Czech Republic, Estonia, Latvia, Luxembourg and Romania
Materials	6	Bulgaria, Cyprus, Estonia, Latvia, Malta and Romania
Industrials	7	Bulgaria, Cyprus, Czech Republic, Estonia, Latvia, Luxembourg and Romania
Consumer Discretionary	5	Bulgaria, Cyprus, Estonia, Latvia and Romania
Consumer Staples	7	Bulgaria, Cyprus, Estonia, Latvia, Malta, Romania and Slovakia
Health Care	9	Bulgaria, Cyprus, Czech Republic, Estonia, Latvia, Luxembourg, Malta, Portugal and Romania
Financials	5	Bulgaria, Cyprus, Estonia, Latvia and Romania
Information Technology	8	Bulgaria, Cyprus, Estonia, Latvia, Lithuania, Luxembourg, Romania and Slovenia
Telecommunication Services	7	Bulgaria, Cyprus, Estonia, Ireland, Latvia, Luxembourg and Romania
Utilities	9	Bulgaria, Cyprus, Estonia, Ireland, Latvia, Malta, Romania, Slovakia and Slovenia

Sources: ESCP Europe analysis based on data from Thomson, Bureau Van Dijk and Annual Reports.

Table 42 shows the concentration levels and the market share of the biggest audit firm (CR1) for the different industry categories for the market of companies listed on regulated national stock exchanges.

Table 42: Average concentration ratios in EU statutory audit markets for companies listed on regulated national stock exchange in 2009 by category of industry

			Average Concentration ratios by number of mandates				Average Concentration ratios by turnover			
Industry	Number of companies[58]	Average number of companies per Member State	CR1	CR4	CR8	HHI	CR1	CR4	CR8	HHI
Energy	94	5	66%	97%	100%	6091	85%	100%	100%	8122
Materials	288	14	44%	88%	96%	3532	66%	97%	100%	5535
Industrials	724	36	35%	85%	94%	2547	52%	95%	99%	4094
Consumer Discretionary	693	32	39%	84%	95%	2919	56%	95%	100%	4478
Consumer Staples	249	12	40%	88%	96%	3109	61%	97%	100%	5028
Health Care	234	13	53%	91%	97%	4589	71%	98%	100%	6317
Financials	1077	49	33%	83%	94%	2313	55%	99%	100%	4670
Information Technology	512	27	47%	86%	94%	3783	65%	96%	99%	5609
Telecommunication Services	57	3	68%	98%	100%	6371	86%	100%	100%	8207
Utilities	97	5	55%	96%	100%	4938	71%	100%	100%	6518

Sources: ESCP Europe analysis based on data from Thomson, Bureau Van Dijk and Annual Reports.

All industries are highly concentrated with HHI above 2,500 when considering the market by mandates and HHI above 4,000 when considering the market by turnover.

Comparison between industries on HHI basis is not that relevant because of the heterogeneity in the average number of companies per Member State.

When considering the market share of the biggest audit firm (CR1), table 41 shows that for all industries the biggest audit firm accounts for more than 50% of the turnover.

[58] The total number of companies listed in this section does not equal the total number of companies on the regulated national stock exchange since a number of companies are not classified by GICS code and thus not taken into account (see Country profiles in Appendices).

IV.2.1.3.4 *Concentration levels on companies in main index of main national stock exchanges*

Table 43 shows the concentration levels in EU statutory audit markets for all companies in main index of main national stock exchanges in 2009 when considering the number of audit mandates.

Table 43: Concentration levels in EU statutory audit markets for all companies in main index of main national stock exchanges in 2009 (by number of mandates)

Member State	Number of companies	Concentration ratios for 2009 by number of mandates			
		CR1	CR4	CR8	HHI
Austria	20	40%	90%	100%	2750
Belgium	20	35%	91%	100%	2401
Bulgaria	15	20%	67%	93%	1467
Cyprus	20	40%	90%	100%	2800
Czech Republic	15	25%	75%	100%	1641
Denmark	20	33%	95%	100%	2834
Estonia	15	60%	100%	100%	4756
Finland	25	40%	100%	100%	3408
France	40	25%	84%	100%	2038
Germany	30	56%	100%	100%	4121
Greece	20	35%	90%	100%	2350
Hungary	12	33%	83%	100%	2222
Ireland	20	40%	95%	100%	3350
Italy	39[59]	30%	98%	100%	2482
Latvia	32	13%	41%	63%	664
Lithuania	27	29%	86%	100%	2194
Luxembourg	12	31%	85%	100%	2189
Malta	18[60]	33%	100%	100%	3025
Netherlands	25	33%	100%	100%	2702
Poland	20	30%	90%	100%	2200
Portugal	20	48%	91%	100%	3195
Romania	10	40%	80%	100%	2400
Slovakia	5[61]	40%	100%	100%	3600
Slovenia	6	67%	100%	100%	5556
Spain	35	46%	100%	100%	3110

[59] Fiat Industrial is missing from our study as the company was created early 2011 (no info available).
[60] MIDI P.L.C. is missing from our study as the company entered the Malta Stock Exchange in 2010.
[61] Tatry mountain resorts and Best Hotel Properties are missing as they entered the Bratislava Stock Exchange in late 2009.

Sweden	29[62]	40%	100%	100%	3089
United Kingdom	99[63]	37%	99%	100%	2666
EU Average	24	37%	90%	98%	2786

Sources: ESCP Europe analysis based on data from Thomson, Bureau Van Dijk and Annual Reports.

Underlined figures: there were less than four audit firms or less than eight audit firms on this audited population and thus no CR4 or CR8 were calculated as it is 100%.

The audit market of companies listed on the main index is highly concentrated for 24 out of 27 Member States when considering the number of mandates with HHIs above 2,000.

- Latvia is the only not concentrated market with an HHI below 1000. According to local authorities, this situation is due to the high price pressure in the market, benefitting the mid-tier and small local firms, which are more flexible and able to provide lower priced services than the Big 4;
- Bulgaria and Czech Republic are moderately concentrated with an HHI between 1000 and 2000. The main reason that explains this moderate concentration level is the absence of consolidation activity in these Member States over the period 1998-2011;
- Of the 24 Member States with an HHI above 2000, France has the least concentrated audit market when considering companies listed on the main index with an HHI of 2,038. The biggest four audit firms in France have a combined market share of 84% (CR4) index of 84% (of the 24 Member States with an HHI above 2000, only Hungary and Romania have CR4 ration lower than France). Two factors contribute to this particular situation: (1) the strong performance of the Mazars Group which has historically been the auditor for a number of the largest French companies (e.g. GDF Suez) and for a number of companies that have grown significantly over the last decade (e.g. Essilor) and (2) the system of mandatory joint audits;
- Germany, is the most concentrated audit market in Europe when considering audit mandates for companies listed on the main index with an HHI of 4,121. Two Big 4 audit firms have together an 87% market share on the main index. This situation derives from a specific historical context: KPMG is the historical auditor of Deutsche Bank which used to have numerous stakes in industrial companies in the country and Pricewaterhouse Coopers is the historical auditor of publicly-owned companies.

[62] The index is made up of 40 quotes for only 39 companies, Atlas Copco being quoted twice.
[63] The index is made up of 102 quotes for only 100 companies, Royal Dutch Shell and Schroders PLC being quoted twice each, in addition, International Consolidated Airlines Group is missing from the main index as the company was created in 2011 (no info available).

Table 44 shows the concentration levels in EU statutory audit markets for all companies in main index of main national stock exchanges in 2009 when considering turnover.

Table 44: Concentration levels in EU statutory audit markets for all companies in main index of main national stock exchange in 2009 (by turnover)

Member State	Number of companies	Concentration ratios for 2009 by turnover			
		CR1	CR4	CR8	HHI
Austria	20	34%	90%	100%	2482
Belgium	20	31%	92%	100%	2361
Bulgaria	15	23%	77%	100%	1749
Cyprus	20	36%	99%	100%	3162
Czech Republic	15	34%	92%	100%	2488
Denmark	20	52%	100%	100%	3594
Estonia	15	53%	100%	100%	4714
Finland	25	59%	100%	100%	4071
France	40	25%	85%	100%	2076
Germany	30	48%	100%	100%	3944
Greece	20	39%	88%	100%	2490
Hungary	12	58%	100%	100%	4255
Ireland	20	43%	98%	100%	3069
Italy	39[64]	43%	99%	100%	2916
Latvia	32	34%	87%	97%	2217
Lithuania	27	47%	98%	100%	3354
Luxembourg	12	65%	99%	100%	4641
Malta	18[65]	32%	100%	100%	2825
Netherlands	25	49%	100%	100%	3308
Poland	20	39%	98%	100%	2762
Portugal	20	53%	97%	100%	3689
Slovakia	5[66]	91%	100%	100%	8404
Spain	35	58%	100%	100%	4105
Sweden	29[67]	53%	100%	100%	3894
United Kingdom	99[68]	47%	100%	100%	3237
EU Average	24	46%	96%	100%	3432

Sources: ESCP Europe analysis based on data from Thomson, Bureau Van Dijk and Annual Reports.

[64] Fiat Industrial is missing from our study as the company was created early 2011 (no info available).
[65] MIDI P.L.C. is missing from our study as the company entered the Malta Stock Exchange in 2010.
[66] Tatry mountain resorts and Best Hotel Properties are missing as they entered the Bratislava Stock Exchange in late 2009.
[67] The index is made up of 40 quotes for only 39 companies, Atlas Copco being quoted twice.

[68] The index is made up of 102 quotes for only 100 companies, Royal Dutch Shell and Schroders PLC being quoted twice each, in addition, International Consolidated Airlines Group is missing from the main index as the company was created in 2011 (no info available).

Underlined figures: there were less than four audit firms or less than eight audit firms on this audited population and thus no CR4 or CR8 were calculated as it is 100%.

Caveat: no turnover information was available in the reference databases for Romania and Slovenia.

Table 44 shows that when considering the audit market of companies listed on the main index by turnover, 24 Member States have a highly concentrated audit market with an HHI above 2000. Bulgaria has a moderately concentrated audit market with an HHI of 1749. No data were available for Romania and Slovenia when considering this audit market by turnover.

The difference between these ratios and concentration ratios calculated by number of mandates is lower than for other populations. This is explained by the fact that companies on the main indexes are more homogeneous in terms of turnover than listed companies or companies in regulated markets (i.e. with a more limited variation from the largest to the smallest company within the index, hence more balanced market shares per audit firm, inducing lower HHIs).

IV.2.1.4 Conclusion

There is a clear difference between the market share of the Big 4 audit firms when considering the overall market for audit firms and the audit market for listed companies. While the market share of Big 4 audit firms differs among Member States the market for listed companies is highly concentrated for most EU Member States.It could therefore be advisable to focus on the audit market of listed companies when considering regulatory measures to tackle the audit market concentration.

Within the different audit markets regarding the audits of listed companies, the concentration on the audit market for companies listed on the main index is the highest with the biggest four audit firms having a market share ranging from 80% to 100% (with exception of Lativa, Bulgaria an Czech Republic) when considering concentration ratios by mandates and ranging from 85% to 100% (with exception of Bulgaria) when considering concentration ratios by turnover.

IV.2.2 Evolution of concentration levels over the past five years

IV.2.2.1 Reminder on methodology used

IV.2.2.1.1 *Overall market*

The evolution of the overall market concentration levels were computed for the period 2005 to 2009 when available, and subject to the following caveats given the lack of sufficient data from both national statistics offices and the IABs:

- Concentration levels for the United Kingdom have been computed for the period 2005-2008;
- Concentration levels for the Netherlands have been computed for the period 2006-2009;
- Concentration levels for Belgium and Sweden are not available.

IV.2.2.1.2 *Listed companies*

The different concentration ratios calculated for 2009 for each Member State have been compared with the 2004 concentration ratios extracted from the London Economics Report[69].

Indeed, the latter calculated CR1, CR4, CR8 and HHI on the basis of the same method as ours. The only difference is the focus of London Economics's analyses on public and listed companies, vs. only listed companies in our analysis.

Yet, this difference is not considered as having an important impact on the different concentration indexes, given the small gap in number of companies (except for Spain, for which the London Economics data could not be used), as outlined below:

- Belgium: 140 companies in the London Economics study, vs. 151 in our database;
- Cyprus: 124 vs. 112;
- Denmark: 126 vs. 167;
- Ireland: 57 vs. 40;
- Netherlands: 183 vs. 135;
- United Kingdom: 1,850 vs. 2,061.

[69] *Study on the Economic Impact of Auditors' Liability Regimes*, London Economics (2006)

Table 45 shows the availability of data for each Member State:

Table 45: Data available per Member State

Member State	Number of mandates	Turnover	2004 concentration ratios (from the London Economics report)			2009 concentration ratios		
			All listed	Regulated market	Main index[70]	All listed	Regulated market	Main index
Austria	✓	✓	✗	✓	✓	✓	✓	✓
Belgium	✓	✓	✓	✓	✓	✓	✓	✓
Bulgaria	✓	✓	✗	✗	✗	✓	✗	✓
Cyprus	✓	✓	✓	✓	✓	✓	✗	✓
Czech Republic	✓	✓	✓	✓	✓	✗	✓	✓
Denmark	✓	✓	✓	✓	✓	✓	✓	✓
Estonia	✓	✓	✓	✓	✓	✗	✗	✓
Finland	✓	✓	✓	✓	✓	✗	✓	✓
France	✓	✓	✗	✓	✓	✓	✓	✓
Germany	✓	✓	✗	✓	✓	✓	✓	✓
Greece	✓	✓	✓	✓	✓	✗	✓	✓
Hungary	✓	✓	✗	✓	✓	✗	✓	✓
Ireland	✓	✓	✓	✓	✓	✓	✓	✓
Italy	✓	✓	✗	✓	✓	✓	✓	✓
Latvia	✓	✓	✓	✓	✓	✗	✗	✓
Lithuania	✓	✓	✓	✓	✓	✗	✓	✓
Luxembourg	✓	✓	✗	✓	✓	✗	✓	✓
Malta	✓	✓	✗	✓	✓	✗	✓	✓
Netherlands		✓	✓	✓	✓	✓	✓	✓
Poland	✓	✓	✓	✓	✓	✗	✓	✓
Portugal	✓	✓	✗	✓	✓	✗	✓	✓
Romania	✓	✗	✗	✗	✗	✓	✗	✓
Slovakia	✓	✓	✗	✓	✓	✗	✓	✓
Slovenia	✓	✗	✗	✓	✓	✗	✓	✓
Spain	✓	✓	✓	✓	✓	✓	✓	✓
Sweden	✓	✓	✗	✓	✓	✓	✓	✓
United Kingdom	✓	✓	✓	✓	✓	✓	✓	✓

Sources: ESCP Europe analysis based on data from the London Economics, Thomson, Bureau Van Dijk and Annual Reports.

The evolution of concentration levels can only be analysed on the basis of the comparison of 2009 levels with London Economics study's 2004 levels. Indeed, financial databases only mention the name of the "latest auditor", without any access to this piece of information for previous years, making it impossible to compare a year-by-year trend.

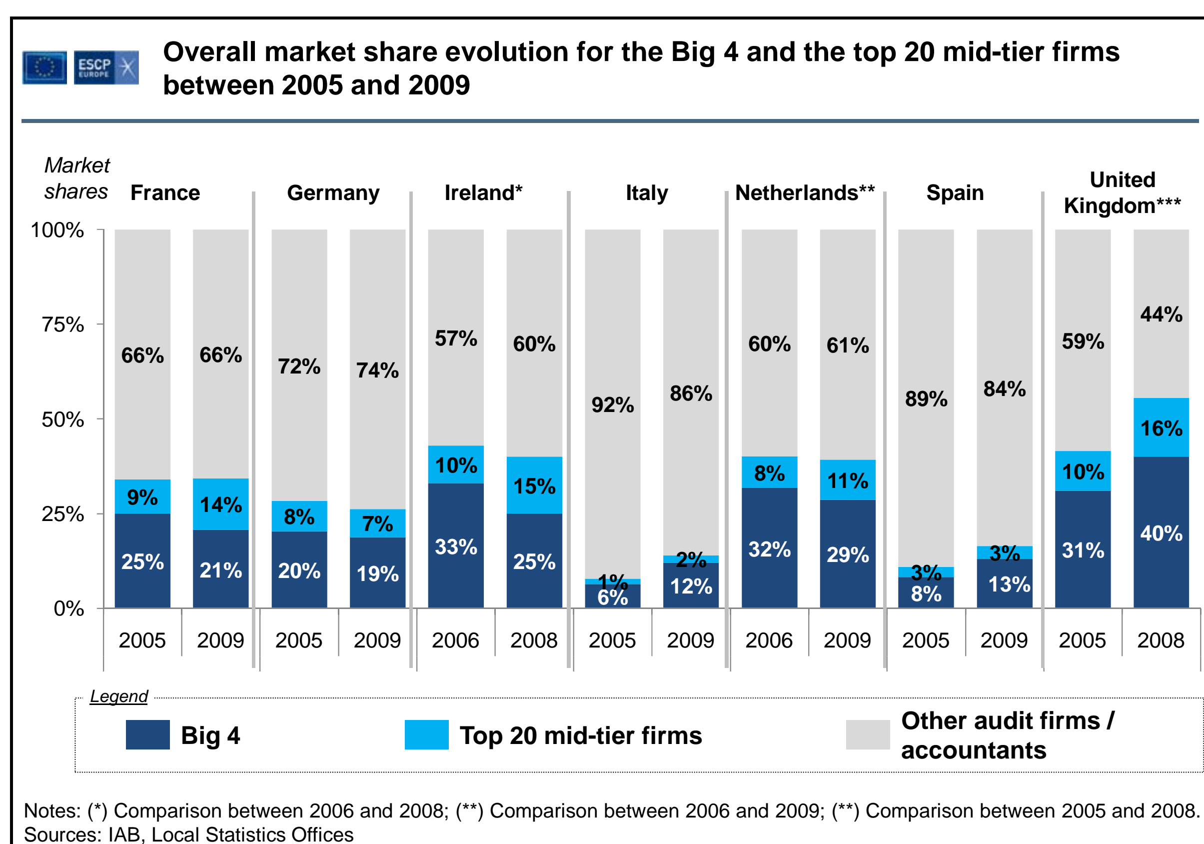
[70] The London Economics report only calculated concentration ratios by number of mandates on main indexes.

Three main reasons explain the data gaps above:

- The London Economics study was based on 25 Member States, as Bulgaria and Romania were not Member States at that time;
- The London Economics study provided concentration levels on all listed companies for 14 out of 25 Member States;
- Concentration ratios by turnover were not calculated on main indexes in the London Economics report, but only on the all listed and regulated market segments.

IV.2.2.2 Overall market concentration evolution

Figure 23: Overall market share evolution for the Big 4 and the top 20 mid-tier firms between 2005 and 2009



Overall market shares remained fairly stable between 2005 and 2009 except in the United Kingdom, which has seen an increase in both the Big 4 market share (+9 points) and the mid-tier firms market share (+6 points).

IV.2.2.3 Listed companies

IV.2.2.3.1 *Evolution of concentration levels for listed companies*

Table 46: Evolution of concentration levels in EU statutory audit markets – all listed companies (by number of mandates)

Member State	Year	Number of companies	Concentration ratios for 2009 by number of mandates				
			CR1	CR4	CR8	HHI	Delta HHI
Belgium	2009	151	24%	55%	75%	1044	+33%
	2004	*140*	*21%*	*49%*	*62%*	*788*	
Cyprus	2009	112	38%	77%	88%	2178	+12%
	2004	*124*	*30%*	*76%*	*87%*	*1951*	
Denmark	2009	167	27%	76%	94%	1786	+11%
	2004	*126*	*26%*	*74%*	*87%*	*1611*	
Ireland	2009	40	46%	88%	100%	2957	+88%
	2004	*57*	*28%*	*70%*	*81%*	*1571*	
Netherlands	2009	135	25%	87%	100%	2007	+10%
	2004	*183*	*23%*	*85%*	*92%*	*1832*	
Spain	2009	155	36%	80%	88%	2033	Not relevant[71]
	2004	*1805*	*16%*	*47%*	*63%*	*696*	
United Kingdom	2009	2061	16%	55%	80%	969	-8%
	2004	*1850*	*18%*	*61%*	*81%*	*1057*	

Sources: ESCP Europe analysis based on data from the London Economics, Thomson, Bureau Van Dijk and Annual Reports.

Underlined figures: there were less than four audit firms or less than eight audit firms on this audited population.

Caveat: Data were not available in the London Economics study for Austria, Bulgaria, France, Germany, Hungary, Italy, Luxembourg, Malta, Portugal, Romania and Slovenia, making a comparison impossible.

Data were not available in the reference databases in 2009 for Czech Republic, Estonia, Finland, Greece, Hungary, Latvia, Lithuania, Luxembourg, Malta, Poland, Portugal, Slovenia and Slovakia.

[71] Concentration measures for Spain are not comparable because of a shift in the number of analysed companies.

Concentration levels in number of mandates increased in almost all Member States (except in the United Kingdom where they have slightly decreased). Nevertheless, when considering the cause for this increase two groups of Member States stand out:

- In Belgium, Denmark and the Netherlands the increase in HHI is mainly due to mid-tier firms' gains in market share (as suggested by the CR8s increases);
- In Cyprus and Ireland the increase in HHI is due to a strengthening of the Big 4's position.

Table 47: Evolution of concentration levels in EU statutory audit markets - all listed companies (by turnover)

Member State	Year	Number of companies	Concentration ratios for 2009 by turnover				
			CR1	CR4	CR8	HHI	Delta HHI
Belgium	2009	151	32%	88%	100%	2256	-19%
	2004	*140*	*47%*	*85%*	*96%*	*2797*	
Cyprus	2009	112	32%	94%	98%	2737	-3%
	2004	*124*	*37%*	*86%*	*94%*	*2826*	
Denmark	2009	167	53%	96%	100%	3493	+54%
	2004	*126*	*33%*	*87%*	*99%*	*2265*	
Ireland	2009	40	40%	98%	100%	2995	+190%
	2004	*57*	*22%*	*56%*	*57%*	*1033*	
Netherlands	2009	135	34%	91%	100%	2353	-20%
	2004	*183*	*34%*	*99%*	*100%*	*2923*	
United Kingdom	2009	2061	43%	98%	100%	2884	+7%
	2004	*1850*	*38%*	*98%*	*99%*	*2699*	

Sources: ESCP Europe analysis based on data from the London Economics, IAB and local statistics offices.

Underlined figures: there were less than four audit firms or less than eight audit firms on this audited population.

Caveat: Data were not available in the London Economics report for Austria, Bulgaria, France, Germany, Hungary, Italy, Luxembourg, Malta, Portugal, Romania, Spain and Slovenia, making thus comparison impossible.

Data were not available in the reference databases in 2009 for Czech Republic, Estonia, Finland, Greece, Hungary, Latvia, Lithuania, Luxembourg, Malta, Poland, Portugal, Slovenia and Slovakia.

Concentration levels in turnover evolved heterogeneously. The less concentrated markets in 2004 experienced the strongest increase in HHI (particularly Ireland with +190%).

IV.2.2.3.2 *Evolution of concentration levels of the audit market of companies listed on regulated national stock exchanges*

In the following two tables, the evolution of concentration levels of the audit market of companie listed on regulated national stock exchanges is shown.

Table 48: Evolution of concentration levels in EU statutory audit markets – companies listed on regulated national stock exchanges (by number of mandates)

Member States	Year	Number of companies	Concentration ratios for 2009 by number of mandates				
			CR1	CR4	CR8	HHI	Delta HHI
Austria	2009	67	38%	77%	91%	2044	-8%
	2004	*44*	*40%*	*78%*	*91%*	*2212*	
Belgium	2009	125	28%	65%	82%	1363	-5%
	2004	*135*	*27%*	*70%*	*84%*	*1431*	
Czech Republic	2009	18	26%	74%	95%	1634	+6%
	2004	*36*	*29%*	*65%*	*82%*	*1540*	
Denmark	2009	159	27%	79%	96%	1876	+43%
	2004	*175*	*21%*	*68%*	*86%*	*1314*	
Finland	2009	117	32%	93%	96%	2690	-11%
	2004	*148*	*43%*	*94%*	*97%*	*3038*	
France	2009	550	15%	51%	65%	740	+34%
	2004	*489*	*15%*	*42%*	*58%*	*551*	
Germany	2009	527	22%	61%	75%	1110	+21%
	2004	*541*	*19%*	*55%*	*66%*	*918*	
Greece	2009	256	30%	68%	91%	1563	-2%
	2004	*292*	*34%*	*66%*	*84%*	*1600*	
Hungary	2009	44	16%	45%	57%	702	-45%
	2004	*36*	*25%*	*64%*	*75%*	*1280*	
Ireland	2009	28	41%	93%	100%	3127	Not relevant[72]
	2004	*65*	*25%*	*80%*	*89%*	*1756*	
Italy	2009	260	29%	87%	97%	2064	+1%
	2004	*276*	*27%*	*88%*	*93%*	*2053*	

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Lithuania	2009	34	30%	86%	97%	2053	+25%
	2004	*43*	*23%*	*79%*	*93%*	*1644*	
Luxembourg	2009	19	25%	75%	95%	1600	0%
	2004	*27*	*30%*	*74%*	*100%*	*1604*	
Malta	2009	19	32%	95%	100%	2742	-13%
	2004	*14*	*43%*	*100%*	*100%*	*3163*	
Netherlands	2009	131	26%	88%	100%	2019	-6%
	2004	*140*	*25%*	*89%*	*96%*	*2147*	
Poland	2009	138	18%	57%	76%	1010	+69%
	2004	*236*	*15%*	*41%*	*61%*	*597*	
Portugal	2009	51	35%	71%	84%	1821	-21%
	2004	*52*	*42%*	*73%*	*83%*	*2300*	
Slovakia	2009	20	15%	45%	70%	850	Not relevant[72]
	2004	*7*	*29%*	*100%*	*100%*	*2040*	
Slovenia	2009	41	34%	66%	88%	1672	-16%
	2004	*15*	*40%*	*73%*	*100%*	*2000*	
Spain	2009	154	36%	80%	88%	2040	-29%
	2004	*115*	*44%*	*91%*	*97%*	*2854*	
Sweden	2009	260	36%	93%	100%	2463	+4%
	2004	*272*	*30%*	*93%*	*99%*	*2370*	
United Kingdom	2009	1023	22%	72%	86%	1394	Not relevant[72]
	2004	*316*	*37%*	*98%*	*100%*	*2654*	

Sources: ESCP Europe analysis based on data from the London Economics, Thomson, Bureau Van Dijk and Annual Reports.

Underlined figures: there were less than four audit firms or less than eight audit firms on this audited population.

Caveat: Data were not available in the London Economics study in 2004 for Bulgaria, and Romania. Data were not available in reference databases for 2009 in Bulgaria, Cyprus, Estonia, Latvia and Romania.

Table 48 shows that for the audit market for companies listed on regulated markets in the EU, when considering mandates:

[72] Due to a change in the scope of companies listed on the regulated market, a comparison between concentration levels in 2005 and 2009 is not relevant on this category.

- 8 Member States have an increase in concentration of their audit market: Czech Republic, Denmark, France, Germany, Italy, Lithuania, Poland and Sweden. A strong HHIs increase is noted in Denmark (+43%), France (+34%), in Germany (+21%), Lithuania (+25) and Poland (+69%); As regards the increase in Denmark, according to official bodies in Denmark, this situation is due to an increase in audit quality requirements and to the termination of the joint-audit system in the Member State;
- 11 Member States have a decrease in concentration of their audit market: Austria, Belgium, Finland, Greece, Hungary, Luxembourg, Malta, the Netherlands, Portugal, Slovenia and Spain. A strong HHI decrease is shown for the audit markets in Hungary (-45%), Portugal (-21%) and Spain (-28%).

Table 49: Evolution of concentration levels in EU statutory audit markets – companies listed on regulated national stock exchanges (by turnover)

Member State	Year	Number of companies	Concentration ratios for 2009 by turnover				
			CR1	CR4	CR8	HHI	Delta HHI
Austria	2009	67	36%	83%	99%	2283	-29%
	2004	*44*	*43%*	*93%*	*96%*	*3198*	
Belgium	2009	125	32%	89%	100%	2260	-28%
	2004	*135*	*48%*	*96%*	*97%*	*3119*	
Czech Republic	2009	18	33%	90%	100%	2402	-36%
	2004	*36*	*56%*	*94%*	*99%*	*3754*	
Denmark	2009	159	53%	96%	100%	3495	+92%
	2004	*175*	*30%*	*77%*	*98%*	*1824*	
Finland	2009	117	58%	99%	100%	4000	-32%
	2004	*148*	*74%*	*100%*	*100%*	*5893*	
France	2009	550	24%	81%	97%	1840	+17%
	2004	*489*	*28%*	*71%*	*90%*	*1577*	
Germany	2009	527	42%	97%	99%	3294	-17%
	2004	*541*	*57%*	*92%*	*96%*	*3976*	
Greece	2009	256	30%	73%	98%	1734	-3%
	2004	*292*	*31%*	*73%*	*97%*	*1784*	
Hungary	2009	44	55%	98%	99%	3912	-8%
	2004	*36*	*60%*	*99%*	*99%*	*4247*	

Ireland	2009	28	40%	98%	100%	3002	Not relevant[72]
	2004	*65*	*41%*	*99%*	*100%*	*3488*	
Italy	2009	260	40%	98%	100%	2787	+5%
	2004	*276*	*34%*	*100%*	*100%*	*2651*	
Lithuania	2009	34	41%	95%	100%	3080	-36%
	2004	*43*	*68%*	*93%*	*100%*	*4802*	
Luxembourg	2009	19	63%	99%	100%	4474	+32%
	2004	*27*	*46%*	*96%*	*100%*	*3389*	
Malta	2009	19	32%	100%	100%	2808	-47%
	2004	*14*	*63%*	*100%*	*100%*	*5328*	
Netherlands	2009	131	34%	91%	100%	2353	-8%
	2004	*140*	*29%*	*100%*	*100%*	*2551*	
Poland	2009	138	35%	88%	97%	2272	-34%
	2004	*236*	*56%*	*83%*	*94%*	*3417*	
Portugal	2009	51	47%	94%	99%	3246	-29%
	2004	*52*	*64%*	*93%*	*99%*	*4553*	
Slovakia	2009	20	71%	97%	99%	5302	Not relevant[72]
	2004	*7*	*95%*	*98%*	*100%*	*8998*	
Spain	2009	154	58%	99%	100%	4050	-36%
	2004	*115*	*78%*	*99%*	*100%*	*6334*	
Sweden	2009	260	48%	100%	100%	3457	+25%
	2004	*272*	*37%*	*99%*	*100%*	*2766*	
United Kingdom	2009	1023	43%	99%	100%	2926	Not relevant[72]
	2004	*316*	*36%*	*100%*	*100%*	*2660*	

Sources: ESCP Europe analysis based on data from the London Economics, Thomson, Bureau Van Dijk and Annual Reports.

Underlined figures: there were less than four audit firms or less than eight audit firms on this audited population.

Caveat: Data were not available in the London Economics study for 2004 in Bulgaria, and Romania. Data were not available for 2009 in reference databases for Bulgaria, Estonia, Latvia and Romania.

Table 49 shows that for the audit market for companies listed on regulated markets in the EU, when considering turnover:

- 5 Member States have an increase in concentration of their audit market: Denmark, France, Italy, Luxembourg and Sweden;
- 13 Member States have a decrease in concentration of their audit market: Austria, Belgium, Czech Republic, Finland, Germany, Greece, Hungary, Lithuania, Malta, the Netherlands, Poland, Portugal and Spain.

While table 49 shows a decrease of concentration levels of the audit market when considering turnover for 13 Member States, all but two Member States still remain at high concentration levels (HHI above 2000).

Only France and Greece have moderately concentrated audit markets when considering turnover.

IV.2.2.3.3 *Evolution of concentration levels on companies in main index of main national stock exchanges*

Table 50: Evolution of concentration levels in EU statutory audit markets – companies in main index of main national stock exchanges (by number of mandates)

Member State	Year	Number of companies	Concentration ratios for 2009 by number of mandates				
			CR1	CR4	CR8	HHI	Delta HHI
Austria	2009	20	40%	90%	100%	2750	0%
	2004	*22*	*42%*	*83%*	*100%*	*2743*	
Belgium	2009	20	35%	91%	100%	2401	+18%
	2004	*19*	*25%*	*88%*	*100%*	*2031*	
Cyprus	2009	20	40%	90%	100%	2800	-26%
	2004	*20*	*50%*	*95%*	*100%*	*3800*	
Czech Republic	2009	15	25%	75%	100%	1641	-45%
	2004	*9*	*40%*	*100%*	*100%*	*3000*	
Denmark	2009	20	33%	95%	100%	2834	+55%
	2004	*19*	*26%*	*78%*	*100%*	*1833*	
Estonia	2009	15	60%	100%	100%	4756	+116%
	2004	*10*	*30%*	*90%*	*100%*	*2200*	
Finland	2009	25	40%	100%	100%	3408	-14%
	2004	*25*	*56%*	*100%*	*100%*	*3984*	
France	2009	40	25%	84%	100%	2038	+12%
	2004	*40*	*30%*	*73%*	*96%*	*1818*	
Germany	2009	30	56%	100%	100%	4121	+2%
	2004	*30*	*53%*	*97%*	*100%*	*4022*	
Greece	2009	20	35%	90%	100%	2350	-8%
	2004	*20*	*40%*	*90%*	*100%*	*2550*	
Hungary	2009	12	33%	83%	100%	2222	-54%
	2004	*12*	*64%*	*100%*	*100%*	*4876*	
Ireland	2009	20	40%	95%	100%	3350	+12%
	2004	*20*	*45%*	*95%*	*100%*	*3000*	

Italy	2009	39[73]	30%	98%	100%	2482	-7%
	2004	*40*	*35%*	*100%*	*100%*	*2662*	
Latvia	2009	32	13%	41%	63%	664	-82%
	2004	*5*	*40%*	*100%*	*100%*	*3600*	
Lithuania	2009	27	29%	86%	100%	2194	-6%
	2004	*21*	*29%*	*95%*	*100%*	*2340*	
Luxembourg	2009	12	31%	85%	100%	2189	-5%
	2004	*11*	*31%*	*92%*	*100%*	*2307*	
Malta	2009	18[74]	33%	100%	100%	3025	-4%
	2004	*14*	*43%*	*100%*	*100%*	*3163*	
Netherlands	2009	25	33%	100%	100%	2702	+4%
	2004	*23*	*32%*	*100%*	*100%*	*2608*	
Poland	2009	20	30%	90%	100%	2200	-30%
	2004	*20*	*44%*	*100%*	*100%*	*3150*	
Portugal	2009	20	48%	91%	100%	3195	+6%
	2004	*20*	*50%*	*85%*	*100%*	*3000*	
Slovakia	2009	5[75]	40%	100%	100%	3600	0%
	2004	*5*	*40%*	*100%*	*100%*	*3600*	
Slovenia	2009	6	67%	100%	100%	5556	+178%
	2004	*15*	*40%*	*73%*	*100%*	*2000*	
Spain	2009	35	46%	100%	100%	3110	-24%
	2004	*35*	*50%*	*97%*	*100%*	*4100*	
Sweden	2009	29[76]	40%	100%	100%	3089	+11%
	2004	*30*	*34%*	*100%*	*100%*	*2792*	
United Kingdom	2009	99[77]	37%	99%	100%	2666	-8%
	2004	*100*	*43%*	*99%*	*100%*	*2912*	

Sources: ESCP Europe analysis based on data from the London Economics, Thomson, Bureau Van Dijk and Annual Reports.

[73] Fiat Industrial is missing from our study as the company was created early 2011 (no info available).
[74] MIDI P.L.C. is missing from our study as the company entered the Malta Stock Exchange in 2010.
[75] Tatry mountain resorts and Best Hotel Properties are missing as they entered the Bratislava Stock Exchange in late 2009.
[76] The index is made up of 40 quotes for only 39 companies, Atlas Copco being quoted twice.
[77] The index is made up of 102 quotes for only 100 companies, Royal Dutch Shell and Schroders PLC being quoted twice each, in addition, International Consolidated Airlines Group is missing from the main index as the company was created in 2011 (no info available).

Underlined figures: there were less than four audit firms or less than eight audit firms on this audited population.

Caveat: Data were not available for Bulgaria and Romania in the London Economics study, as they were not part of the European Union at that time.

Table 50 shows that for the audit market for companies listed on the main index, when considering mandates:

- 11 Member States have an increase in concentration of their audit market: Belgium, Denmark, Estonia, France, Germany, Ireland, Malta, the Netherlands, Portugal, Slovenia and Sweden.
- 12 Member States have a decrease in concentration of their audit market: Cyprus, Czech Republic, Finland, Greece, Hungary, Italy, Latvia, Lithuania, Luxembourg, Poland, Spain and United Kingdom.
- 2 Member States have a constant concentration of their audit market: Austria and Slovakia.

Even though the number of Member States in which the audit market concentration increased or decreased is comparable, the number of audit firms auditing companies listed on the main index is eight or less in all Member States except Latvia.

IV.2.2.4 Conclusion

No clear trend can be distinguished how the concentration of the audit market of listed companies, companies, the audit market of listed on regulated markets and the audit market of companies listed on the main index evolved between 2004 and 2009. The concentration levels also evolved in different ways for the different audit markets in the different Member States. However, the concentration of the different audit market remains in most Member States highly concentrated.

IV.3 Focus on the third criterion: barriers to entry and development of mid-tier firms on the overall and listed market segments

IV.3.1 Objective and methodology

The objective of this section is to assess whether mid-tier firms:

- Have been able to gain market share in the overall market;
- Have managed to grow within the listed market segment.

On the basis of our desk research, the following steps have been followed:

- Analysis of the turnover growth of mid-tier firms in the past five years, and comparison with the overall market growth in the past five years;
- Focus on the market position of mid-tier firms with listed companies.

As mentioned earlier, the scope of the analysis of turnover growth includes six Member States, due to a limited coverage of Belgium and Sweden by the International Accounting Bulletin, which is the reference source used for the analysis of the turnover of audit firms.

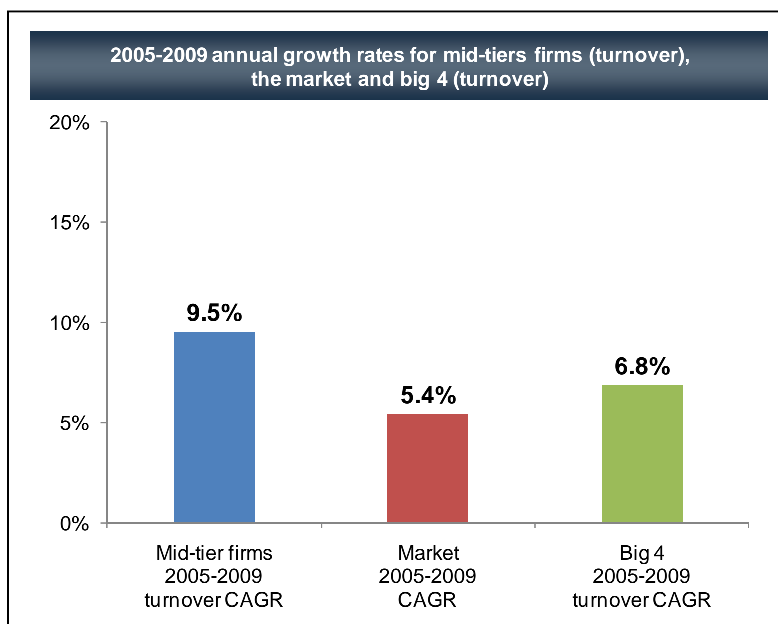
IV.3.2 Analysis of the turnover growth of mid-tier firms

IV.3.2.1 Cross-country analysis

Turnover of mid-tier firms grew significantly from 2005 to 2009, with a +9.5% annual growth (as a reference, the average GDP growth in these six Member States over this period was +1.0%, ranging from +3.8% in Spain to -3.9% in the United Kingdom).

More specifically, mid-tier firms out-performed both the overall market and the Big 4, by 4.1 points and 2.7 points respectively, as outlined below:

Figure 24: Annual growth rates for mid-tier firms (turnover), the overall market and the Big 4 (turnover)



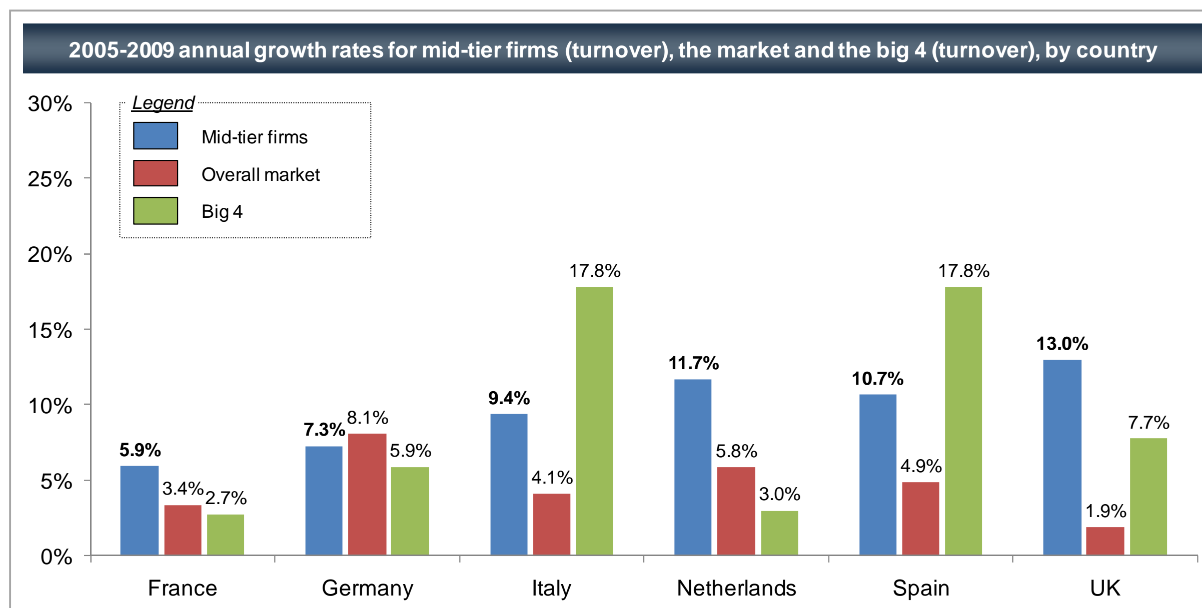
Source: ESCP Europe analysis based on IAB data.

Caveat: the scope of the analysis of turnover growth includes six Member States.

The above growth rates (both for Big 4 and mid-tier firms), based on the overall audit and non-audit market fees, indicate that the mid-tier firms' market share has increased more than the Big 4 share – suggesting that there does not seem to be any significant barriers to the development of mid-tiers.

IV.3.2.2 Detail by Member State

Figure 25: Annual growth rates for mid-tier firms (turnover), the market and the Big 4 (turnover), by Member State



Source: ESCP Europe analysis based on IAB data.

The above country-by-country analysis indicates that:

- In France, the Netherlands and the United Kingdom mid-tier firms have outperformed both the overall market and the Big 4;
- In Germany, the annual growth of mid-tier firms was also above that of the Big 4, even if slightly under the overall market;
- In Italy and Spain, on the contrary, mid-tier firms have grown at a significantly slower pace than the Big 4.

IV.3.3 Focus on the market position of mid-tier firms with listed companies

The aim of this section is to identify whether mid-tier firms have grown within the listed market segment.

Table 51: Number of mid-tier firms' with at least one mandate on the listed market segment

	Number of mid-tier firms having at least one mandate with a listed company		
	All listed companies	**Regulated market companies**	**Main index companies**
Belgium[78]	n.a.	n.a.	n.a.
France	20	16	1[79]
Germany	24	22	0
Italy	7	7	0
Netherlands	3	3	0
Spain	7	7	0
Sweden	3	3	0
UK	25	24	1[80]

Source: ESCP Europe analysis based on IAB data.

Three comments can be made on the above figures:

1. In the largest Member States by GDP (France, Germany and the United Kingdom), more than 15 mid-tier firms operate in the listed market segment;
2. Yet, barely any of these firms are active with companies listed on the main index – France is the only exception: Mazars has 14 mandates in France, BDO has only one mandate in the UK (other significant players were active on the French market such as RMS Salustro Reyel, BDO Marque et Gendrot and Constantin, but these firms were acquired by Big 4 audit firms);
3. In all other Member States, there is a low number of mid-tier firms active in the listed market segment.

[78] The International Accounting Bulletin does not cover Belgium, and it is therefore difficult to list all mid-tier firms operating in this country in detail.
[79] Mazars has 14 mandates.
[80] BDO, 1 mandate.

At European level, listed company audits are clustered around three main mid-tier firms. The data analysis on listed companies in seven Member States indicates that only three mid-tier firms have ten or more mandates, as follows:

- Grant Thornton = 4 Member States with more than 10 mandates:
    - France = 48 mandates;
    - Germany = 13 mandates;
    - Sweden = 18 mandates;
    - The United Kingdom = 243 mandates;
- BDO = 3 Member States with more than 10 mandates:
    - Germany = 50 mandates;
    - Sweden = 18 mandates;
    - The United Kingdom = 155 mandates;
- Mazars = 3 Member States with more than 10 mandates:
    - France = 125 mandates;
    - Italy = 17 mandates;
    - The United Kingdom = 35 mandates.

As for other mid-tier firms, they usually operate on a national level, auditing listed companies that mainly have a national presence.

In terms of listed company market share (in number of mandates and in turnover), the mid-tier firms share is as follows:

Table 52: Market share of mid-tier firms with listed companies by Member State, in number of mandates and in turnover

	Mid-tier firms' market share with listed companies – By mandate			Mid-tier firms' market share with listed companies – By turnover		
	All listed companies	Regulated market companies	Main index companies	All listed companies	Regulated market companies	Main index companies
Belgium	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
France	17%	19%	19%	18%	18%	16%
Germany	25%	23%	0%	2%	2%	0%
Italy	12%	11%	0%	1%	1%	0%
Netherlands	12%	12%	0%	8%	8%	0%
Spain	9%	9%	0%	0%	0%	0%
Sweden	12%	7%	0%	0%	0%	0%
UK	39%	22%	1%	2%	1%	0%

Sources:ESCP Europe analysis based on data from IAB, Thomson, Bureau Van Dijk and Annual Reports.

These figures are in line with comments made earlier on the number of mid-tier firms active in the listed market segment, with:

- A relatively significant market share of mid-tier firms in the largest Member States by GDP (France, Germany and the United Kingdom), especially in the United Kingdom;
- A marginal market share on the main index segment, with the exception of Mazars in France;
- A limited presence of mid-tier firms in Italy, the Netherlands, Spain and Sweden (market share ≤ 12%);
- Overall market shares in turnover appear significantly higher than in number of mandates in almost all Member States (except in France and in the Netherlands), suggesting a focus of mid-tier firms on the lower end of the listed market segment.

The following table gives the number of listed companies for the eight Member States analysed in this section. Regarding the United Kingdom, the significantly higher market share of mid-tier firms is linked to a much higher number of listed companies in the UK (respectively 2.6 to 2.7 times more than in France and in Germany), as outlined below:

Table 53: Number of listed companies by Member State

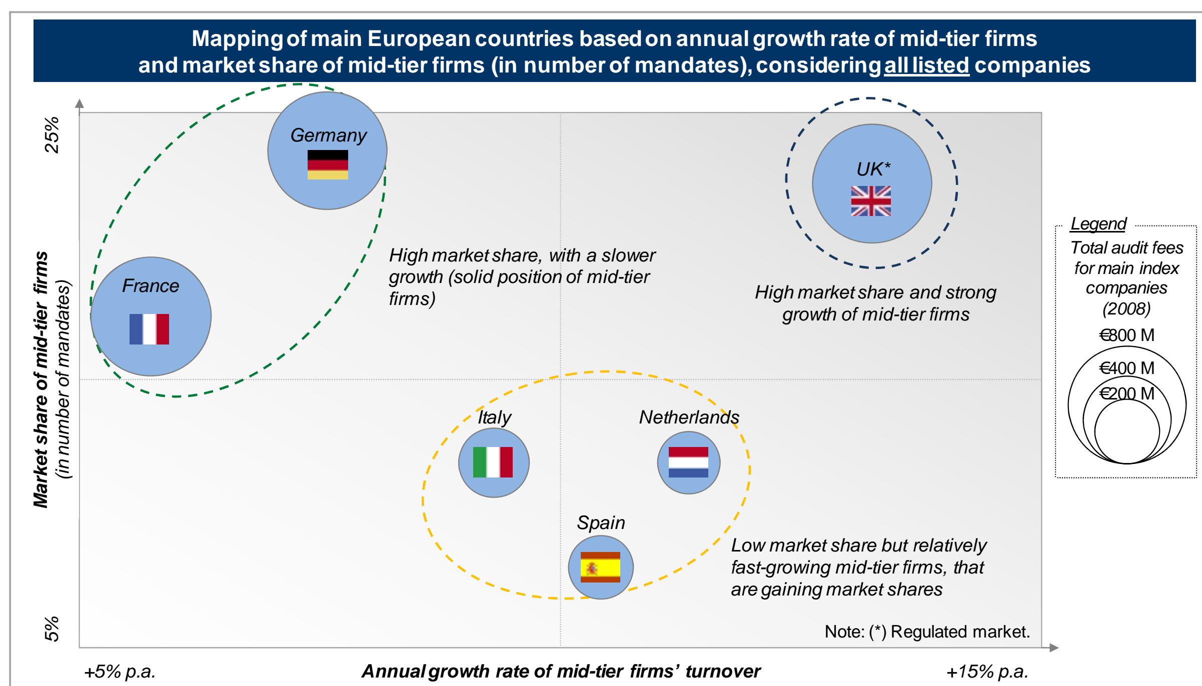
Member State	Number of listed companies
Belgium	151
France	761
Germany	781
Italy	269
Netherlands	135
Spain	155
Sweden	391
United Kingdom	2061

Sources:ESCP Europe analysis based on data from Thomson and Bureau Van Dijk.

To be able to compare market segments with approximately the same size and number of companies, when comparing the United Kingdom to other Member States, the “all listed” segment in any given Member State should be compared to the “regulated” segment in the United Kingdom (composed of 1,023 listed firms). When this indicator is considered, the market share of mid-tier firms in the United Kingdom is comparable to that of France and Germany.

Finally, the data analysis of both market shares and mid-tier firms' turnover growth is outlined below:

Figure 26: Mapping of current market share of mid-tier firms and their turnover growth



Source:ESCP Europe analysis based on data from IAB.

Three Member State clusters emerge from this mapping, with different market dynamics:

- The United Kingdom, where mid-tier firms are fast consolidating their already relatively strong position (strong M&A activity among mid-tiers since 2005, as mentioned earlier);
- France and Germany, where mid-tier firms are developing more slowly, with a relatively high but stable market share;
- Italy, Spain and the Netherlands, where the position of mid-tier firms appears weaker, but seem to be catching up.

IV.3.4 Ranking barriers to entry

Two different sources were used to assess the importance of barriers to entry:

- The answers of the 120 respondents to the online survey;
- The results of the qualitative interviews performed.

IV.3.4.1 Entry barriers as perceived by the market - Results from the online survey

The different stakeholders participating to the online survey were asked to rank nine barriers to entry.

The answer to the question *"How important (on a scale of 1 (least important) to 5 (most important), 0 if you do not know) do you rate the following factors as barriers for audit firms other than the Big 4 to provide audit services to listed companies usually audited by Big 4?"* are presented in the following table:

Table 54: Ranking of the barriers to entry according to the online survey respondents

	Barrier to entry	Percentage of respondents ranking the factor as the most important or the second most important factor
1.	Audit firms are too small and lack capacity to handle audit assignments undertaken typically by large audit firm	69%
2.	Reputation of Big 4 firms	56%
3.	Audit firm cannot provide services covering many countries	52%
4.	Audit firm lack of sector knowledge and experience	45%
5.	Audit firm lack of technical capacity in certain area of expertise such as IT, actuarial affairs, financial instruments	36%
6.	Client switching inertia	36%
7.	Audit firm lack of technical capacity regarding IFRS	33%
8.	Audit liability risk	28%
9.	Lack of adequate audit liability insurance	28%

Source: ESCP Europe online survey.

IV.3.4.2 Entry barriers as perceived by the market – Results from the qualitative interviews

IV.3.4.2.1 *Summary of results*

51 interviews were conducted during this study among different types of stakeholders: audit clients, regulators, audit firms and other key stakeholders.

The barriers to entry mentioned most often during the interviews are:

- The size of audit firms:
    - The limited size of mid-tiers and other players lead to problems of staffing for large multinational companies;
    - The lack of geographical coverage;
    - The professional rules limiting the fees from a single client from 10% to 15% of an audit firm turnover;
- The reputation or relationship with other key players. More specifically:
    - The selection criteria favouring the Big 4;
    - The Bank covenants stipulating that the auditor should be a Big 4;
    - The strong relationship between banks or lawyers (who have a strong influence on the management) and the Big 4;
- The ability to provide non-audit services;
- The corporate structure of audit firms:
    - The obligation for a majority of management board members to be qualified accountants;
    - The employee ownership, which is said to be less supportive in terms of investments and development towards large clients[81].

[81] Oxera, *"Ownership rules of audit firms and their consequences for audit market concentration",* October 2007

IV.3.4.2.2 *Focus on the selection criteria*

Table 55: Ranking of the criteria to select an audit firm according to the online survey respondents

	Purchasing criteria	**Percentage of respondents ranking the factor as the most important or the second most important factor**
1.	Capacity to provide an integrated audit of the group and its subsidiaries with an overall minimum level of quality	40%
2.	Knowledge by the audit firm of the industry(ies) in which the company operates	33%
3	Reputation	30%
4.	Previous experience of the company with audit firm	17%
5.	Fees	15%
6.	Knowledge by the audit firm of the company	15%
7.	Size of the audit firm	11%
8.	Geographical coverage	9%
9.	References from others about the audit firms	8%
10.	Range and size of existing clients of the audit firms	6%
11.	Audit firm's corporate governance	3%
12.	Diversity of expertise	3%

Source: ESCP Europe online survey.

The results of the online survey are in line with the qualitative interviews conducted. The two most important criteria for companies to select an audit firm favour the Big 4: capacity to provide integrated audits on group level and knowledge of the industry. Reputation and previous experience are respectively the third and fourth most important criteria.

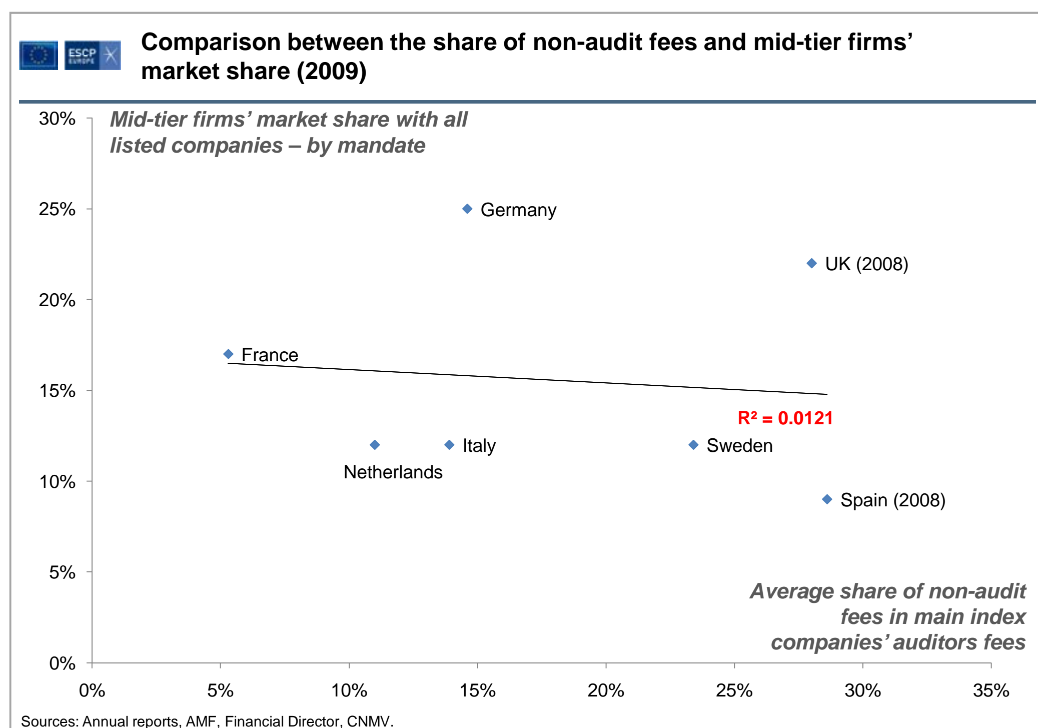
IV.3.4.2.3 *Focus on the provision of non-audit services as a potential entry-barrier*

A stricter prohibition on the provision of non-audit services to audit clients is often considered by academic papers and interviewed stakeholders as an opportunity for mid-tier firms to develop their audit and non-audit activities, since they could position themselves either on statutory audit tenders of Big 4's non-audit clients or on non-audit work for Big 4's audit clients[82]. Ojo [2009] concludes that *"a prohibition on the provision of specific non-audit services by the major 4 audit firms [...] could serve as a powerful tool in facilitating greater entry of currently 'disadvantaged' audit firms into the audit market. Such a move would also foster a higher level of competition whilst ensuring that the level of audit quality is not undermined."*

To assess whether non-audit services constitute a barrier to enter into the statutory audit market for mid-tier firms, an analysis of the audit market share and non-audit services was made to see whether mid-tier firms' market share of listed companies is lower in Member States where the proportion of non-audit fees disclosed by listed companies is low.

Since audit fees data for the 27 Member States are only available for companies on the national main index, the share of non-audit fees disclosed by main index companies is used as a proxy.

Figure 27: Comparison between the share of non-audit fees and mid-tier firms' market share (2009)



NB: Given the much higher number of listed companies in the UK (respectively 2.6 to 2.7 times more than in France and in Germany), the "all listed" segment in any given Member State is compared to the "regulated" segment in the United Kingdom.

[82] *Regulating the international audit market and the removal of barriers-to-entry: the provision of non-audit services by audit firms and the 2006 statutory audit directive* – Ojo, 2009.

This graph shows that there is no correlation between the average proportion of non-audit fees and the market share of mid-tier firms:

- A low market share of mid-tier firms matches a high proportion of non-audit services in Sweden and Spain;
- In Italy and the Netherlands, a low market share of mid-tier firms is associated with a relatively low share of non-audit fees;
- In the United Kingdom, the much higher share of non-audit fees does not prevent mid-tier firms from having a high market share;
- France and Germany have low levels of non-audit fees and high market shares of mid-tier firms.

This absence of correlation is confirmed by:

- The fact that most interviewed stakeholders do not consider non-audit services a barrier to entry for mid-tier firms;
- The share of non-audit services in mid-tier firms' turnover and its evolution over 2005-2009, is shown in the following table:

Table 56: Evolution of the non-audit services' share in mid-tiers' turnover, 2005-2009

	2005	2006	2007	2008	2009	2005-2009 evolution
France	28%	28%	34%	33%	28%	+0 pt
Germany	54%	55%	59%	56%	58%	+ 4 pts
Ireland	n.a.	n.a.	39%	n.a.	56%	+17 pts vs. 07
Italy	49%	37%	30%	35%	44%	-5 pts
Netherlands	40%	38%	40%	37%	35%	-5 pts
Poland	n.a.	n.a.	30%	35%	33%	+3 pts vs. 07
Spain	55%	n.a.	n.a.	46%	53%	-2 pts
Sweden	n.a.	n.a.	n.a.	19%	n.a.	n.a.
UK	60%	61%	63%	60%	56%	- 4 pts

Source: ESCP Europe analysis based on data from IAB.

Caveat: the only source of relevant and exhaustive data on the revenues of the top 10 audit firms by Member States is the International Accounting Bulletin (IAB). However, the data is only available for nine Member States.

The ability to provide non-audit services does not seem to constitute a real barrier to entry for mid-tier firms.

IV.3.5 Conclusion

The analyses of this section show that:

- For the non-listed market segment, barriers to the development of mid-tier firms appear limited, since mid-tier firms:
  - Outperformed both the audit market (5.4% annual growth) and the Big 4 (+6.8% annual turnover growth) in turnover growth between 2005 and 2009, with a +9.5% annual growth;
  - Gained market share in the Member States covered, except in Belgium and Sweden;
- For the listed market segment, there are higher barriers to entry and development for mid-tier firms, given:
  - The limited number of mid-tier firms (3 to 8) and their low market share (≤ 12%) in this segment in Italy, the Netherlands, Spain and Sweden;
  - Mid-tier firms focus on the lower end of the listed market segment given their absence from the main index companies (with the exception of Mazars in France);
  - Only three mid-tier (Grant Thornton, BDO and Mazars) have more than 10 mandates with listed companies in more than two Member States (out of seven Member States covered at this stage), suggesting a highly national focus of most mid-tier firms.
- The different barriers to entry for mid-tier firms on the listed market segment are:
  - Size of the audit firm;
  - A geographical coverage too limited;
  - Problems of reputation or limited relationships with other key players;
  - A lack of capacity (in terms of technical and sector knowledge (IFRS, IT and financial instruments);

IV.4 Focus on the fourth criterion: risk of the demise of one of the Big 4

IV.4.1 Objective and methodology

Simulation of concentration levels after the demise of one of the Big 4.

Arthur Andersen's demise has raised the fear that concentration levels would increase further if another top audit firm were to face a similar fall. We have, therefore, simulated the demise of a Big 4 firm and the underlying consequences on concentration levels within the European Union.

The simulation covers two scenarios:

- The demise of the number one Big 4 (in terms of number of mandates and turnover of audited companies) in a given Member State. This situation could occur for instance following a scandal limited to a national scale;
- The demise of the number one Big 4 on a European scale.

The impact of the demise has been analysed with the tools and metrics used by the European Commission when assessing horizontal mergers.

The European Commission uses the following threshold to assess horizontal mergers:

Table 57: HHI thresholds used to assess horizontal mergers

Post-merger HHI	Delta HHI	Horizontal competition concerns[83]
HHI ≤ 1,000	Any	✗
1,000 < HHI < 2,000	Δ < 250	✗
	Δ ≥ 250	✓
HHI ≥ 2,000	Δ < 150	✗
	Δ ≥ 150	✓

The simulation has been conducted on the audit market of companies listed on regulated markets in order to maximize coverage of Member States. The following table lists the number one firm in terms of mandates and turnover.

The audit market of all listed companies has been considered for Bulgaria, Cyprus and Romania, as data for the audit market of companies listed on the regulated exchanges are not available for these Member States.

The simulation has not been conducted for Estonia and Latvia as the listings of the market of all listed companies or companies listed on the regulated market are not available.

[83] Each of these HHI levels, in combination with the relevant deltas, may be used as an indicator of the absence of competition concerns. However, they do not give rise to a presumption of either the existence or the absence of such concerns.

Table 58: Number one Big 4 per Member State on regulated market

Member State	Number one Big 4	
	By number of mandates	By sum of audited companies' turnover
Austria	KPMG	KPMG
Belgium	DELOITTE	DELOITTE
Bulgaria	DELOITTE	DELOITTE
Cyprus	KPMG	KPMG
Czech Republic	DELOITTE	PRICEWATERHOUSECOOPERS
Germany	KPMG	KPMG
Denmark	DELOITTE	KPMG
Finland	PRICEWATERHOUSECOOPERS	PRICEWATERHOUSECOOPERS
France	ERNST & YOUNG	ERNST & YOUNG
Greece	PRICEWATERHOUSECOOPERS	PRICEWATERHOUSECOOPERS
Hungary	PRICEWATERHOUSECOOPERS	ERNST & YOUNG
Ireland	KPMG	PRICEWATERHOUSECOOPERS
Italy	PRICEWATERHOUSECOOPERS	PRICEWATERHOUSECOOPERS
Lithuania	PRICEWATERHOUSECOOPERS	PRICEWATERHOUSECOOPERS
Luxembourg	ERNST & YOUNG	DELOITTE
Malta	DELOITTE	KPMG
Netherlands	ERNST & YOUNG	PRICEWATERHOUSECOOPERS
Poland	ERNST & YOUNG	KPMG
Portugal	DELOITTE	DELOITTE
Romania[84]	DELOITTE	-
Slovenia[84]	KPMG	-
Spain	ERNST & YOUNG	ERNST & YOUNG
Sweden	DELOITTE	DELOITTE
United Kingdom	PRICEWATERHOUSECOOPERS	PRICEWATERHOUSECOOPERS

Source: IAB.

The following table is a ranking of the Big 4 in terms of number of mandates and sum of audit firms' turnover on regulated markets.

[84] Turnover not available in these Member States.

Table 59: Ranking of the Big 4 on EU regulated markets

Big 4	Number of mandates	Sum of audited companies' turnover (€M)
DELOITTE	767	2,147,379
ERNST & YOUNG	737	2,213,215
KPMG	876	2,539,305
PRICEWATERHOUSECOOPERS	852	3,044,775

Source: IAB.

Pricewaterhouse Coopers, as the largest Big 4 in the EU, has been retained for the simulation (PWC ranks number one in terms of turnover of audited companies and number two in terms of mandates).

The behaviour of the demised firm's clients seems to depend on the market's concentration level. When Arthur Andersen disappeared in 2002, the London Economics study reported that 87% of its clients in the US settled for a Big 4 (versus 51% of its clients in Europe).

Today, given the current concentration levels in the EU, the demise of a Big 4 audit firm would certainly lead to more conservative behaviours from audit clients than in 2002, because:

- Many listed firms would not consider using a mid-tier firm because they perceive that their investors "need" the signature and seal of a Big 4;
- Decision-makers usually appear rather conservative when selecting key service providers, hence a preference for a Big 4 in order not to be challenged by top management;
- Only a few mid-tier firms operate widely (i.e. have more than 10 mandates) in the Member States, suggesting a limited availability of mid-tier alternatives for truly international listed companies.

The HHI index can be used to compare situation in the US in 2001 before the demise of Arthur Andersen and situation today in Europe regarding concentration levels:

- According to calculation in section IV.2. (table 38), the EU HHI average for all listed companies in turnover in 2009 is 2,709;
- In the US, HHI index for Public companies in turnover was around 2,100 in 2001[85].

In order to reflect this increase in concentration levels all over Europe, two different assumptions were made, the first one simulating the highest levels possible in terms of concentration increase and the lowest reflecting the situation in the US in 2002:

- Assumption A - High Case: 100% of the clients of a failing Big 4 settle for one of the remaining Big 3, and this, proportionally with the Big 3's market share;
- Assumption B – Low Case: 87% of the clients of a failing Big 4 settle for one of the remaining Big 3 (proportionally with the Big 3's market share) and 13% settle for other active firms in the market (proportionally with their market shares), as it happened in the US in 2002.

[85] GAO, *"Public Accounting Firms, Mandated Study on Consolidation and Competition"*,2003.

It was also considered that the remaining audit firms would have the capacity to absorb the clients of the failing Big 4 audit firm, as it was the case in 2002. This assumption can be explained by one main reason: in case of the failing of a Big 4 audit firm, the number of accountants and the number of clients companies would remain the same, and employees of the failing Big 4 firm would be hired by the remaining Big 3 firms. The London Economics illustrates this point in its study published in 2006:

"A final point to note is that the potential supply of statutory audit services was little affected as the Arthur Andersen audit partners were picked up by the Big 4 firms as follows:

- *In Austria, Belgium, Denmark, Italy, Portugal, Netherlands, Spain, Sweden and the UK, the former Arthur Andersen audit partners joined Deloitte;*
- *In the Czech Republic, Estonia, France, Finland, Germany, Greece, Hungary, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Slovakia and Slovenia, the former Arthur Andersen audit partners joined Ernst & Young;*
- *Finally, in Ireland, the former Arthur Andersen audit partners joined KPMG."*[86]

IV.4.2 Simulation

Two scenarios with respective high and low cases have therefore been simulated:

- Scenario 1: demise of the number one Big 4 (Pricewaterhouse Coopers) on a European scale
  - Scenario 1A: 100% of the clients of PWC settle for one of the remaining Big 3;
  - Scenario 1B: 87% of the clients of PWC settle for one of the remaining Big 3 and 13% settle for other firms in the market.
- Scenario 2: demise of the number one Big 4 in a Member State
  - Scenario 2A: 100% of the clients of the demise Big 4 settle for one of the remaining Big 3;
  - Scenario 2B: 87% of the clients of the demise Big 4 settle for one of the remaining Big 3 and 13% settle for other firms in the market

The following tables present the impact of the demise on the HHI for each scenario. The blue lines highlight cases that would raise concentration concerns on the basis of thresholds defined by the European Commission competition authorities, on the basis of both the current HHI and the potential delta HHI after a merger or acquisition (outlined above, e.g. concentration concern for an HHI above 2,000 and a delta HHI above 150).

[86] *"Study on the Economic Impact of Auditors' Liability Regime"*, London Economics, 2006.

Scenario 1: demise of Pricewaterhouse Coopers

Table 60: Impact of the demise of Pricewaterhouse Coopers (concentration ratios by number of mandates)

Member State	Current HHI	Scenario 1A (100%)		Scenario 1B (87%)	
		Post-demise HHI	Delta	Post-demise HHI	Delta
Austria	2044	2549	505	2475	431
Belgium	1363	1788	425	1717	354
Bulgaria	170	179	10	178	8
Cyprus	2178	3374	1196	3118	940
Czech Republic	1634	2202	567	2082	447
Denmark	1876	2578	702	2441	565
Finland	2690	3893	1203	3564	874
France	740	908	168	882	141
Germany	1110	1493	383	1412	302
Greece	1563	1602	39	1629	66
Hungary	702	885	183	829	127
Ireland	3127	4853	1726	4440	1313
Italy	2064	2720	657	2521	457
Lithuania	2053	2666	613	2460	407
Luxembourg	1474	1908	434	1835	361
Malta	2742	3892	1150	3624	882
Netherlands	2019	2629	610	2526	507
Poland	1010	1251	242	1214	205
Portugal	1821	2671	849	2502	681
Romania	290	342	52	334	44
Slovakia[87]	850	850	0	850	0
Slovenia[87]	1672	1672	0	1672	0
Spain	2044	2910	865	2728	684
Sweden	2463	3090	626	2815	352
United Kingdom	1394	1819	425	1702	308

Sources: ESCP Europe analysis based on data from Thomson, Bureau Van Dijk and Annual reports.

[87] PWC does not operate in the Member State.

Table 61: Impact of the demise of Pricewaterhouse Coopers (concentration ratios by turnover)

Member State	Current HHI	Scenario 1A (100%)		Scenario 1B (87%)	
		Post-demise HHI	Delta	Post-demise HHI	Delta
Austria	2283	2735	452	2683	400
Belgium	2260	2794	534	2752	492
Bulgaria	873	1109	236	1070	197
Cyprus	2737	3971	1234	3666	929
Czech Republic	2402	2926	524	2960	558
Denmark	3495	4728	1233	4598	1103
Finland[88]	4000	3864	-137	3316	-684
France	1840	2292	452	2246	406
Germany	3294	5037	1743	4576	1282
Greece	1734	2020	286	1891	157
Hungary	3912	5578	1666	5280	1368
Ireland	3002	3941	938	3570	567
Italy	2787	3347	559	3016	229
Lithuania	3080	4307	1227	3882	802
Luxembourg	4469	5967	1497	5726	1256
Malta	2808	4136	1327	3907	1099
Netherlands	2353	2946	594	2756	404
Poland	2272	2809	537	2726	454
Portugal	3246	4417	1171	4218	972
Slovakia[89]	5302	5302	0	5302	0
Spain	4003	4744	742	4634	631
Sweden	3457	4288	831	3785	328
United Kingdom	2926	3338	412	2983	57

Sources: ESCP Europe analysis based on data from Thomson, Bureau Van Dijk and Annual reports.

[88] PWC is so dominant on the market (58% market share by turnover vs. 22% market share for the second firm) that its demise would allow a more balanced breakdown of market shares and thus would lead to a decrease in HHI.

[89] PWC does not operate in the Member State.

Scenario 2: demise of the number one Big 4 in a Member State

Table 62: Impact of the demise of the number one Big 4 in a Member State (concentration ratios by number of mandates)

Member State	Current HHI	Scenario 2A (100%)		Scenario 2B (87%)	
		Post-demise HHI	Delta	Post-demise HHI	Delta
Austria[90]	2044	2164	120	1946	-97
Belgium	1363	1531	168	1409	46
Bulgaria	170	185	16	181	12
Cyprus	2178	2874	696	2544	366
Czech Republic	1634	2082	448	1944	310
Denmark	1876	2590	715	2353	477
Finland	2690	3893	1203	3564	874
France	740	937	197	885	145
Germany	1110	1404	294	1294	184
Greece	1563	1602	39	1629	66
Hungary	702	885	183	829	127
Ireland	3127	4531	1404	4077	950
Italy	2064	2720	657	2521	457
Lithuania	2053	2666	613	2460	407
Luxembourg	1474	1871	397	1755	281
Malta	2742	3892	1150	3624	882
Netherlands	2019	2660	641	2503	484
Poland	1010	1295	286	1222	212
Portugal	1821	2129	307	1910	88
Romania	290	345	55	324	34
Slovakia	850	1050	200	1021	171
Slovenia[91]	1672	1855	183	1668	-3
Spain	2044	2368	324	2118	74
Sweden	2463	4186	1723	9996	7533
United Kingdom	1394	1819	1394	1702	1394

Sources: ESCP Europe analysis based on data from Thomson, Bureau Van Dijk and Annual reports.

[90] KPMG is so dominant on the market (38% market share by mandates vs. 17% market share for the second firm) that its demise would allow a more balanced breakdown of market share and thus would lead to a decrease in HHI.

[91] KPMG is so dominant on the market (34% market share by mandates vs. 12% market share for the second firm) that its demise would allow a more balanced breakdown of market share and thus would lead to a decrease in HHI.

Table 63: Impact of the demise of the number one Big 4 in a Member State (concentration ratios by turnover)

Member State	Current HHI	Scenario 2A (100%)		Scenario 2B (87%)	
		Post-demise HHI	Delta	Post-demise HHI	Delta
Austria	2283	3256	973	2967	683
Belgium	2260	2860	600	2748	488
Bulgaria	873	1029	156	980	107
Cyprus	2737	3949	1212	3622	885
Czech Republic	2402	2926	524	2960	558
Denmark[92]	3495	3123	-372	2973	-522
Finland[93]	4000	3864	-137	3316	-684
France	1840	2357	517	2269	430
Germany	3294	4764	1470	4256	962
Greece	1734	2020	286	1891	157
Hungary	3912	4668	756	4024	112
Ireland	3002	3941	938	3570	567
Italy	2787	3347	559	3016	229
Lithuania	3080	4307	1227	3882	802
Luxembourg[94]	4469	3465	-1004	2939	-1530
Malta	2808	4152	1344	3886	1078
Netherlands	2353	2946	594	2756	404
Poland	2272	2803	531	2553	281
Portugal	3246	4209	963	3711	465
Slovakia	5302	7051	1749	5735	433
Spain[95]	4003	4046	43	3474	-529
Sweden	3457	4288	831	3785	328
United Kingdom	2926	3338	412	2983	57

Sources: ESCP Europe analysis based on data from Thomson, Bureau Van Dijk and Annual reports.

[92] KPMG is so dominant on the market (53% market share by mandates vs. 20% market share for the second firm) that its demise would allow a more balanced breakdown of market share and thus would lead to a decrease in HHI.

[93] PWC is so dominant on the market (58% market shares by mandate vs. 22% market share for the second firm) that its demise would allow a more balanced breakdown of market share and thus would lead to a decrease in HHI.

[94] Deloitte is so dominant on the market (63% market share by mandates vs. 16% market share for the second firm) that its demise would allow a more balanced breakdown of market share and thus would lead to a decrease in HHI.

[95] Deloitte is so dominant on the market (57% market share by mandates vs. 23% market share for the second firm) that its demise would allow a more balanced breakdown of market share and thus would lead to a decrease in HHI.

IV.4.3 Conclusion

The demise of a Big 4 at a European scale or at a national scale would equally have a negative impact on concentration levels in most Member States:

	Scenario 1		Scenario 2	
	Scenario 1 A	**Scenario 1 B**	**Scenario 2 A**	**Scenario 2 B**
Member States with concentration concerns (market shares calculated by mandates)	17 out of 25 Member States	17 out of 25 Member States	16 out of 25 Member States	12 out of 25 Member States
Member States with concentration concerns (market shares calculated by turnover)	20 out of 23 Member States	18 out of 23 Member States	17 out of 23 Member States	14 out of 23 Member States

According to stakeholders, the probability of the demise of a Big 4 at a European scale is relatively low. However, the failure of a Big 4 in one Member State following a national scandal is perceived as plausible, and this could result in a global failure if it happened in the largest Member States (as happened with Arthur Andersen globally following their demise in the US). Considering the high impact on concentration levels that would result from such a failure, possible safety measures should be considered (i.e. the rules set out in the Dodd-Frank Wallstreet Reform and Consumer Protection Act[96]; public oversight of the audit sector at a European level, etc.). Moreover, over the medium term, measures to encourage the development of mid-tier firms should be considered.

[96] Section 165(d) of the Dodd-Frank Act requires each nonbank financial company supervised by the Federal Reserve Board and each bank holding company with total consolidated assets of $50 billion or more to submit a resolution plan in case of orderly liquidation, or “living will,” that includes information regarding: the manner and extent to which any insured depository institution affiliated with the company is protected from risks from the activities of any nonbank subsidiaries of the company; full descriptions of the ownership structure, assets, liabilities, and contractual obligations of the company; identification of the cross-guarantees tied to different securities identification of major counterparties; a process for determining to whom the collateral of the company is pledged; and any other information that the Board and the FDIC jointly require by rule or order.

IV.5 Focus on the fifth criterion: audit price levels

IV.5.1 Objectives and methodology

There is a perception that in highly concentrated markets, prices tend to be high because leading firms are in a position of strength vis à vis their clients.

The following analysis aims at verifying this assumption. Because of the lack of reliable data, the analysis is based on the main index markets for which audit fees are disclosed in the annual reports. Indeed, audit fees appearing in financial databases used cannot be considered as solid enough for the analysis (numerous data gaps, significant discrepancies when comparing the Thomson Research to the Osiris figures on this specific data point, etc.). The method used consisted, for each Member State, in pulling out audit fees disclosed in each annual report of companies listed on the main index.

To assess price levels, audit fees paid by audited companies as a percentage of their turnover was retained to reduce biases related to company sizes (e.g. the United Kingdom average audit fees paid are lower as there are more smaller companies in its main index).

Only the Member States for which the percentage of main index companies with significant published data have been considered in the following analysis (more than 50% of companies with published data for the Member State), since the number of companies are not statistically representative below that threshold.

It should also be noted that the data on audit fees presented in the next tables include both audit and audit-related fees, as there were no available data on audit fees only. As such, this analysis can be considered as a sensible proxy for analysing the correlation between statutory audit fees and concentration level, since non-audit services account for a relatively consistent share of revenues across the Member States.

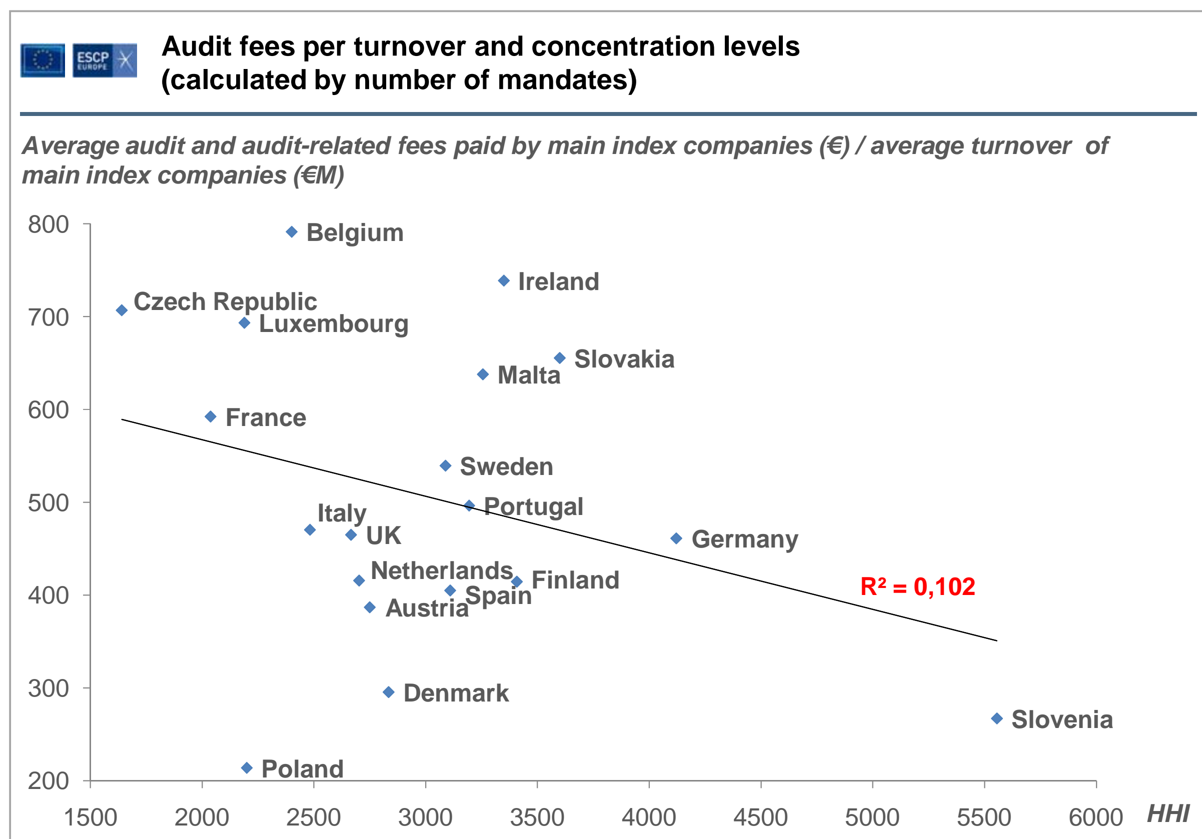
IV.5.2 Price levels analysis

Table 64: Comparison between audit fees and concentration levels (2009)

Member State	Average audit fees paid by main index companies (€M)	Average audit and audit-related fees paid by main index companies (€) / Average turnover of main index companies (€M)	HHI (by number of mandates)	HHI (by turnover)
Austria	1,8	387	2750	2482
Belgium	10,9	792	2401	2361
Czech Republic	2,4	707	1641	2488
Denmark	2,1	295	2834	3594
Finland	2,5	414	3408	4071
France	17,7	592	2038	2076
Germany	16,8	461	4121	3944
Ireland	2,8	739	3350	3069
Italy	6,3	470	2482	2916
Luxembourg	2,5	693	2189	4641
Malta	0,1	638	3256	3206
Netherlands	9,6	416	2702	3308
Poland	0,7	214	2200	2762
Portugal	1,7	496	3195	3689
Slovakia	0,2	655	3600	8404
Slovenia	0,4	267	5556	N.A.
Spain	5,8	405	3110	4105
Sweden	5,3	539	3089	3894
UK	8,8	465	2666	3237

Sources: ESCP Europe analysis based on data from AMF, Annual reports and Financial Director.

Figure 28: Audit fees per turnover vs. concentration levels (calculated by number of mandates)



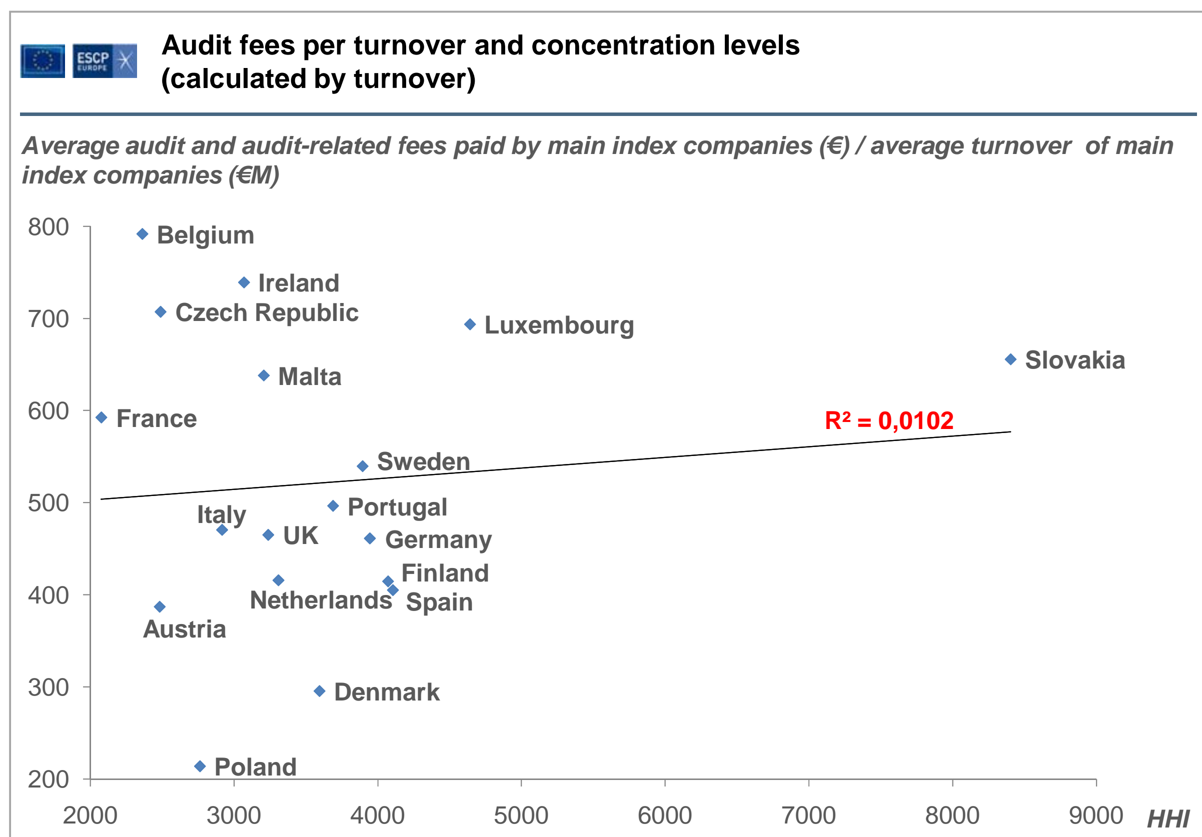
Sources: ESCP Europe analysis based on data from AMF, Annual reports and Financial Director.

Caveat: Data for audit fees presented in the analysis above are audit and audit-related fees, as there were no data available for audit fees only.[97]

This correlation analysis is based on averages and on too small a sample to be considered as statistically representative.

[97] *As such, this analysis can be considered as a sensible proxy for analysing the correlation between statutory audit fees and concentration level, since non-audit services account for a relatively consistent share of revenues across the Member States.*

Figure 29: Audit fees per turnover vs. concentration levels (calculated by turnover)



Sources: ESCP Europe analysis based on data from AMF, Annual reports and Financial Director.

Caveat: Data for audit fees presented in the analysis above are audit and audit-related fees, as there were no data available for audit fees only.[98]

This correlation analysis is based on averages and on too small a sample to be considered as statistically representative.

The above two figures (comparison of audit and audit-related fees paid by main index companies per average turnover and HHIs by number of mandates or by turnover) do not demonstrate a correlation between price levels and concentration levels, as supported by the following examples:

- Belgium, which is one of the least concentrated markets, has relatively high audit fees per turnover. On the other hand, France, which is also one of the least concentrated markets, has average audit fees per turnover;
- Germany, which is one of the most concentrated markets, has average fees per turnover. On the contrary, Slovakia has one of the highest fees per turnover and is one of the most concentrated markets (by turnover).

[98] *As such, this analysis can be considered as a sensible proxy for analysing the correlation between statutory audit fees and concentration level, since non-audit services account for a relatively consistent share of revenues across the Member States.*

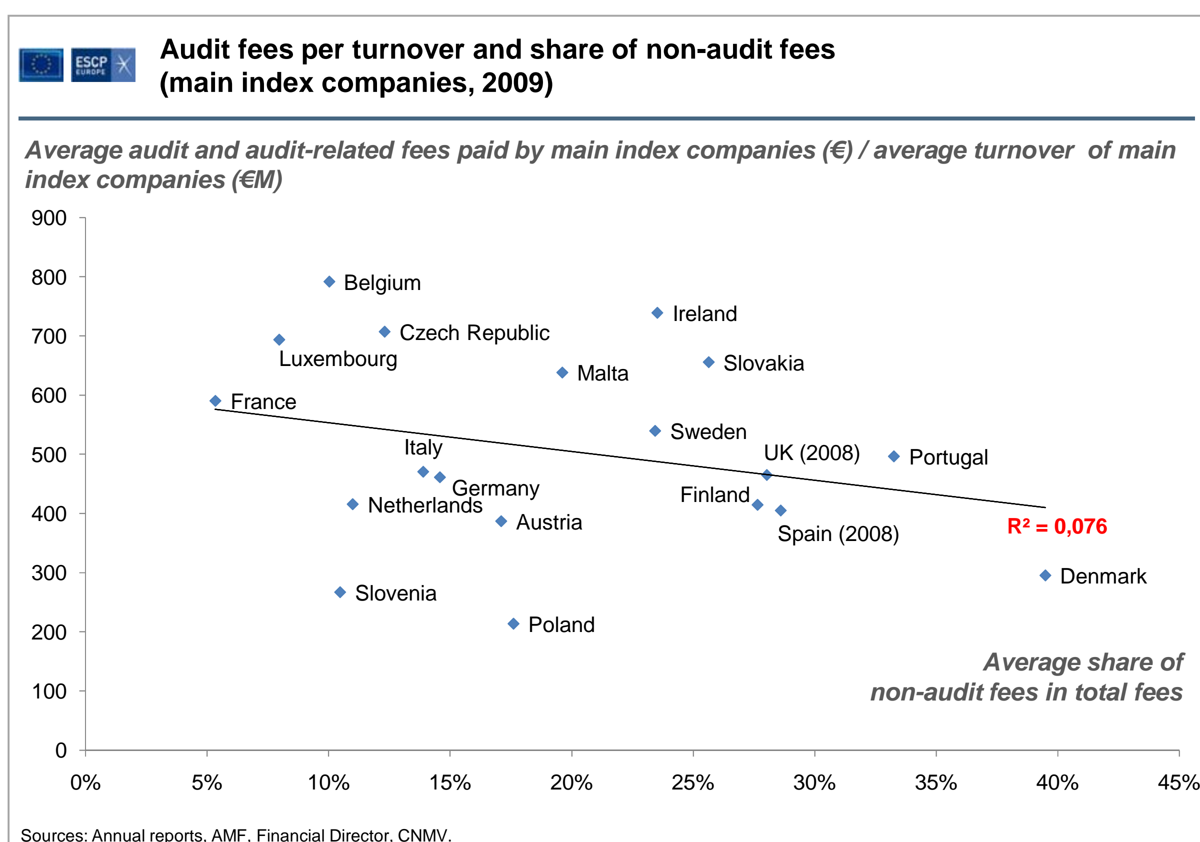
IV.5.3 Focus on the provision of non-audit services and potential impact on audit fees

IV.5.3.1 Correlation between the share of non-audit fees and average audit fees

There is a general perception that the provision of non-audit services may have an impact on the level of audit fees. Large audit firms may use the audit business as a loss leader to boost fees from non-audit services, thus creating a barrier to entry for mid-tier firms not providing them.

To assess whether this assumption is true, the following figure analyses the correlation between the share of non-audit services and the average fees for audit and audit-related services.

Figure 30: Audit fees vs. share of non-audit fees (main index companies)



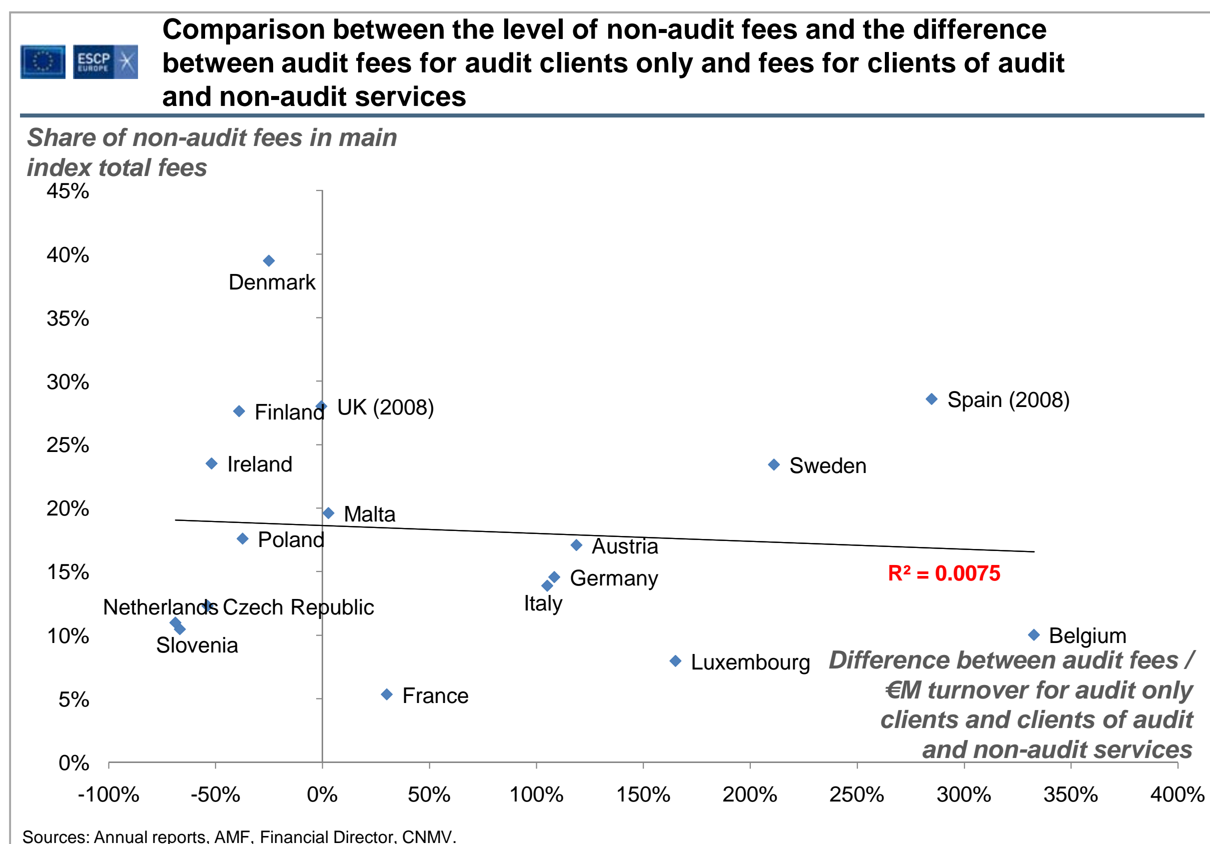
Caveat: Data for audit fees presented in the analysis above are audit and audit-related fees, as there were no data available for audit fees only.[99]

This correlation analysis is based on averages and on too small a sample to be considered as statistically representative.

[99] *As such, this analysis can be considered as a sensible proxy for analysing the correlation between statutory audit fees and concentration level, since non-audit services account for a relatively consistent share of revenues across the Member States.*

The average audit and audit-related fees compared to turnover do not appear correlated with the share of non-audit fees, i.e. the average audit fees do not seem to be lower when the share of non-audit fees is higher.

Figure 31: Comparison between the share of non-audit fees and the difference between audit fees for audit clients only and fees for clients of audit and non-audit services per Member State



Caveat: Data for audit fees presented in the analysis above are audit and audit-related fees, as there were no data available for audit fees only.[100]

This correlation analysis is based on averages and on too small a sample to be considered as statistically representative.

The figure 31 fails to demonstrate that there is a correlation between the level of non-audit fees and the difference of prices between fees for audit-only clients and clients of both audit and non-audit services. Consequently, the impact of the provision of non-audit services on average level of audit fees cannot be proved.

[100] *As such, this analysis can be considered as a sensible proxy for analysing the correlation between statutory audit fees and concentration level, since non-audit services account for a relatively consistent share of revenues across the Member States.*

IV.5.3.2 Cross-subsidization

There is a common perception among mid-tier firms and regulators interviewed that statutory audit is used by Big 4 audit firms as a loss leader:

- *"Even though there is no statistical survey to demonstrate it, using statutory audit as a loss leader is a common practice among the Big 4."* Public audit oversight body
- *"It is obvious that the Big 4 win markets thanks to aggressive audit prices, because they know that they are going to compensate them through non-audit services."* Mid-tier audit firm
- *"Audit is sometimes considered as a loss leader. Non-audit services usually have higher margins."* Mid-tier audit firm

Several academics also mention the use of audit fees as a loss leader:

- Piot and Schatt[101] [2010] consider that the strict regulation in France on the provision of non-audit services to audit clients allows *"not to sacrifice statutory audit as a loss leader"*;
- Quick and Rasmussen [2009] assess that *"based on the current situation in the audit market, where audit services have low margins, it could be assumed that knowledge spillovers from consulting services are not used to increase audit quality but to reduce audit costs."*[102]

IV.5.3.3 Conclusion on the impact of the provision of non-audit services to audit clients

While no correlation could be shown between the level of non-audit fees and the difference in prices between fees for audit-only clients and clients of both audit and non-audit services, academics, auditors and regulators consider that non-audit services are used by audit firms as a loss leader.

[101] *Does audit regulation benefit to the public interest? Some learnings from the French model* – Piot and Schatt, 2010.

[102] *Auditor Independence and the provision of non-audit services: perceptions by German Investors* – Quick and Warming-Rasmussen, International Journal of Auditing, Vol. 13, Issue 2, June 2009.

IV.6 Focus on the sixth criterion: independence of audit firms

Two main issues are analysed to assess the independence of audit firm:

- The provision of non-audit services to audit clients;
- The overfamiliarity between audit firms and their clients, with the lack of audit firm rotation.

IV.6.1 Provision of non-audit services to audit clients

IV.6.1.1 Definition of non-audit services and current regulations

IV.6.1.1.1 *Definition of non-audit services*

Audit firms have traditionally provided their audit and non-audit clients with a range of so-called non-audit (or non-assurance) services. Indeed, the demand for additional services in addition to the audit of financial statements has increased with the global development of companies, and the increasingly complex legal and tax environments. In addition, as the major audit firms have expanded their international networks and developed their sector expertise, they have leveraged their capacity to provide a wide range of services. The main non-audit services can be grouped into four categories outlined in the following table:

Table 65: Categories of non-audit services

	Main non-audit services[103]
Accounting and bookkeeping services	- General accounting services; - Systems assurance; - Business risks assessment; - Internal audit, transaction services; - Advice on international accounting standards; etc.
Taxation and legal services	- Tax planning and compliance; - Tax audits and appeal services; - International tax advice and guiding; etc.
Corporate finance and business recovery	- Share issues and stock-market flotations; - Project and structured finance; - Mergers and acquisitions; - Debt management, insolvency; etc.
Business and management consultancy	- Strategy consulting; - Operational and organizational consulting; - IT consulting; etc.

Source: Key Note.

[103] Key Notes, 2010.

Certain specific services (usually referred to as “audit-related” services) are generally not considered as non-audit services because of their proximity with the audit work.

Member States have different definitions of non-audit services making it difficult to draw a clear line between audit-related and non-audit services. This can be demonstrated by taking French and UK regulators’ definition, outlined below.

IV.6.1.1.1.1 Audit-related and non-audit services as defined by the French audit regulator

The definition and scope established by the H3C[104] regarding procedures directly related to statutory audit and prohibited non-audit services are considered the strictest in the EU and are close to the definition of the United States through the Sarbanes-Oxley Act.

The French legislation has historically taken into account the fact that the provision of non-audit services by the statutory auditors to their audit clients could create a conflict of interest and compromise the independence of the auditor. However, until 2005, there was no exception set by law but only guidance (provided the Code of Deontology issued by the “Companie Nationale des Commissaires”, the French audit professional body). The 2003 Financial Security Law created an independent audit regulator, the H3C which issued a revised Code of Ethics for statutory auditors approved by the French Ministry of Justice in November 2005.

The French Code Ethics for Statutory Auditors:

- Prohibits the provision of non-audit services (“*any advice or service not falling within the scope of the procedures directly related to the statutory audit engagement, such as defined by the professional standards applicable in France*”) by the statutory auditor and its network affiliates to the audited entities (article 10 and 23);
- Restricts the non-audit services that can be performed by the networks affiliates to the parents and subsidiaries of the audited entity (article 24).

In article 10 of the French Code of Ethics, the H3C defines non-audit services as “*any advice or service not falling within the scope of the procedures directly related to the statutory audit engagement, such as defined by the professional standards applicable in France*”.

The procedures directly related to the statutory audit engagement, i.e. the so-called “audit-related services” are thoroughly described in each of the following “Normes d’Exercice Professionnel” (the professional standards applicable in France which are set by law):

- NEP 9010: « *Audit entrant dans le cadre de diligences directement liées à la mission du CAC* », i.e. audit of financial statements outside the requirement of the statutory audit;

[104] Haut Commissariat aux Comptes.

- NEP9020: « *Examen limité entrant dans le cadre des diligences liées à la missions du CAC* », i.e. review of the financial statements, for example review of interim financial statements for listed companies;
- NEP9030: « *Attestation entrant dans le cadre de diligences directement liées à la mission du CAC* », in which the statutory audit certifies for specific information the consistency with accounting records as well as legal or regulatory compliance, etc.;
- NEP9040: « *Constats résultant de procédures convenues avec l'entité* », i.e. reports on the factual findings resulting from agreed-upon-procedures, for example the certificates issued by external auditors in respect of research projects funded under the 7th EU Framework Programmes;
- NEP9050: *« Consultations entrant dans le cadre de diligences directement liées à la mission du CAC »* i.e. consultations about issues related to financial statements in which the statutory auditors provide information or give their opinion and recommendations;
- NEP9060: *« Prestations entrant dans le cadre de diligences liées à la mission du CAC rendues lors de l'acquisition d'entités »,* i.e. procedures requested by the audit client in respect of the financial statements and the financial information of companies acquired, these procedures being limited to those described in the above-mentioned list (NEP9010, NEP9020, NEP9050 Agreed-upon-procedures, NEP9050 Consultations).
- NEP9070: *« Prestations entrant dans le cadre de diligences liées à la mission du CAC rendues lors de la cessions d'entités »*, i.e. procedures requested by the audit client in respect of the financial statements and the financial information of the business(es) or entity(ies) it contemplates to sell, these procedures being limited to those described above in the NEP9060.

Non-audit services are then broken down into three categories:

- Services that are strictly prohibited;
- Services that that are assumed to potentially affect independence;
- Other non-audit services not included in the detailed description provided by article 24 of the French Code of Ethics for the first two categories.

More precisely, article 24 states that *"when a service is provided by member of the network to any entity controlled by or controlling the entity"*, the French statutory auditor must ensure that his/her independence is not affected by the provision of such services". It provides firstly with a list of three strictly prohibited services:

1. *"Preparing any information of an accounting or financial nature that is included in the consolidated financial statements to be audited by the French statutory auditor;*
2. *Designing or implementing internal control procedures or risk management procedures relating to the preparation or verification of accounting or financial information that is included in the consolidated financial statements to be audited by the French statutory auditor;*
3. *Performing any act of management or administration, either directly or as a substitute for management of the entity."*

It provides then a list of ten non-audit services which presumably affect the statutory auditor's independence if provided by a member of the networks:

1. *Bookkeeping, preparing and drawing up financial statements, compiling financial information or financial communication;*
2. *Recruitment of staff for a "sensitive position" in the entity, as defined in article 26*[105]*;*
3. *Participation in any decision-making process within the context of the design or implementation of financial information systems;*
4. *Provision of legal services or advice to personnel employed at "sensitive positions" in the entity, as defined in article 26;*
5. *Provision of services or advice related to financing matters or to financial information;*
6. *Provision of tax services or advice that could have an impact on the results of the entity whose financial statements are being audited (by the French statutory auditor);*
7. *Provision of legal services or advice that could have an influence on the structure or functioning of the person or entity being audited;*
8. *Defence of management's interests, or acting on their behalf, in connection with the negotiation, or search for partners in capital transactions or financing;*
9. *Representation of entities controlling or controlled by the entity being audited and their management before any jurisdiction, or participating as an expert in a dispute in which such entities are involved;*
10. *Taking full or partial charge of an outsourced service in the above-mentioned cases.*

The French code of Ethics also states that *"Should any one of these services be provided, the French statutory auditor shall analyse the circumstances and the related risks and, if necessary, shall apply appropriate safeguards. The French statutory auditor may only pursue the audit engagement if (the French statutory auditor) is in a position to substantiate that the service does not affect (the French statutory auditor's) professional judgement, opinion or the conduct of the audit. If in doubt, either the French statutory auditor or the entity whose financial statements are being audited, shall submit the matter for comment to the Haut Conseil du Commissariat aux Comptes (Statutory Auditors High Council)*".

The direct and obvious consequence of this strict regulation is that the average proportion of non-audit fees, within the total fees paid by companies on the French main index, is much lower than the European average (5.3% vs. an EU average of 19%).

[105] Article 26 of the French Code of Ethics: *"In accordance with this code, a member of the management team of an audit firm shall be considered to be any person able to influence the opinions expressed within the context of the statutory audit engagement or having decision-making power as regards the management, remuneration, promotion or supervision of the members of the statutory audit engagement team. Pursuant to the provisions of this code, the following shall be considered to have so-called "sensitive" positions within the entity whose financial statements are being audited: a) Any person acting in the capacity of corporate officer; b) Any employee of the entity responsible for keeping the accounts or preparing the financial statements and management reports; c) Any senior executive that may be able to influence the preparation of these financial statements and reports."*

IV.6.1.1.1.2 Audit-related and non-audit services as defined by the UK audit regulator

The definition and scope established by the UK Auditing Practices Board (part of the UK Financial Reporting Council) is detailed below as an example of definition for audit-related services. It defines audit-related services as *"those non-audit services [...] where the work involved is closely related to the work performed in the audit, and the threats to auditor independence are clearly insignificant and, as a consequence, safeguards need not be applied."*

According to the Auditing Practices Board, audit-related services include:

- *"Reporting required by the auditor under law or regulation;*
- *Reviews of interim financial information;*
- *Reporting on regulatory returns;*
- *Reporting to a regulator on client assets;*
- *Reporting on government grants;*
- *Reporting on internal financial controls when required by law or regulation;*
- *Extended audit work that is authorised by those charged with governance, performed on financial information or financial controls, where this work is integrated with the audit work and is performed on the same principal terms and conditions."*

French and UK examples show that it is difficult to find a shared definition of non-audit services. Moreover, while the French definition excludes audit-related services from the non-audit regulatory prohibition, the UK definition includes audit and audit-related services.

IV.6.1.1.2 ***Current regulations and guidelines on the share of non-audit services***

IV.6.1.1.2.1 Introduction

Since 2002 and the demise of Arthur Andersen, national regulators have been more and more concerned that the provision of non-audit services to audit clients may compromise the auditors' independence, and lead to conflicts of interest.

As mentioned in the EC Green Paper, *"there is no EU-wide ban preventing auditors from offering non-audit services to audit clients. According to Article 22 of the Directive, audit services should not be provided in cases where 'an objective, reasonable and informed third party would conclude that the statutory auditor's or audit firm's independence is compromised'. This rule applies also to the provision of non-audit services. Article 22 has so far been implemented in a very divergent manner across the EU."*

IV.6.1.1.2.2 Overall situation in the Member States

Since 2002, all Member States[106] have implemented requirements limiting the scope of services that an auditor may provide to audited companies. However, the requirements within Member States are not homogeneous and, generally, are set very loosely.

The IOSCO[107] 2007 *Survey on the regulation of non-audit services provided by auditors to audited companies* (which covers 13 out of 27 Member States) defines several required frameworks as follows:

- Basic threats and safeguard approach: focuses on *"general ethical conduct and the auditor's own self-assessment of any threats to his or her objectivity."* This required framework is that of the IFAC Code of Ethics before the 2009 revision[108];
- Threats and safeguards approach, with the addition of specific rules: this framework basically corresponds to Member States applying the IFAC Code of Ethics before its revision;
- Rules based approach, subject to broad principles: while this framework is more "rule-based", it also relies on a series of broad principles. The US adopted this type of framework in 2002 through the Sarbanes–Oxley Act.

Most Member States have adopted one of the two first approaches, which are more "principles based" than "rule-based".

IV.6.1.1.2.3 The United States

The United States adopted the Sarbanes-Oxley Act, (SOX Act) in July 2002 which introduced major changes to corporate governance and financial practices.

The legislation was enacted as a reaction to major corporate and accounting scandals – including those affecting Enron, Tyco International and WorldCom – to restore lost confidence of investors and eliminate potential conflicts of interest arising out of "non-audit services".

The Sarbanes-Oxley Act applies only to registered public accounting firms, and audit firms that provide auditing services to public companies registered with the SEC.

The SEC rules on audit independence cover five key areas:

- Prohibited Non-Audit Services;
- Audit Committee Approval of non-audit Services;
- Partner Rotation;
- Conflict of Interest; and
- Increased Communication and Disclosure.

[106] Except Czech Republic. Source: Response to the questionnaire regarding Lot 2 of this study.
[107] International Organisation of Securities Commissions.
[108] It should be noted that the IFAC Code of Ethics was drafted by IFAC members, that is to say auditors.

The act prohibits any registered audit firm from providing the following non-audit services to public companies:

- Bookkeeping;
- Financial information system design or implementation;
- Appraisal and valuation services;
- Actuarial services;
- Internal audit outsourcing;
- Management and human resources functions;
- Investment advising service;
- Legal Services;
- And expert services.

The United States thus can be seen as an example of rule-based principles concerning the provision of non-audit services to audit clients.

IV.6.1.1.2.4 Switzerland

The Swiss Federal Audit Oversight Authority (FAOA) considers the independence of auditors as a prerequisite for audit quality:

- *"The outward appearance of independence is a vital importance to third parties as far as the goal of reliable accounting and auditing is concerned."* FAOA;[109]
- *"The FAOA regards adherence to independence requirements as essential in assuring the quality of audit services and public confidence in those services"* FAOA.[110]

The provision of non-audit services is not prohibited in Switzerland. However, audit firms have to follow the Institute as "Independence guidelines"[111], which were revised in December 2010 to be in line with the revision of the Code of Ethics.

Several types of situations prevent the auditor from providing non-audit services. For example:

- The auditor cannot provide Corporate Finance services;
- If the auditor has any management responsibility in a company, or if they provide management consulting services, they cannot offer audit services to the client;
- An auditor cannot provide audit services to a company for which they provide IT services related to accounting.

Finally, since 2011, audit firms are required to file an ad hoc report when the ratio of non-audit fees for a public company client (as disclosed within the company's financial statements) exceeds 1/3 for two consecutive years.

Switzerland thus can be seen as another relevant example of rule-based principles concerning the provision of non-audit services to audit clients.

[109] "FAOA Activity Report", 2009
[110] "FAOA Activity Report", 2010
[111] "RICHTLINIEN ZUR UNABHÄNGIGKEIT 2007, Zuletzt geändert: 6. Dezember 2010"

IV.6.1.1.2.5 IFAC Code of Ethics

The IFAC Board (representing the IFAC members and associates, which are primarily national professional accountancy bodies and represent accountants employed in public practice, industry and commerce, government, and academia) has established the International Ethics Standards Board for Accountants (IESBA) which has issued the *Code of Ethics for Professional Accountants,* being ethical requirements that an IFAC member firm or body is mandated to respect. Between the requirement of the Code of Ethics and the requirements of local jurisdictions, the member body or firm is required to apply the most stringent standard.

This *Code of Ethics* aims at *"establishing the fundamental principles of professional ethics for professional accountants and [at providing] a conceptual framework that professional accountants shall apply in order to:*

a. *Identify threats to compliance with the fundamental principles;*
b. *Evaluate the significance of the threats identified;*
c. *Apply safeguards, when necessary, to eliminate the threats or reduce them to an acceptable level. Safeguards are necessary when the professional accountant determines that the threats are not at a level at which a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances available to the professional accountant at that time, that compliance with the fundamental principles is not compromised."* [112]

The fundamental principles defined by the *Code of Ethics* are integrity, objectivity, professional competence and due care, confidentiality and professional behaviour. Providing non-audit services is considered by the *Code of Ethics* as a threat to the compliance of the fundamental principle of objectivity, which is defined as the obligation not to *"allow bias, conflict of interest or undue influence of others to override professional or business judgments."*

The 2009 revision of the Code of Ethics (effective since January 1st, 2011) strengthens the independence requirements of auditors, particularly with a new set of restrictions on the provision of non-audit services to Public Interest Entities (PIEs)[113]. The following non-audit services are explicitly prohibited:

- Accounting and bookkeeping services in most cases;
- Tax calculations when they aim at preparing accounting entries for financial statements;
- Internal audit services that have an impact on accounting records or financial statements;
- Valuation services that have a material effect on the financial statements;
- Design or implementation of IT systems, significantly impacting financial reporting, accounting records or financial statements;

[112] *Handbook of the Code of Ethics for Professional Accountants* – IFAC, 2010 edition.
[113] Public Interest Entitiess are defined by the IFAC *Code of Ethics* as "all listed entities and any entity defined by regulation or legislation as a public interest entity or for which the audit is required by regulation or legislation to be conducted in compliance with the same independence requirements that apply to the audit of listed entities.

- Certain recruiting services.

For all types of non-audit services, the *Code of Ethics* also requires potential threats to independence to be considered.

Finally, the revised Code of Ethics introduces a prohibition on the evaluation of key audit partners performance regarding the provision of non-audit services to audit clients.

IV.6.1.2 Current levels of non-audit services

IV.6.1.2.1 *Objectives and methodology*

This section assesses the current level of non-audit services through the following two complementary analyses:

- The level of non-audit services in the large audit firms' turnover and for the years 2005-2009, based on historical data provided by the International Accounting Bulletin (IAB). The Member States covered by IAB are France, Germany, Italy, Ireland, the Netherlands, Poland, Spain, Sweden and the UK. IAB also published in 2006 an overall review of Nordic countries (including Denmark, Finland, Sweden, but also Island and Norway) that will be used here as a proxy for the EU Scandinavian Member States;
- The level of non-audit services in the audit fees disclosed by companies listed on the main index of each Member State, based on data provided by AMF[114] for France, the Financial Director magazine for the UK, CNMV[115] for Spain, and a compilation of main index companies' annual reports for all other Member States.

Scope

- Given the higher availability of data for 2009 compared to 2010, the reference year selected is 2009. Since not all companies disclosed their audit fees in 2009, the proportion of companies with available data is also be indicated;
- The IAB data does not provide a breakdown between audit and non-audit services, but it does provide a breakdown between "audit and accounting services" and other types of services. The category "audit and accounting services" includes statutory and non-statutory audit, but also other types of accounting services such as *"general accounting services, systems assurance, business risks assessment, internal audit, transaction services […] and advice on international accounting standards, etc."*[116];
- The IAB data focuses on top market players in some Member State (data was available for nine Member States), which may not be fully representative for the entire market. The coverage ratio (total audit revenues covered by IAB divided by total audit market size) is

[114] Autorité des Marchés Financiers.
[115] Comisión Nacional del Mercado de Valores.
[116] *Case COMP/M.2824 – Ernst & Young/Andersen Company*, 2002.

indicated on the top of each Member State's data in the table 67 *Evolution of the revenue breakdown of main audit firms per Member State (2005-2009).*

IV.6.1.2.2 *Share of non-audit revenues in auditors' turnover (2009)*

Table 66: Revenue breakdown of main audit firms per Member State (2009)

			Non-audit and accounting breakdown					
	Audit & accounting	**Non-audit & non-accounting**	Tax services	Manage-ment consulting	Corporate finance	Corporate recovery or insolvency	Litigation support	Others
France*	**61%**	**39%**	9%	2%	1%	0%	0%	26%
Germany	**46%**	**54%**	27%	7%	9%	1%	1%	9%
Ireland	**44%**	**56%**	24%	9%	8%	7%	1%	6%
Italy	**52%**	**48%**	13%	27%	3%	0%	1%	4%
Netherlands	**50%**	**50%**	28%	6%	2%	0%	0%	14%
Poland	**50%**	**50%**	23%	7%	4%	0%	1%	16%
Spain	**49%**	**51%**	22%	16%	3%	0%	0%	10%
Sweden*	**77%**	**23%**	13%	7%	2%	0%	0%	1%
UK	**36%**	**64%**	26%	22%	5%	3%	0%	9%

Source: ESCP Europe analysis based on data from IAB.

(*) 2008 for France and Sweden. 2008 was taken as reference year for France for its higher market coverage ratio and for Sweden as it is the only year for which IAB published a report.

The UK has the highest percentage of non-audit & non-accounting services at 64%.

Germany, Ireland, Italy, the Netherlands, Poland and Spain are all around 50%.

France (39%) and Sweden (23%) are below 50%.

However, as mentioned under "scope", the fees for accounting services cannot be separated from auditing resulting in the total revenue by audit firms resulting from services other than auditing is higher than shown in Table 66.

IV.6.1.2.3 *Evolution of non-audit revenues in auditors' turnover (2005-2009)*

Table 67: Evolution of the revenue breakdown of main audit firms per Member State (2005-2009)

		2005	2006	2007	2008	2009	2005-2009 Evolution of non-audit
France	Share of total market covered by IAB	20%	16%	13%	38%	n.a.	n.a.
	Audit & accounting	75%	73%	66%	61%	n.a.	
	Non-audit & non-accounting	**25%**	**27%**	**34%**	**39%**	n.a.	
Germany	Share of total market covered by IAB	20%	26%	26%	27%	26%	
	Audit & accounting	49%	49%	48%	49%	46%	
	Non-audit & non-accounting	**51%**	**51%**	**52%**	**51%**	**54%**	**+ 3 pts**
Ireland	Share of total market covered by IAB	n.a.	n.a.	11%	n.a.	15%	
	Audit & accounting	n.a.	n.a.	38%	n.a.	44%	
	Non-audit & non-accounting	n.a.	n.a.	**62%**	n.a.	**56%**	**- 6 pts vs. 07**
Italy	Share of total market covered by IAB	3%	1%	8%	30%*	38%*	
	Audit & accounting	n.r.	n.r.	n.r.	54%	52%	
	Non-audit & non-accounting	**n.r.**	**n.r.**	**n.r.**	**46%**	**48%**	**+2 pts vs. 08**
Netherlands	Share of total market covered by IAB	n.a.	40%	41%	35%	39%	
	Audit & accounting	n.a.	57%	42%	55%	50%	
	Non-audit & non-accounting	n.a.	**43%**	**58%**	**45%**	**50%**	**+ 7 pts vs. 06**
Poland	Share of total market covered by IAB	n.a.	n.a.	43%	53%	56%	
	Audit & accounting	n.a.	n.a.	44%	47%	50%	
	Non-audit & non-accounting	n.a.	n.a.	**56%**	**53%**	**50%**	**-6 pts vs. 07**
Spain	Share of total market covered by IAB	8%	n.a.	n.a.	12%	17%	
	Audit & accounting	53%	n.a.	n.a.	62%	49%	
	Non-audit & non-accounting	**47%**	**n.a.**	**n.a.**	**38%**	**51%**	**+ 4 pts**
UK	Share of total market covered by IAB	40%	42%	42%	42%	54%*	
	Audit & accounting	39%	40%	37%	40%	36%	
	Non-audit & non-accounting	**61%**	**60%**	**63%**	**60%**	**64%**	**+ 3 pts**

Source: ESCP Europe analysis based on data from IAB.

(*) To calculate IAB market coverage for 2008 and 2009 in Italy and for 2009 in the UK, the overall market turnover of these two Member States was estimated based on the historical average market growths.

Over 2005-2009, the share of non-audit and non-accounting services in auditors' revenues has increased in the majority of analysed Member States (Germany, Italy, Netherlands, Spain and UK) by

+3 to +4 points on average, the Netherlands having the highest increase (from 43% in 2005 to 50% in 2009). Ireland and Poland are the only two Member States where the share of non-audit services declined between 2007 and 2009.

The global evolution towards the increase of non-audit services is the result of the large audit firms' objective to develop non-audit activities. This can be illustrated by the large share of non-audit and non-accounting acquisitions by Big 4 firms since 1998[117].

IV.6.1.2.4 *Proportion of non-audit services in main index companies' audit fees*

Table 68: Breakdown of main index companies' audit fees per Member State (2009)

	Audit and audit-related fees	Non-audit fees	Number of companies in the main index	Share of companies with disclosed audit fees
Austria	82.9%	17.1%	20	100%
Belgium	90.0%	10.0%	20	95%
Bulgaria	n.r.	n.r.	15	7%
Cyprus	n.r.	n.r.	20	25%
Czech Republic	87.7%	12.3%	15	73%
Denmark	60.5%	39.5%	20	100%
Estonia	n.r.	n.r.	15	20%
Finland	72.4%	27.6%	25	100%
France	94.7%	5.3%	40	98%
Germany	85.4%	14.6%	30	100%
Greece	n.r.	n.r.	20	50%
Hungary	n.r.	n.r.	12	25%
Ireland	76.5%	23.5%	20	85%
Italy	86.1%	13.9%	39	95%
Latvia	n.r.	n.r.	32	22%
Lithuania	n.r.	n.r.	27	26%
Luxembourg	92.0%	8.0%	12	58%
Malta	80.4%	19.6%	18	94%
Netherlands	89.0%	11.0%	25	92%
Poland	82.4%	17.6%	20	95%

[117] See Tables 31 and 32 for details.

Portugal	66.7%	33.3%	20	80%
Romania	n.r.	n.r.	10	40%
Slovakia	74.4%	25.6%	5	60%
Slovenia	89.5%	10.5%	6	100%
Spain (2008)	71.4%	28.6%	35	94%
Sweden	76.6%	23.4%	29	100%
UK (2008)	72.0%	28.0%	131	73%
Average	81%	19%	25	71%

Sources: ESCP Europe analysis based on AMF, Annual reports and Financial Director. Data was considered as non relevant when less than half of the companies disclosed their fees.

The average proportion of non-audit fees included in total audit fees disclosed by companies from the main index is around 19%.

- The lowest share of non-audit fees is that of France (5.3%), where regulation on the provision of non-audit services is the strictest;
- In Portugal, Spain, the UK, Slovakia and Finland, where regulation on non-audit services is less strict, non-audit fees are close to 30% of total fees. In Member States such as Spain, non-audit fees can be performed by an audit firm's entity with a separate legal form (e.g. separate share capital), which, according to a survey by Quick, Reiner and Warming-Rasmussen increases the perceived independence of the audit firm[118];
- In Belgium, Czech Republic, Italy, Luxembourg, the Netherlands and Slovenia, where the regulation is partly based on the 2006/43/EC Directive, the share of non-audit fees is under the European average (between 8% and 14%);
- Austria, Malta, Poland and Sweden are in line with the European average.

With the caveat that fees received for accounting and auditing services cannot be separated, the ca. 19% of non-audit fees in the 27 Member States can be put in perspective with the ca. 20% non-audit fees in the US in 2009[119]. The US non-audit rate was around 50% in 2002 and strongly decreased after the implementation of the Auditor Independence Rules adopted by the SEC in 2002. The average EU ratio appears relatively moderate considering that no such strict regulation has been implemented at a European level.

[118] Quick, Reiner and Warming-Rasmussen – *Auditor Independence and the provision of non-audit services: perceptions by German Investors.* International Journal of Auditing, Vol. 13, Issue 2, June 2009.

[119] Audit Analytics, *Audit fees and non-audit fees, an eight year trend,* May 2011. Scope of the survey: audit fees paid by accelerated filers (companies *"whose public float (as opposed to market capitalization) exceeds $75 million as of the last day of their second quarter").*

IV.6.1.2.5 *Conclusion*

- Non-audit services account for a significant share of audit firms' fees ranging from 50% to 60% (with the exception of UK, France and Sweden);
- This share has tended to increase in the last five years, partly due to M&A activity targeting non-audit service providers;
- As regards independence of audit firms and the provision of non-audit services to statutory clients:
  - The current average level (19%[120]) stands at a comparable level to the US;
  - This rate ranges from 5% in France (due to stringent professional rules) to 30-40% in three or four Member States.

IV.6.1.3 Impact of the provision of non-audit services to audit clients on auditors' independence

A number of surveys have evaluated the impact of non-audit services on auditors' independence and audit quality. Non-audit fees included in total fees are usually compared with different indicators of earnings management that are used as proxies to measure auditors' independence (Frankel, Johnson and Nelson, 2002; Ashbaugh, LaFond and Mayhew, 2003; Chung and Kallapur, 2003, Francis and Ke, 2004; Larcker and Richardson, 2004; Van Houtert, 2010, etc.). These studies have given mixed evidence on whether non-audit services result in reduced independence:

[120] Caveat: This figure is based on IAB data which includes both audit and accounting services. The EU average can be thus understated.

Table 69: Surveys on the impact of non-audit services on auditors' independence

Authors	**Title**	**Date**	**Does the provision of non-audit services impair auditor's independence and audit quality?**
Van Houtert	*Financial reporting quality and non-audit services: evidence from the Netherlands*	2010	YES
C. Piot, A. Schatt	*Is audit regulation a public interest matter? Key learning from French model*	2010	NO
M. Ojo	*Regulating non-audit services: towards a principle based approach to regulation*	2009	YES (in some cases)
T. Sing-Chiu Lau, Y. M. Mensah	*Does the performance of on-audit services by auditors impair independence? Evidence from firms post-service performance*	2009	YES
J. Le Maux	*Non-audit fees and discretionary accruals: French case study*	2007	NO
S. Taylor, S. Taylor, C. Ruddock	*Non-audit services and earnings conservatism: is auditor independence impaired?*	2004	NO
H. Ashbaugh, R. LaFond, B. W. Mayhew	*Do non-audit services compromises Auditor independence? Further Evidence*	2003	YES
M. DeFond, K. Raghunandan, K.R. Subramanyam	*Do non-audit service fees impair auditor independence? Evidence from going concern opinion*	2002	NO
B. Arruñada	*The provision of non-audit services by auditors: let the market evolve and decide*	1999	NO

Similarly, the responses to the Green Paper on whether auditors should be able to provide non-audit services are mixed.

Table 70: Summary of the opinion of key stakeholders on the provision of non-audit services by auditors

Type of stakeholders	Opinion	Should the auditor be able to provide non-audit services?
Professional bodies	The vast majority of professional bodies say no to the prohibition of non-audit services	YES
Big 4	The Big 4 generally oppose a prohibition on non-audit services to audit clients although there is some appreciation for considering or restricting non-audit services to audit clients, (e.g. with the requirement for audit committee approval for non-audit services).	YES
Mid-tiers	The prohibition of non-audit services by audit firms is considered as an important measure to maintain independence by some SMPs, this prohibition only being applied to Public Interest Entities and systemic financial institutions. However, it is important for SMPs to propose such services; otherwise the existence of SMPs could be threatened.	No for Public Interest Entities and financial institutions
Investors	Non-audit services must be discouraged as they are sources of conflicts of interest, there should be requirements to establish appropriate protections in case of provision of non-audit services and better disclosure of non-audit services carried out by the auditor, to inform the shareholders	NO
Public authorities	The provision of non-audit services should not be prohibited, as it is argued that it increases the auditor’s knowledge of the company, and thus quality. A list of prohibited non-audit services could be a way forward though, and audit committees should take their responsibility for taking decision in case of the provision on non-audit services by the auditor for Public Interest Entities and financial institutions	YES
Provider of non-audit services	Competitors such as lawyers and tax advisors do not believe that auditors should be able to provide non-audit services	NO
Preparers, businesses and organisations of companies	From the perspective of audit quality, it is important to maintain diversity of skills in audit firms, and thus not to prohibit the provision of non-audit services	YES

Source: The Green Paper, Audit Policy: lessons from the crisis.

To illustrate the opinion of professional bodies, The Audit Inspection Unit of the Professional Oversight Board, a part of the Financial Reporting Council in the UK, published “key messages” to the audit profession, which include statements on the provision of non-audit services to audit clients:

- *"Firms must accept that non-audit services should not be provided where safeguards cannot appropriately mitigate threats to their independence. Surveys[121]of fee income show that the ratio of non-audit fees to audit fees for audit clients in the UK has declined over the years. However, the rate of decline has been small in recent years and the AIU[122] is concerned that one major firm has embarked on a growth strategy where a key driver is the development of non-audit services to be provided to non-audit clients."*Audit Inspection Unit, 2009/2010 Annual Report, 21st July 2010.

From the investor's perception *"the provision of both internal and external audit services by the same firm has obvious implications for audit independence in that the external audit firm will in effect audit its own work and may be taking on management functions."* This concern is corroborated in an article by Quick and Warming-Rasmussen[123] that investigated the impact of non-audit services on investors' perceptions of auditors' independence in Germany. According to this study, shareholders usually perceive a negative effect of non-audit services on auditor's independence.

Conclusion

Even though the provision of non-audit services to audit clients is regulated in all Member States, the regulations are heterogeneous and generally loosely set. As a result, the share of non-audit services within total fees on the main index varies from one Member State to another, from 5.3% in France to 39.5% in Denmark. In addition, the share of non-audit services has generally increased over the past few years.

Stakeholders' response to the on-line survey indicates general acceptance that certain non-audit services cannot be provided to companies by their auditors, including internal audit, valuations, litigations and tax optimization services.

Yet, should specific services be restricted, internal audit, valuation, litigation and tax optimisation should be the first to be concerned, in the opinion of regulators and audit firms responding to the online survey, as outlined below:

- Internal control review: 60%;
- Comfort letters (with respect to debt issuance for example): 55%;
- Due diligence services: 49%;
- Tax compliance services: 45%;
- Other corporate finance services: 38%;
- Recruitment services: 28%;
- IT systems services: 28%;
- Tax optimisation services: 25%;
- Litigation services: 17%;
- Valuation services: 17%;
- Internal audit services: 15%.

[121] "Key facts and trends in the accountancy profession", issued by the UK Oversight Board in June 2010.
[122] Audit Inspection Unit
[123] *Auditor Independence and the provision of non-audit services: perceptions by German Investors* – Quick and Warming-Rasmussen, International Journal of Auditing, Vol. 13, Issue 2, June 2009.

IV.6.2 Overfamiliarity between the auditors and their clients

Following the past financial scandals, the issues of auditors' independence and the potential overfamiliarity between auditor and client have been much debated. From the investors' point of view, the close relationship between auditor and client could give rise to dependence and the impairment of independence, particularly when the auditor has held the appointment or mandate for many years.

The incidence of changing auditors is quite low, particularly with large listed companies, as shown by the Oxera study in the UK:

Table 71: Average switching rate of audit mandates for companies of the FTSE 100 and FTSE 250 between 1998 and 2004 in the UK

	FTSE 100	FTSE 250
Average switching rate between 1998 and 2004 in %	2.1%	2.8%

Source: Oxera, "Competition and choice in the UK audit market", 2006.

Long audit tenure is also a topic that has been discussed in the US, as demonstrated by the recent speech of PCAOB Chair Doty (June 2011[124]):

"Enhancing the relevance of the auditor's report will do no good if we don't at the same time provide investors a sound basis for confidence in the audit. An audit has value to the public only to the extent that it is performed by a third party who is viewed as having no financial stake in the outcome.

As I've described, though, auditors face real pressures to please their clients. Too often, PCAOB inspectors find that auditors have failed to exercise the required scepticism and have accepted evidence that is less than persuasive. Indeed, the examples are galling in their simplicity.

For example, PCAOB inspectors found at one large firm that an engagement team was aware that a significant contract was not signed until the early hours of the fourth quarter. Nevertheless, the audit partner allowed the company to book the transaction in the third quarter, which allowed the company to meet its earnings target. Although the firm discussed the timing of the transaction with the customer, it failed to obtain persuasive evidence of an arrangement for revenue recognition purposes in the third quarter. The company had been an audit client of the firm for close to 50 years."

[124] *Rethinking the Relevance, Credibility and Transparency of Audits*, PCAOB Chair Doty, 2 June 2011.

Analyses have been conducted on audit tenure in the US to identify 20 large companies that have been audited by the same firm for the last 80 to 120 years:

Company	Auditor	Auditor since year:
Procter & Gamble	Deloitte	1890
Goodyear Tire & Rubber	Pricewaterhouse Coopers	1898
Radioshack Corp.	Pricewaterhouse Coopers	1899
Beamis	Pricewaterhouse Coopers	1907
General Electric Co.	KPMG	1909
Dow Chemical Co.	Deloitte	1910
American Electric Power	Deloitte	1911
J. C. Penney Co.	KPMG	1916
Ball Corp.	Pricewaterhouse Coopers	1920
Coca Cola Co.	Ernst & Young	1921
Caterpillar Inc.	Pricewaterhouse Coopers	1925
Kroger Co.	Pricewaterhouse Coopers	1925
Sherwin Williams Co.	Ernst & Young	1925
Goldman Sachs	Pricewaterhouse Coopers	1926
Schlumberger Ltd	Pricewaterhouse Coopers	1927
Dean Food Co.	Deloitte	1927
Kimberly Clark Corp.	Deloitte	1928
General Mills	KPMG	1928
FMC Corp.	KPMG	1928
Progress Energy Inc.	Deloitte	1930

Source: Reuters based on data compiled by Audit Analytics in December 2010.

Therefore, the currently low switching rates and consequently long audit tenures can raise the issue of potential auditor-company overfamiliarity, and negatively affect the trust investors have in the audit function.

IV.7 Focus on the seventh criterion: audit quality

The nature of the global financial crisis has put audit quality under the spotlight for many of the stakeholders.

Over the last two years, audit quality has become the subject of numerous enquiries and position papers from regulators, standards setters, governmental or parliamentary bodies.

After attempting to define what audit quality is, this section will first assess how critical quality issues are, and second discuss how quality interacts and impacts other market issues (i.e. concentration, price levels, independence of audit firms).

IV.7.1 Definition of audit quality

IV.7.1.1 Audit quality as defined by stakeholders

Academics, professional bodies and audit oversight bodies have all provided definitions of audit quality, in order to establish criteria against which auditors' performance may be assessed.

IV.7.1.1.1 *Academics*

One of the most common definitions of audit quality has been suggested by Linda DeAngelo: "*the market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system, and (b) report the breach*"[125].

Many academic studies have sought to investigate audit quality issues; however, as highlighted by both the FRC[126] and the PCAOB[127], they have not produced a common definition of a high quality audit that could be used as a standard and a basis for assessing actual auditors' performance. The PCAOB also suggested that "*academic studies that focused on many input-based factors have failed to find conclusive evidence of direct positive relationship with better audit quality*" and that "*measuring audit quality through output-based factors can also be problematic since the outcome of an audit is not immediately observable*", with "*simplistic indicators*" that "*cannot be viewed as true measures of higher audit quality*".

The results of our own review of the literature show that the main indicators used as proxies for audit quality are:

- The degree of earnings management based on abnormal working capital accruals;

[125] DeAngelo [1981] - Auditor Size and Audit Quality, published in the Journal of Accounting & Economics (December 1981, pp.183-199)
[126] FRC [November 2006] – Discussion paper – Promoting Audit Quality
[127] PCAOB [October 2008] – Discussion – Treasury Advisory Committee's Recommendation Relating to the Feasibility of Developing Key Indicators of Audit Quality and Effectiveness

- The frequency of qualified audit opinions or the propensity to issue a going-concern opinion for financially distressed companies.

The various studies on these audit-quality proxies, and the extent to which mandatory rotation, joint audits and the provision of non-audit services enhance audit quality and do not lead to any homogenous nor firm conclusions.

IV.7.1.1.2 *Professional standards*

The International Standard on Quality Control published in 2009 ("ISQC 1") does not define audit quality; however it includes a clear objective for guidance:

"*The objective of the firm is to establish and maintain a system of quality control to provide it with reasonable assurance that:*

(a) The firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and

(b) *The reports issued by the firm or engagement partners are appropriate in the circumstances*".

ISA 220 "Quality control for an audit of financial statements" has a similar objective.

"*The firm shall establish and maintain a system of quality control that includes policies and procedures that address each of the following elements:*

(a) Leadership responsibilities for quality within the firm;

(b) Relevant ethical requirements;

(c) Acceptance and continuance of client relationships and specific engagements;

(d) Human resources;

(e) Engagement performance;

(f) *Monitoring*".

IV.7.1.1.3 *The EU's Eighth Directive*

Article 40 of the Eighth Directive on Statutory Audit recommends the publication for public interest entities of an annual Transparency Report which includes, at least, the following information:

- Legal structure and ownership;
- Association with any network, and its structure and arrangements;
- Governance structure;
- Internal quality control system and leadership statement on its effectiveness;
- Date of last quality assurance review;
- List of public entities audited during the last fiscal year;
- Independence practices and confirmation of independence compliance review;

- Policy on continuing professional education;
- Financial information, such as total audit fees as a percentage of total revenues and fees charged for other assurance, tax, and non-audit services;
- Partners' compensation policies.

Some of these transparency requirements can be linked to audit quality, and the inspections undertaken by the audit oversight bodies of EU Member States include a review of the audit firms' assertions in their respective Transparency Reports regarding these items.

IV.7.1.1.4 ***Audit oversight bodies***

The FRC (Financial Reporting Council) has a leading position among audit oversight bodies in terms of its work and research on the audit quality issue.

Since the publication in November 2006 of its discussion paper "Promoting Audit Quality", it has developed an Audit Quality Framework[128] which is "*designed to support effective communication between auditors, audit committees, preparers, investors and other stakeholders on audit quality*". It does not define audit quality but aims at promoting the following key drivers of audit quality:

- *The culture within an audit firm;*
- *The skills and personal qualities of audit partners and staff;*
- *The effectiveness of the audit process;*
- *The reliability and usefulness of audit reporting;*
- *Factors outside the control of auditors affecting audit quality*.

These key drivers can be mapped with ISCQ1 key principles, which a system of quality control should address. For each of these drivers, the FRC has also developed a set of practical indicators that UK audit firms are invited to use in their Transparency Reports "*by setting out the steps that they are taking to achieve audit quality by reference to this Audit Quality Framework*".

One of the few definitions of audit quality provided by an oversight body has been suggested by the Audit Inspection Unit[129] (UK's independent inspection unit reporting to the Professional Oversight Board of the FRC): "*Undertaking a quality audit involves obtaining sufficient and appropriate evidence to support the conclusions on which the audit report is based and making objective and appropriate audit judgements [...]. A quality audit involves appropriate and complete reporting by the auditors which enables the Audit Committee and Board properly to discharge their responsibilities*".

[128] FRC [February 2008] – The Audit Quality Framework
[129] AIU [June 2005] – 2004/5 Audit Quality Inspections – Public Report

IV.7.1.2 Perceived audit quality and intrinsic audit quality

As stated by academics, audit oversight bodies and professional standards setters, a standard definition of audit quality is difficult to agree upon. This can be explained by the difficulty to measure audit quality, even for audit clients.

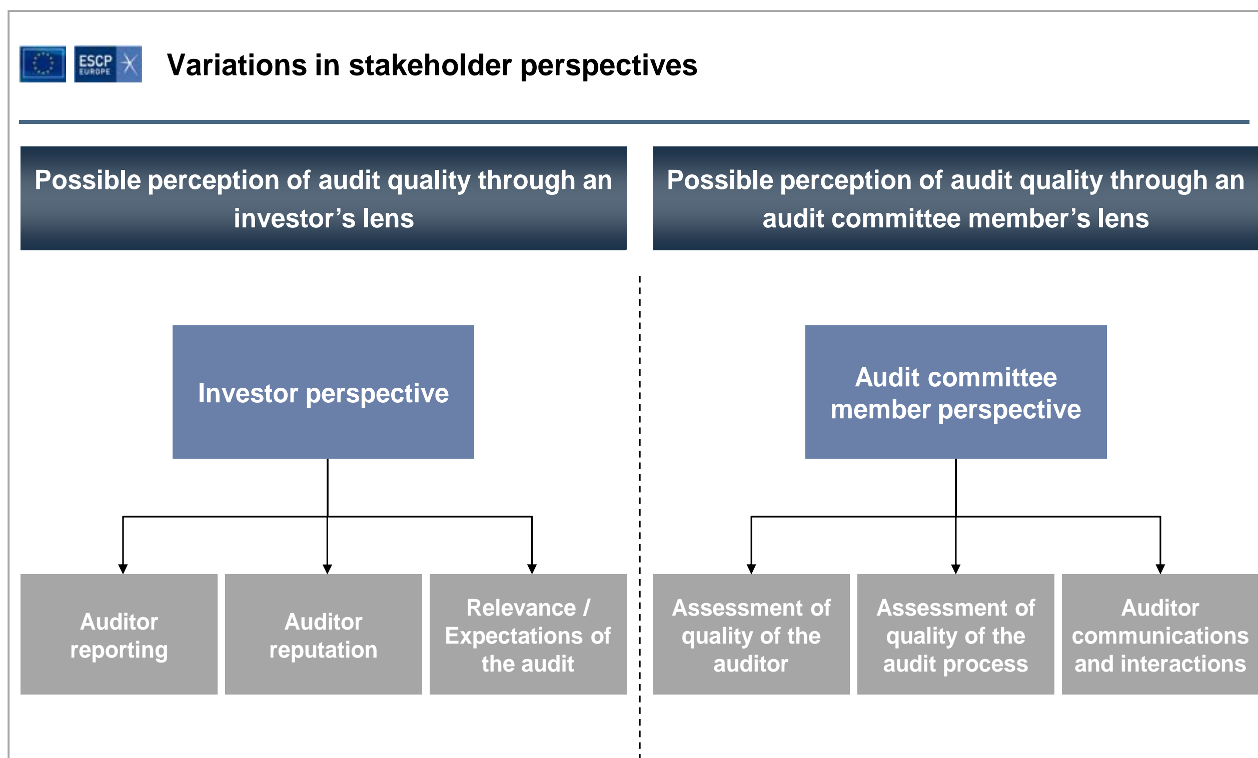
The House of Lords emphasizes this point stating that: *"As Professor Stella Fearnley of the University of Bournmouth said: 'The quality of audit is quite often unobservable to client themselves.'[130]"*, as they do not have sufficient, or useful information in the reports published by auditors.

The following analysis of the IAASB suggests a method to differentiate intrinsic audit quality and perceived audit quality, to be able to better measure the overall quality of audit.

According to the IAASB, many direct and indirect factors influence audit quality and their perceptions may depend on stakeholders: "*Perception of audit quality varies amongst stakeholders depending on the level of direct involvement in audits and on the lens through which they assess audit quality*".

An example of theses variations in stakeholder perspectives is presented in the following illustration:

Figure 32: Variations in stakeholder perspectives



Source: Audit Quality an IAASB Perspective [January 2011].

[130] *"Auditors: market concentration and their role"*,House of Lords, 2011.

The IAASB suggests that audit quality can be viewed in terms of three fundamental aspects which are:

- Inputs;
- Outputs;
- Context factors.

Inputs include auditing standards and audit processes. They are typically part of the items concerned by the controls undertaken by audit oversight bodies through their inspections. These indicators can be linked to the "intrinsic audit quality".

Outputs are mainly comprised of auditor reports and auditors' communications to those charged with governance. These indicators are commonly used by stakeholders to assess audit quality as they are easier to observe. They can be linked to the "perceived audit quality".

Context factors include laws and regulations, the corporate governance environment, and applicable financial reporting frameworks.

In conclusion, different stakeholders have different expectations, hence definitions, regarding audit quality.

In order to analyse how critical quality issues appear, IAASB's two separate concepts will be used:

- Intrinsic audit quality: factual/actual quality that can be measured;
- Perceived audit quality: potential issue following scandals and emphasised by recent crisis.

IV.7.1.3 Measure of intrinsic audit quality: areas covered by the inspection reports published by audit oversight bodies

To measure intrinsic audit quality, audit oversight bodies regularly carry out inspections on a limited number of audits. The main areas covered by these reports in France, the Netherlands, the United Kingdom and Germany are outlined below.

In France, the "Haut Conseil du Commissariat aux Comptes" controls at least every six years (every three years for public interest entities) the chartered auditors. The 2009 report gives the result of this inspection on the following topics:

- Process and organization;
- Human resources;
- Independence of the auditors;
- Internal quality control;
- Legal requirements application and compliance.

In the Netherlands, the AFM's[131] inspections were designed to answer the following questions:

- Does the audit firm ensure that the external auditor takes responsibility for the conduct of the statutory audit? Is the auditor able to fulfill this responsibility?
- Does the audit firm ensure that the external auditor conducts the audit in a structured manner, using an adequate audit approach, and with a documented audit file?
- Does the audit firm ensure that the external auditor of the financial statements assesses whether the general accounting policy regarding going concern is appropriate?
- Does the audit firm ensure that the external auditor, when acting as group auditor, is actively involved and exercises professional scepticism with regard to other foreign and non-foreign auditors engaged and thereby obtains assurance that he can rely on audit work carried out by these other auditors?
- Does the audit firm ensure that the external auditor obtains sufficient and appropriate audit evidence with regards to the existence and valuation of the following balance sheet items:
    - Financial assets (financial sector)?
    - Work in progress (construction sector/municipalities)?
    - Vehicles (automotive sector)?
    - Property (real estate sector/municipalities)?
- Does the audit firm ensure that the external auditor obtains sufficient and appropriate audit evidence with regards to completeness of revenue recognition?

In the United Kingdom, the AIU's review covers the following issues:

- "Tone at the top" and internal communications;
- Transparency reports;

[131] Authority for the Financial Markets.

- Independence and ethics;
- Performance evaluation and other human resources matters;
- Audit methodology, training and guidance;
- Client risk assessment and acceptance / continuance;
- Consultation and review;
- Audit quality monitoring;
- Other firm-wide matters.

Finally, in Germany, the Auditor Oversight Commission inspection scope covers:

- Client acceptance and independence;
- Partners evaluation and remuneration;
- Education and training;
- Engagement quality control review;
- Risks of breaches and irregularities;
- Audit of Going Assumption;
- Audit of measurement of goodwill and other assets and review of accounting estimates;
- Audit of the risk and forecast reporting in the management report;
- Reporting on the accounting policies, discretionary powers and grooming transactions;
- Risk-based audit approach;
- Use of work from external auditors;
- Use of experts.

As can be seen with the examples in these four Member States, the audit inspection scope varies from one country to another, and no standardised inspection is used. However, some key areas of concern from the audit oversight bodies can be highlighted, as they appear in most of inspections:

- Audit methodology and process;
- Audit quality monitoring;
- Independence of the auditors;
- Human resources;
- Risk assessment.

IV.7.2 Main audit quality challenges

IV.7.2.1.1 *Intrinsic audit quality*

As previously stated, intrinsic audit quality can be assessed through inputs which include auditing standards, auditors' attributes or audit process. Due to the confidentiality of audit work, the assessment of their appropriate use by audit firms can essentially be performed by audit oversight bodies through their inspections.

IV.7.2.1.1.1 Audit quality according to online survey respondents

As part of this study, we sought to measure the degree of satisfaction of stakeholders in respect of overall quality. The twenty-four Independent Regulators or Governmental bodies & Ministry officials who chose to answer the question "*How satisfied (on a scale of 1 (extremely unsatisfied) to 5 (extremely satisfied), 0 if you do not know) are you in respect of the following criteria when auditors are concerned [Overall quality]*" provided an average mark of 3.42 for Overall quality, with a standard deviation of 0.75. In order to ensure that the disclosed results are unbiased, we decided not to report the answers from the professional bodies that could be perceived as less independent regarding this issue[132].

Table 72: Satisfaction of the respondents of the online survey in terms of quality

How satisfied (on a scale of 1 (extremely unsatisfied) to 5 (extremely satisfied), 0 if you do not know) are you in respect of the following criteria in respect of auditors [Overall quality]	Responses
1 (Extremely unsatisfied)	0
2	3
3	10
4	9
5 (Extremely satisfied)	2
Total	**24**

Source: ESCP Europe online survey.

[132] Examples of professional body answer not taken into account in above table: ACCA, Latvian Association of Certified Auditors, Chamber of Financial Auditors of Romania, etc.

This result is however challenged by the general findings from the audit oversight bodies' inspections given their inspection findings. They conclude that there is a need for continuous efforts and improvements in this area.

IV.7.2.1.1.2 Audit quality according to audit oversight bodies

Overall results of audit quality from inspection reports in Germany, the Netherlands and the United Kingdom are presented below:

Figure 33: United Kingdom - AIU inspection report overall findings for the year 2010/11

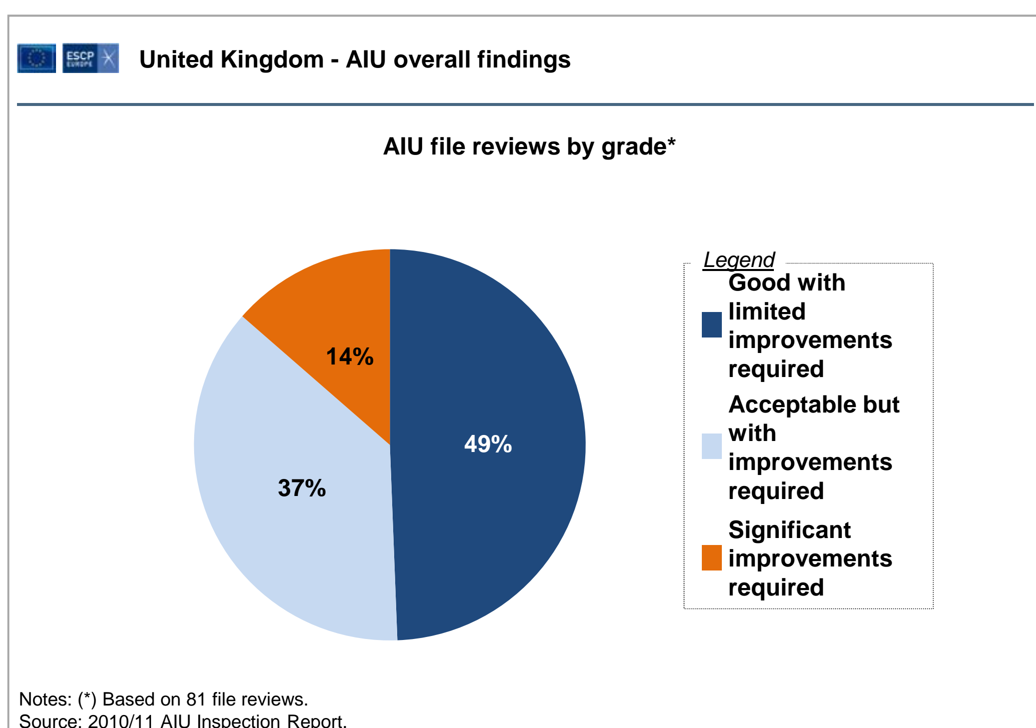


Figure 34: Netherlands – AFM inspection report overall findings for the year 2008

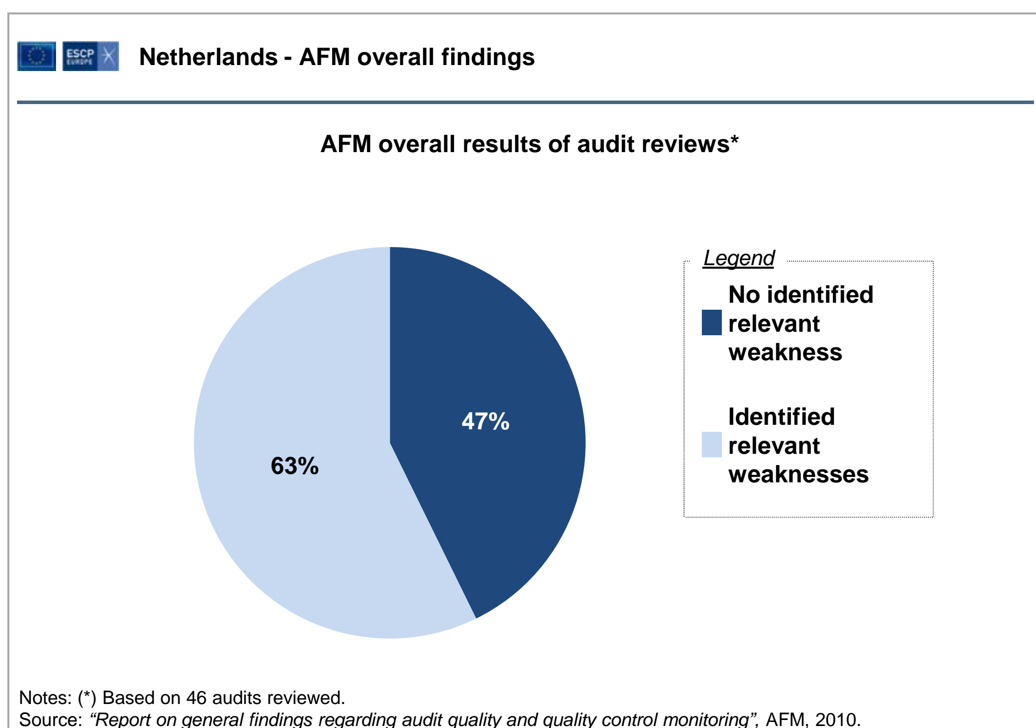
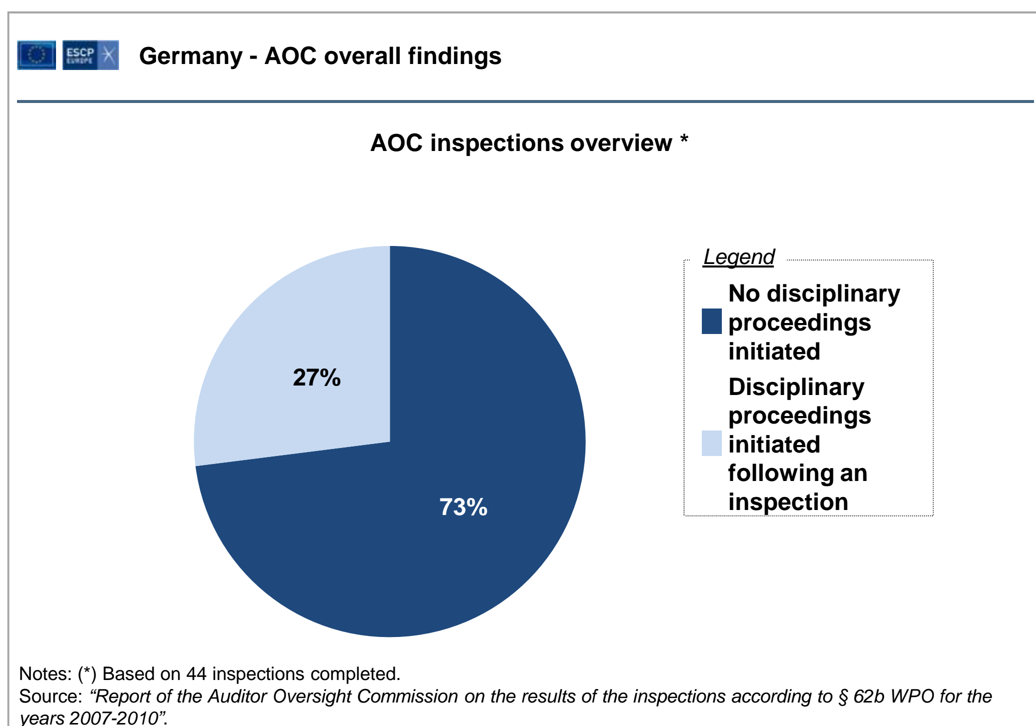


Figure 35: Germany – AOC inspection report overall findings for the year 2010



Note: no figures were available in French and Italian inspection reports, only qualitative perceptions were mentioned.

Two comments stand out when analysing inspections reports:

- On average, half of audit reports needed improvements and/or contained weaknesses;
- When analysing the available inspection reports in France, Germany, Italy, the Netherlands and the United Kingdom, the three following issues regarding audit quality appear to be the most often highlighted by the audit oversight bodies:
  - Professional scepticism: no sufficient professional scepticism was shown towards statements made by clients;
  - Audit evidence: the audit evidence did not provide sufficient assurance to support some opinions exposed;
  - Quality control: little evidence of quality control review appeared to the oversight bodies.

However, it should be mentioned that oversight bodies point out an improvement in audit quality over the past few years, with audit firms taking into account the inspectors' feedback.

IV.7.2.1.1.3 Audit quality according to IFIAR

The inspection findings reported by IFIAR members in their last three meetings (March 2010, September 2010 and April 2011) mainly concern the following areas:

- At the engagement level:
  - Exercise of professional scepticism;
  - Audit evidence and documentation;
  - Group audit;
  - Recognition and handling of fraud risk;
  - Revenue recognition;
  - Audit of fair values;
  - Audit of impairment;
  - Provision of non-audit services and other threats to independence.
- At the firm level:
  - Engagement Quality Control Review;
  - Firm's own internal inspection process;
  - Incentive and remuneration structure.

Stakeholders interviewed point out that firms tend to improve audit quality, either by implementing the recommendations of their audit oversight bodies or by taking action on their own.

This suggests that the implementation of inspections by audit oversight bodies has had a positive impact on enhancing intrinsic audit quality.

IV.7.2.1.2 *Perceived audit quality*

The perception of audit quality for stakeholders such as investors or audit committee members mainly relates to "outputs of the audit" as shown in the examples described by the IAASB in a recent publication[133]:

- Auditor reporting;
- Auditor communications and interactions;
- Relevance or Expectation of the Audit.

A few months after the publication of the "Audit Quality – An IAASB perspective" paper, the IAASB also launched a consultation paper[134] which aimed at exploring auditor reporting. It summarised the issues identified through recent discussions, public consultations and research studies about users' perceptions of the relevance and usefulness of auditor reporting:

- Even though independent auditor's opinion on an entity's financial statement is valued, the content of the auditor's report is not viewed as being as useful or informative as it could be;
- The communicative value of the auditor's report could be improved if changes were made to its structure and wording;
- Users also point out the existence of a gap between the information they believe is needed and what is made available to them in the entity's financial statements or other publicly available information (e.g. prospectus, annual reports, etc.).

These potential improvements of perceived audit quality can also be illustrated by the recent report published by the House of Lords[135], quoting clients expressing their needs regarding auditors' reports:

- "*In the words of Mr. Guy Jubb, Head of Corporate Governance at Standard Life Investments, 'The output of the audit is the audit report and that is what we see. We have very little transparency currently as to what the actual audit process involves(…) audit reports (…) are very, very standardised in their content… are often riddled with 'get out of jail free' clauses.' Mr. Jubb was nevertheless clear that 'The reliability we have to place upon audited financial information is the lifeblood of capital markets.'"*

Perceived audit quality is, therefore, strongly influenced by the communicative value of the auditor's report, the additional information that could be provided by the entity, and the related information that could be included in the auditor's report.

In conclusion, the most critical issue regarding quality, linked to the current financial turmoil, appears to be perceived quality for investors, rather than intrinsic audit quality.

[133] IAASB [January 2011] – Audit quality an IAASB perspective
[134] IAASB [May 2011] – Consultation Paper – Enhancing the Value of Auditor Reporting: Exploring Options for Change
[135] House of Lords [March 2011] – Auditors: Market concentration and their role.

IV.7.3 Review of the issues raised in terms of audit quality

IV.7.3.1 Does a high level of concentration have a negative impact on audit quality?

One of the questions raised by the European Commission regarding the reasons behind the financial crisis is the role of the auditors and the potential link between concentration of the audit market and audit quality. Several other stakeholders also question the relation between concentration levels and audit quality, among which The House of Lords and the OFT[136]:

- The House of Lords[137] seems to consider that "*there is inevitably a connection between the assessment of Big Four's performance and the question of market concentration*";
    - More precisely, it states that it is the potential effect of concentration levels on audit quality, among other issues, that motivated their study: *"Concern about concentration of large firm audit in the hands of the Big Four, and the impact on competition, choice, price and quality was our main motive in launching this inquiry."*
- The OFT in its provisional decision published in July 2011[138] highlights how important the quality of audit is for the functioning of the economy and its concern about the effect of high concentration levels on audit market efficiency:
    - *"The quality of audit services is a useful tool for assuring investors of the financial health of UK companies and helping to ensure en efficient allocation of capital in the UK economy";*
    - *"The OFT has been concerned for some time that the supply of audit services to large companies in the UK is highly concentrated, with low levels of switching and substantial barriers to entry and expansion, as well as barriers to exit. As such, the OFT is concerned that the market may not be working well for customers."*

Yet, it is difficult to draw a clear conclusion on the impact of concentration on audit quality, since others do not perceive a link between these issues:

- The Federal Audit Oversight Authority (the Swiss audit oversight body, the "FAOA"), commenting on the percentage of public companies audited by regulated audit firms[139] ("*as of 31 December 2010, the three largest audit firms in Switzerland, Ernst & Young AG, KPMG AG and PriceWaterhouseCoopers AG, cover more than 90 percent of the Swiss market capitalization*") stated that:
    - "*It has no interest in there being too high a level of concentration on the Big 3 firms. The interest is far more in having a sufficient supply of licensed audit firms with the authority and ability to audit public companies*". This lack of concern regarding the

[136] Office of Fair Trading.
[137] House of Lords [March 2011] – Auditors: Market concentration and their role.
[138] Office of Fair Trading [2011] – Statutory Audit: Consultation on the OFT's provisional decision to make a market investigation reference to the Competition Commission of the supply of statutory audit services to large companies in the UK.
[139] FAOA [2011] - Activity Report 2010.

level of concentration is partly supported by the fact that "*The FAOA identified a larger average number of deficiencies per firm review at the small to medium-sized state-regulated audit firms than at the annually inspected Big 3"*. It also specifies that "*as only one inspection has been performed to date at the small to medium-sized regulated audit firms*" (whereas they are performed on an annual basis for Big 3 firms), "*improvements at these firms will first be measurable in the future*".

- James Doty, chairman of the PCAOB, clearly questioned the alleged relationship between audit quality and market concentration in one of his recent speeches[140]:
  - "*I do not believe that the global audit firm networks themselves pose systemic risk to our economy. But initiatives to shrink the global firms would likely weaken their ability to audit the large, multi-national companies that may themselves be systematically important.*
  - *The global audit firm is not too big to fail: it is too important to leave unregulated. To protect investors, governments should regulate them, not cripple them.*
  - *There's no reason to think that if there were more major firms they'd be more likely to stand up to their clients. […]*
  - *This position offers no support for anti-competitive, price fixing practices. But the competition issues are the bailiwick of competition authorities. And I would be concerned about measures to promote competition proposed in the name of audit reform and expressed in the rhetoric of market transparency that would, in application, have a negative effect on audit quality.*"

IV.7.3.2 Do price levels have an impact on audit quality?

We have already established that high levels of concentration in the audit market do not systematically lead to high prices and that there is no strong correlation between price levels and concentration levels.

This lack of correlation is also suggested by the results of our survey, where stakeholders were requested to range from the highest to the lowest their perception of fees invoiced by a selection of service providers (in terms of hourly rate). Twenty Independent Regulators or Governmental bodies & Ministry officials chose to answer this question (in order to ensure that the disclosed results are viewed as unbiased, we decided not to report the answers from the professional bodies that could be perceived as less independent regarding the issue at stake in this question):

[140] Doty [5 May 2011] – Keynote Address: The Reliability, Role and Relevance of the Audit: A Turning Point – Baruch College New York

Table 73: Ranking of the perception of fees invoice of different types of service providers (in terms of hourly rate)

	Rank 1 (highest fees)	Rank 2	Rank 3	Rank 4	Rank 5 (lowest fees)
Audit firms	0	4	3	7	6
Banks	7	2	5	4	2
Consulting firms	5	4	5	4	2
Credit rating agencies	1	1	6	3	9
Law firms	7	9	1	2	1
Total	**20**	**20**	**20**	**20**	**20**

Source: ESCP Europe online survey.

Note: the results presented in this table should be read as follows: e.g. fees invoiced by law firms were the most frequently reported as being part of top two quintiles.

Credit rating agencies and audit firms fees are perceived as the lowest ones despite the fact that their markets are the most concentrated.

As part of this study, we have considered whether the pressure on auditors' fees was perceived as a threat on audit quality.

The answers from the thirty-two Independent Regulators or Governmental bodies & Ministry officials who chose to answer the question "*Do you think that the pressure on auditors' fees may have an impact on the quality of the audit?*" (in order to ensure that the disclosed results are viewed as unbiased, we decided not to report the answers from the professional bodies that could be perceived as less independent regarding the issue at stake in this question):

Table 74: Link between auditor's fees and quality of the audit according to the online survey respondents

Do you think that the pressure on auditors' fees may have an impact on the quality of the audit?	Responses
Yes	24
No	1
N/A	7
Total	**32**

Source: ESCP Europe online survey.

Some audit regulators have expressed publicly their concern regarding the potential impact of price pressure on audit quality.

In two of the latest press releases issued by the International Forum of Independent Audit Regulators[141], it was reported that "*some members noted concerns that audit fee pressure resulting from the ongoing challenging market conditions may have a negative impact on audit quality*".

More specifically, the Canadian Public Accountability Board raised the issue of fee pressure on audit firms:

"*Audit committees should also think about the pressure being placed on audit firms to reduce their fees. They should ask themselves what impact this pressure may have on audit quality and on public confidence in the integrity of financial statements. […] Increased fee pressure may lead to a reduction in audit effort at a time when increased effort is needed. That's why audit committees demanding lower fees need to be sure they understand the implications – not only for today, but for tomorrow. Viewing the audit as a commodity, differentiated primarily on price, has the potential to negatively affect audit quality. We believe that the interests of shareholders are best served if an appropriate audit fee is paid – one that ensures the sustainability of audit quality*".

In conclusion, stakeholders consider that there is a risk that pressure on audit fees could put audit quality at risk.

IV.7.3.3 Has auditor independence an impact on audit quality?

There is unanimous consensus among stakeholders that there is a positive correlation between auditor independence and perceived quality.

Auditor independence in appearance is effectively viewed as a pre-requisite for audit quality, especially among investors.

Several inspection reports from oversight bodies emphasize the importance of independence of auditors in their inspection process and the importance of the public recognition of this independence, making a direct link between independence in appearance and perceived audit quality:

- *"The measures and systems to ensure independence of the firm and the personnel entrusted with performing an engagement are subject to each inspection because their special significance for the trust of the public in auditor's work."*[142]*;*
- *"The proper identification and assessment of threats and safeguards is crucial to the effectiveness of the Ethical Standards in maintaining auditor independence. Firms must recognise that this is particularly important at a time when the need for more specific prohibitions is being debated."*[143]

[141] IFIAR [April 2011] Berlin and [September 2010] Madrid

[142] *"Report of the Auditor Oversight Commission on the results of the inspections according to §62b WPO for the years 2007-2010".*

[143] *"Annual Report 2010/11",* FRC - Audit Inspection Unit, July 2011.

ISQC1 emphasizes independence, when defining relevant ethical requirements: "*The firm shall establish policies and procedures designed to provide it reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements […] maintain independence where required by relevant ethical requirements*".

The Code of Ethics for Professional Accountant as issued by the IFAC in 2009 proposes a conceptual framework approach to independence, and identifies two main aspects:

(a) Independence of Mind: the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional scepticism;

(b) Independence in Appearance: the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighting all the specific facts and circumstances, that a firm's, or a member of the audit team's, integrity, objectivity or professional scepticism has been compromised.

IV.7.4 Conclusion

There is no unanimously agreed upon definition of audit quality as it is subject to many direct and indirect influences. However, when assessing measures to enhance audit quality, one should bear in mind that it comprises of two main aspects, each having equal importance:

- Intrinsic audit quality which is mainly influenced by input factors such as auditing standards, auditors' attributes and audit process;
- Perceived audit quality which is more directly linked to output factors such as auditors' reports and communications.

Audit regulators indicate that the main areas requiring improvements are professional scepticism, audit evidence and audit quality monitoring.

Perceived audit quality is a critical issue and would benefit from a better communication from auditors in the way their reports are structured and worded, more useful or informative content regarding the financial statements and the addition of other related information that could be included in the auditor's report.

Finally, there is no consensus among stakeholders whether audit concentration has an impact on audit quality. However, there are perceived links between audit quality and:

- The level of audit fees, as there is consensus among stakeholders that pressure on audit fees may impair audit quality;
- The auditor's independence, which is viewed as a pre-requisite for high audit quality (both perceived and intrinsic).

V POSSIBLE MEASURES IN ORDER TO BETTER MEET THE CRITERIA FOR ASSESSMENT OF THE FUNCTIONING OF THE AUDIT MARKET

In this part we will discuss more than 20 possible measures that would contribute to addressing audit market concentration, barriers to entry of the audit market of the largest companies, audit price levels, independence of auditors and audit quality.

The key measures resulting from this discussion are:

- Introducing mandatory joint audits which would contribute to addressing audit market concentration, barriers to entry of the audit market of the largest companies, audit price levels and auditor independence;
- Audit firm rotation, which would contribute to enhancing auditor independence and to increasing levels of competition in the audit market;
- Ban the provision of non-audit services to audit clients which would address audit market concentration and auditor independence;
- Reinforce the role of the audit committee, which would contribute to addressing audit prices levels, auditor independence and audit quality;
- Detail audit methodology and its risks, which would contribute to addressing auditor independence and audit quality;
- Implement the International Standards on Auditing, which would contribute to addressing audit quality.

V.1 Link between the criteria for assessment of the functioning of the market and possible measures

V.1.1 Criteria for the assessment of the functioning of the market

The analyses undertaken highlight seven main criteria for the assessment of the functioning of the market:

1. Changes to network structure;
2. Concentration levels;
3. Barriers to entry and development of the mid-tier firms;
4. Possible demise of a Big 4 firm;
5. Audit price levels:
    a. Price levels of audit fees;
    b. Provision of non-audit services and potential impact on audit fees;
6. Independence of the auditors:
    a. Provision of non-audit services to audit clients;
    b. Overfamiliarity between the auditors and their clients;

7. Audit quality:
    a. Intrinsic audit quality;
    b. Perceived audit quality.

Potential action steps are therefore focused on the improvement in the functioning of the audit market for the largest or listed companies.

V.1.2 Overview of potential action steps

On the basis of the issues raised in the Green Paper, our review of publications, and the interviews and focus groups carried out, 27 potential action steps have been identified:

1. Annually disclose date of initial audit appointment and reasons for keeping or changing auditor;
2. Ban acquisitions of audit players by the Big 4;
3. Ban "Big 4-only" restrictive covenants;
4. Ban the provision of non-audit services to all types of clients;
5. Break up, dissolve or split the Big 4;
6. Cap the Big 4's market share of listed companies;
7. Create a European passport for audit firms;
8. Create a European quality certification;
9. Detail audit methodology and its risks;
10. Encourage consolidation or specialisation of mid-tier audit firms;
11. Encourage consortia among mid-tier audit firms;
12. Encourage appointment of mid-tier audit firms by the public sector;
13. Introduce mandatory firm rotation;
14. Introduce mandatory joint audit;
15. Introduce mandatory joint audit with a ban on the appointment of two Big 4 firms;
16. Introduce mandatory tendering;
17. Implement ISAs;
18. Limit the provision of non-audit services to statutory audit clients;
19. Limit proportion of fees from a single client;
20. Establish contingency plans for the potential demise of a Big 4 (living will);
21. Publicly disclose loan agreements;
22. Increase the number of public interest entities that need to be audited;
23. Reinforce the role of the audit committee;
24. Review audit firms ownership and partnership rules;
25. Submit audit fees at AGMs (for approval);
26. Submit audit fees to regulators (for approval);
27. Limit liabilities.

All measures are considered for all companies subject to statutory audits i.e. encompassing Public Interest Entities and non Public Interest Entities. When a measure is limited to to Public Interest Entities, this is explicitly mentioned.

Other potential action steps have not been retained, since they are beyond the terms of reference of this study.

Examples of such action steps are:

- Extending auditors' role to assessing forward looking information (our market review takes the current role of the auditor as given, and analysing this action step would mean comprehensively reviewing the current and possible role of the auditor);
- Extending auditors' role to assess Corporate Social Responsibility;
- Adapting statutory audit to SME, for example to simplify the process or lower audit costs considering the less critical demands of investors in this segment;[144]
- Reinforcing supervision and cooperation among the different European national regulators
- Creating specialised committees in charge of regulating financial institutions, and more specifically introducing specialised committees responsible for the approval of complex financial products (following the recent financial crisis), composed of all key stakeholders directly or indirectly concerned;
- An enhanced cooperation between audit regulators, financial market regulators and other relevant regulators, which could be focused on specific industry sectors and companies:
    - Enhanced controls and inspections;
    - Improved cooperation;
    - Pro-active three-way discussions on accounting treatment of significant and complex issues (e.g. the impact of uncertainties caused by the Greek debt crisis on banks' financial statements).

[144] As discussed earlier, our analyses suggest different market dynamics in this segment compared to large or listed companies, and our focus was on the large or listed segment, where issues identified appear as more critical.

V.1.3 Link between the potential action steps and the criteria for assessment of the functioning of the market

Before prioritising the different potential action steps, the table below aims at identifying on which issue(s) each step would have the most critical impact. It needs to be considered as indicative, since it does not mention how strong the impact of each measure would be (which will be discussed in the following section, when getting to prioritisation).

Table 75: Link between the possible measures to enforce and the criteria for assessment of the functioning of the market

Action Steps	Changes to network structure	Concen-tration levels	Barriers to entry and develop ment of mid-tier firms	Possible demise of a Big 4	Audit price levels		Independence of auditors		Audit quality	
					Price levels of audit fees	Provis-ion of non-audit services and potential impact on audit fees	Provis-ion of non-audit services to audit clients	Overfa-miliarity between the auditors and their clients	Intrinsic audit quality	Perceiv-ed audit quality
Annually disclose date of initial appointment and reasons for keeping or changing auditor			✓					✓		
Ban acquisitions of audit players by the Big 4	✓	✓								
Ban "Big 4-only" restrictive covenants			✓							
Ban the provision of non-audit services to all types of clients	✓	✓				✓	✓			
Break up/dissolve/split the Big 4	✓	✓								

Cap the Big 4's market share with listed companies		✓	✓							
Create a European passport for audit firms			✓							
Create a European quality certification			✓						✓	✓
Detail audit methodology and its risks								✓		✓
Encourage consolidation or specialisation of mid-tier audit firms	✓	✓	✓							
Encourage consortia among mid-tier audit firms			✓							
Encourage appointment of mid-tier audit firms by the public sector			✓							
Introduce mandatory firm rotation					✓			✓	✓	✓
Introduce mandatory joint audit		✓	✓		✓			✓		
Introduce mandatory joint audit with a ban on the appointment of two Big 4 audit firms		✓	✓		✓			✓		
Introduce mandatory tendering			✓		✓					

Implement ISAs									✓	✓
Limit the provision of non-audit services to statutory audit clients						✓		✓		✓
Limit proportion of total fees from a single client								✓		
Establish contingency plans for the potential demise of a Big 4 (living will)				✓						
Publicly disclose loan agreements								✓		✓
Increase the number of public interest entities that need to be audited			✓							
Reinforce the role of the audit committee					✓		✓	✓	✓	✓
Review audit firms ownership and partnership rules			✓							
Submit audit fees at AGMs (for approval)					✓			✓		✓
Submit audit fees to regulators (for approval)					✓			✓		✓

V.1.4 Action steps prioritisation

In order to focus on the more critical issues, and on action steps that will have the quickest impact on the market, identified measures are prioritised on the basis of the following criteria:

- Attractiveness = Impact on the four main issues identified:
    - Barriers to entry for the mid-tiers;
    - Audit Quality;
    - Independence of audit firms;
    - High concentration levels (including the risk of demise of a Big 4);
- Feasibility:
    - Complexity of implementation;
    - Potential time required for implementation;
    - Acceptability to stakeholders in the 27 Member States.

For attractiveness, each criterion was rated from -5 (very negative impact) to +5 (very positive impact), 0 meaning “no impact”.

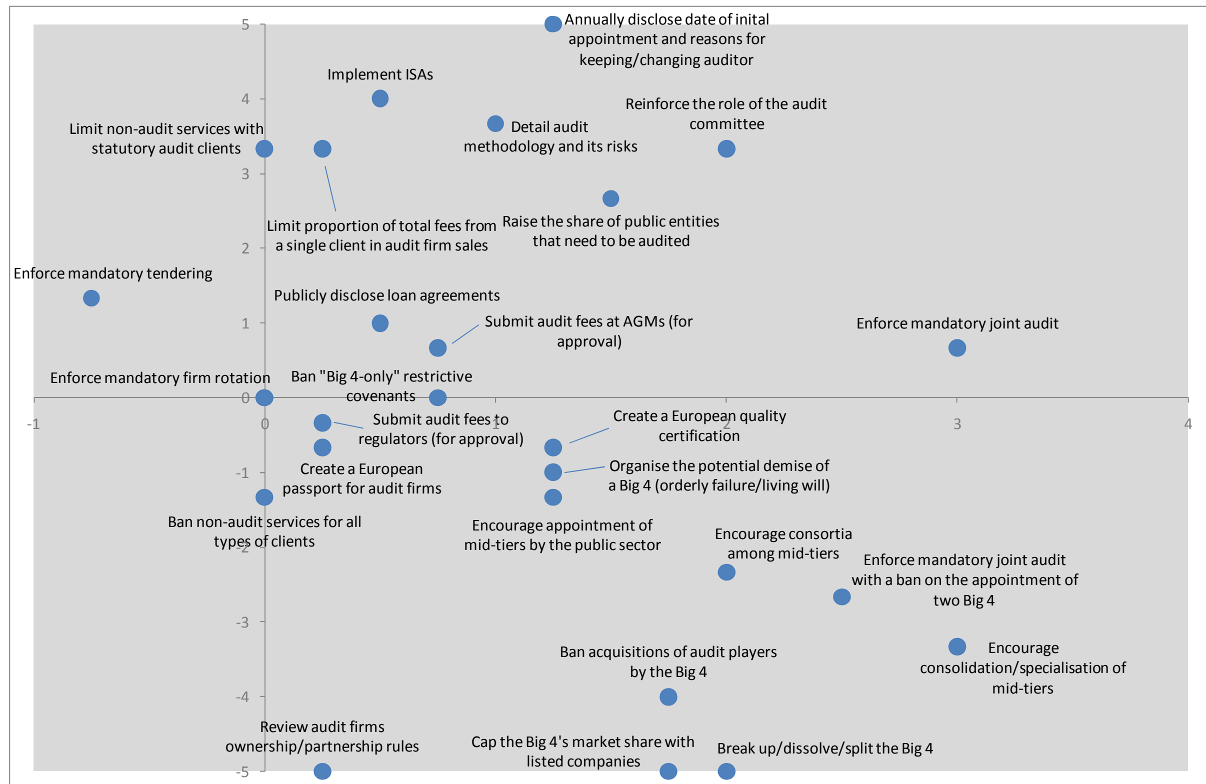
For feasibility, each criterion was rated from -5 (very low feasibility) to +5 (very high feasibility).

It should be noted that an action step can have a “0.0” rating if it has a positive rating on one of the different criteria, compensated by a negative rating on other criteria.

The figure below outlines the results of this prioritisation work:

Figure 36: Prioritisation of potential steps to be taken on the basis of their attractiveness and feasibility

- *X-axis = Attractiveness = Impact on the four main issues identified;*
- *Y-axis = Feasibility.*



The rationale for these ratings is as follows*:

Table 76: Rationale behind the assessment of action steps' attractiveness and feasibility

List of action steps	Overall attractiveness	Overall feasibility
Annually disclose date of initial appointment and reasons for keeping or changing auditor	1.3	5.0
Ban acquisitions of audit players by the Big 4	1.8	-4.0
Ban "Big 4-only" restrictive covenants	0.8	0.0
Ban non-audit services for all types of clients	0.0	-1.3
Break up, dissolve or split the Big 4	2.0	-5.0
Cap the Big 4's market share with listed companies	1.8	-5.0
Create a European passport for audit firms	0.3	-0.7
Create a European quality certification	1.3	-0.7
Detail audit methodology and its risks	1.0	3.7
Encourage consolidation or specialisation of mid-tiers	3.0	-3.3
Encourage consortia among mid-tiers	2.0	-2.3
Encourage appointment of mid-tiers by the public sector	1.3	-1.3
Enforce mandatory firm rotation	0.0	0.0
Enforce mandatory joint audit	3.0	0.7
Enforce mandatory joint audit with a ban on the appointment of two Big 4	2.5	-2.7
Enforce mandatory tendering	-0.8	1.3
Implement ISAs	0.5	4.0
Limit non-audit services with statutory audit clients	0.0	3.3
Limit proportion of total fees from a single client in audit firm sales	0.3	3.3
Require preparation on a contingency plan by audit firms (living will) to address any potential demise of a large network	1.3	-1.0
Publicly disclose loan agreements	0.5	1.0
Raise the share of public entities that need to be audited	1.5	2.7
Reinforce the role of the audit committee	2.0	3.3
Review audit firms ownership and partnership rules[145]	0.3	-5.0
Submit audit fees at AGMs (for approval)	0.8	0.7
Submit audit fees to regulators (for approval)	0.3	-0.3

**Rationale being the assessment of action steps' attractiveness and feasibility are detailed in the following section.*

[145] A further debate is currently emerging among European stakeholders on the integration of non-executive members into audit committees/audit firm supervisory boards.

V.2 Detail of possible measures

V.2.1 Action step 1: Annually disclose date of initial appointment and reasons for keeping or changing auditor

The initial appointment date and reasons for keeping or changing auditor should be disclosed in the companies' annual report or in their financial statements.

It would help to address the possible overfamiliarity between the audit firms and its client.

V.2.2 Action step 2: Ban the acquisition of audit players by the Big 4

This possible measure would mainly have an impact further on concentration. Some Member States might resist this measure as they may consider it as an anticompetitive measure.

V.2.3 Action step 3: Ban "Big 4-only" restrictive covenants

V.2.3.1 Definition and importance of restrictive covenants

Restrictive covenants (informally referred to as "Big 4-only clauses") are clauses or requirements in contractual agreements between companies and their banks that state that only a Big 4 audit firm can provide audit services to the company.

Restrictive covenants did not appear as a critical issue based on the interviews and our survey:

- Only 1 response out of 156 surveyed stressed the negative impact of the bank covenants.
- Only 1 interviewee from a mid-tier firm mentioned that *"bank covenants are an important entry barrier for the mid-tier firms."*
- This issue did not come up as critical in any of the Focus Groups.

Nevertheless, several publications and studies carried out by different institutions like the House of Lords[146], OECD[147], EGIAN[148], ACCA[149], FRC[150] consider the restrictive covenants as a major barrier to the development of the mid-tier firms and, therefore, as an important cause of the current market concentration.

[146] House of The Lords (2nd Report Session 2010-2011), Auditors: Market Concentration and their role, Volume I, pages 18-19.
[147] OECD Policy Roundtables (2009), Competition and Regulation in Auditing and Related Professions, page 244
[148] European Group of International Accounting Networks and Associations, Position Paper on Audit Reform (June 2011).
[149] Association of Chartered Certified Accountants.
[150] Financial Reporting Council (October 2009), Choice in the UK Audit Market, 4th Progress Report, page 4.

V.2.3.2 Restrictive covenants in the Member States

No particular measures have been taken to prohibit restrictive covenants in Europe, despite the revelation of several cases in some Member States (Finland, Germany, Spain and UK)[151].

V.2.3.3 Cost-benefit analysis of banning the restrictive covenants

FRC[152], EGIAN[153], journalists[154] and several firms[155] plead for the ban of restrictive covenants.

The main benefits and costs identified for this potential measure are explained below.

Benefits:

1. The ban of restrictive covenants would have a direct and immediate impact. However, the impact on the reduction of the "Big 4 bias" is expected to be limited.

Costs and Limitations:

2. Current frequency and scope of restrictive covenants in the market are still not well known.
3. The ban of restrictive covenants could be seen as an interventionist measure by Member States.

V.2.3.4 Conclusion

While there is still a lack of data measuring how widespread this practice is and lack of clarity on the feasibility to implement this measure on a European level, the prohibition of restrictive covenants can be expected to have a positive impact on market competition.

V.2.4 Action step 4: Ban the provision of non-audit services to all types of clients

This possible measure refers to a complete ban of the provision of non-audit services by audit firms. For firms that are active in the non-audit services market, this would result in splitting into two firms (one being a "pure audit" firm, the other becoming a provider of non-audit services) as was

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[151] OECD Policy Roundtables (2009), Competition and Regulation in Auditing and Related Professions,
[152] Financial Reporting Council, Response to the Green Paper (2010).
[153] Interview with the Chairman of EGIAN.
[154] "Restrictive bank covenants keep Big four on top" (Christodoulou, 2010), Accountancy Age, 17 June 2010. "EC AUDIT REFORM: Big 4 clauses must go" (Editorial,2011), International Accounting Bulletin, 7 February.
[155] Summary of Deloitte response to the European Commission Green Paper.

observed in some countries following the 2001 Enron scandal, or the non-audit services being taken over by a consulting firm (e.g. acquisition of Ernst & Young Consulting by Cap Gemini in 2000, acquisition of the Grant Thornton information technology and strategy consulting practice by Hitachi Consulting in November 2000, eventual acquisition of PwC Consulting by IBM).

The main benefits of banning the provision of non-audit services to all types of clients would be the following:

- To strongly address the issue of independence of audit firms:
  - This would clearly enhance the perceived independence of auditors;
  - This may also have a positive effect on intrinsic independence, e.g. when audit firms work on a consulting project that could impact their scepticism and/or raise a conflict of interest;
- To lower a potential barrier-to-entry for mid-tier firms to acquire clients that have very strong (i.e. audit and non-audit) relationship with their audit firm;
- To ensure audit fees are not artificially low because of potential cross-subsidisation from non-audit services.

On the other hand, banning non-audit services would also have a certain number of drawbacks:

- To weaken the market position and sector expertise of mid-tier firms, since non-audit services account for a significant share of their revenues;
  - This was highlighted by the Committee on Economic and Monetary Affairs of the European Parliament in its report on audit policy, in which it "*recognises that the provision on non-audit services, where not incompatible with auditor independence, can play an essential role in broadening the skills base of small and medium-sized audit firms*";
- To potentially negatively impact audit quality, as claimed by audit firms:
  - It would appear harder for audit firms' sector experts to keep their expertise up-to-date, since they would no longer share their time between audit and non-audit assignments which offer different sector perspectives;
  - It may become more difficult for audit firms to attract the best students, as one of their strength is the possibility to offer "juniors" various career perspectives within their organisation;
  - It could become more complex to retain senior partners if they would be faced with a reduced prospect for growth of their activities;
  - Many of the issues raised by regulators in their inspections relate to lack of technical expertise, such as fair value measurement, including valuation of complex financial instruments, impairments or use of IT skills. Such concerns could increase;
- To indirectly increase concentration levels, e.g. if a Big 4 decides to leave the audit market to focus on non-audit services, in a sector on which few players are active;
- To face resistance from countries outside the European Union, since such a measure would impact the international networks of mid-tier and the Big 4 audit firms;

Note: If implemented, it could be considered to limit a complete ban to provide non-audit services to large PIEs. This would reduce the potential negative impact on mid-tier audit firm, which are less active in this market segment.

V.2.5 Action step 5: Break up, dissolve or split the Big 4 firms

This possible measure refers to, for instance, a Big 4 splitting into two audit firms. It could have a strong impact on reducing the concentration in the audit market as well as reducing barriers to entry for mid-tier audit firms. However, stakeholders consider it could potentially have a negative impact on audit quality, as it could lower the Big 4 sector expertise and capacity.

Some Member States might resist this measure as they may consider it as an unduly interventionist measure.

V.2.6 Action step 6: Cap the Big 4 firms' market share with listed companies

This action step would have a strong impact on concentration and barriers to entry for mid-tiers.

However, it could have a potentially negative impact on audit quality, as it could lower the Big 4 sector expertise and capacity and could also be seen as unduly interventionist.

V.2.7 Action step 7: Create a European passport for audit firms

This would have a limited impact on mid-tier audit firms, since they would still lack geographical reach to carry out mandates on international companies. Moreover, the harmonisation of audit education programmes and legislation could become a complex pre-requisite.

V.2.8 Action step 8: Create a European quality certification

The creation of a European quality certification could impact the covenant issue, but it would have a very limited impact on the competition issue. The main benefits and costs are mentioned below.

Benefits:

1. The certification would formally recognise the aptitude of selected mid-tier firms to perform high-quality audits on the same basis as the Big 4's;
2. Potentially could encourage the large companies to give audit mandates to mid-tier firms.

Costs and Limitations:

3. This type of certification could indirectly have a negative impact on concentration levels, since it could create a barrier to entry for non-certified firms in the medium term;
   - In Italy, where 21 audit firms are certified to audit listed companies, concentration levels appear higher than the European average.
4. The certificate is considered to have a limited impact on market concentration. Mid-tier firms do not need certificates to be recognised in their own Member State and are limited at European level by their own capacity to reach international companies:
   - Many mid-tier firms are already recognised at national level, having for example mandates with listed companies (cf. table 76 below);
   - However, mid-tier firms often do not have a European reach with listed companies in more than 2-3 EU Member States (only BDO, Grant-Thornton and Mazars have more than ten mandates in three different Member States).
5. The creation of a European certification is considered to be difficult to define and harmonise for all Member States. Several points would need to be clarified:
   - Should certification be delivered at a national or European level?
   - What would be the criteria for certifying a firm?
   - How should professional training be harmonised?

Table 77: Number of mid-tier firms with at least one mandate on the listed market segment

	Number of mid-tier firms having at least one mandate with a listed company	Corresponding total number of mandates
France	**20**	**237**
Germany	**24**	**214**
Italy	**7**	**34**
Netherlands	**3**	**17**
Spain	**7**	**18**
Sweden	**3**	**48**
UK	**25**	**817**

Source: IAB.

The interviews performed during this study show that the idea of creating a European quality certification for audit firms is not generally well received. As one mid-tier firm stated, *"we don't*

want a third level of governance for the audit profession – we already have national and global standards". The view often expressed by mid-tier firms during the interviews was that both at the national and international levels, good standards already existed, as well as professional rules of practice.

In respect of international auditing standards, the work of IFAC, EGIAN, IFIAR etc. have, in recent years, contributed to the development and improvement of audit practices at an international level, and there is a general acceptance that auditors of multinational companies must comply with international standards. The multinationals are now more aware that compliance to these standards, including membership of the international professional bodies referred to above, are, effectively, a prerequisite for an audit appointment. There are now 22 members of the Forum of Firms that committed to comply with international audit standards, and who are subject to peer group quality inspections. The general feeling is that rather than invent another level of quality control (the European Quality Certification), more emphasis should be put on compliance and enforcement of audit standards – by the existing oversight bodies and professional associations.

We therefore conclude that the creation of a European certificate would not solve the issue of audit market concentration.

V.2.9 Action step 9: Detail audit methodology and its risks

V.2.9.1 Definition and objective

In order to prevent loopholes in the total coverage of compliance, risk monitoring as well as the substantive verification of assets, liabilities, revenues and expenses, better communication between external auditors on one hand and those charged with corporate governance and shareholders on the other hand would be expedient.

This improved communication could include the provision of a long form audit report intended for shareholders and/or those charged with corporate governance (i.e. audit committee or supervisory board) which would include the following points:

- Detailed methodology used and limits of the analysis;
- Main audit findings on the going concern and risks facing the company.

International Standards on Auditing (ISAs) already raised the issue of a better communication between auditors and those charged with corporate governance in ISA 260:

- The auditor shall communicate in writing with those charged with governance regarding significant findings from the audit if, in the auditor's professional judgment, oral communication would not be adequate. Written communications need not include all matters that arose during the course of the audit. (Ref: Para. A37-A39);

- The auditor shall communicate in writing with those charged with governance regarding auditor independence when required by paragraph 17.

Two Member States (France and Germany) have already implemented measures that address these issues to a certain extent:

- "Long-form audit report" in Germany;
- "Justification des appréciations" in France.

The following sections present these national measures in detail and a cost benefit analysis on the basis of lessons to be learned from the national measures and stances of stakeholders collected through focus groups.

V.2.9.2 Germany case study

A long form audit report rule is enforced in Germany as detailed in the German Commercial Code (§ 321 HGB).

The German long form audit report consists of a specific document, distinct from the audit report, exclusively intended for the company's supervisory board.

As presented at the European Audit Regulatory Committee[156], this long form audit report must include the following:

- General Findings
    - Comment on the general situation of the company and going concern assessment (based on the audited records and management report);
    - Facts and significant risks that affect the future development and existence of the company;
    - Any irregularities or violations of statutory provisions or the articles of incorporation by representatives or employees of the company.
- Basis of the Audit
    - Subject, nature and scope of the audit;
    - Applied Accounting and Auditing Standards;
    - Confirmation of the auditor's independence.
- Accounting Policy Decisions
    - Accounting methods, substantial bases of valuation and changes thereof;
    - Exercise of accounting and measurement options;
    - Exercise of discretion, estimation and judgement;
    - Structuring measures ("window dressing" transactions);
    - Any material disclosures not already in the notes.

[156] Log-Form Audit Report in Germany, Audit Regulatory Committee, 3 March 2011.

- Risk Management and Internal Control
    - In case of listed companies: whether the executive management has implemented sufficient risk management and internal control systems.

V.2.9.3 France case study

The « Justification des appréciations » is a French legal rule enacted in 2004[157] according to which the auditor justies the accounting assessments used in the annual report from a methodological point of view. It includes assessments on:

- Accounting methods used (especially when they substantially impact the financial evaluation of the company);
- Important accounting estimates, especially those based on professional judgement because of a lack of objective data;
- Overall presentation of annual and consolidated accounts;
- Internal audit methods used by the company that participate in the preparation of the accounts.

The « Justification des appréciations » consists in a section of the annual audit report and is therefore intended for the company's management, supervisory board and shareholders. In practice, this section comes down to a brief note in the annual audit reports with far less details than the German long form report.

V.2.9.4 Cost-benefit analysis

V.2.9.4.1 *Lessons to be learned from existing experience*

German long form report

The German long form report is an effective measure as it succeeds in providing details about methodology used, limits of the analysis, main audit findings on the going concern and the risks faced by the company.

Nevertheless, in its current implementation, it fails to address the need for better understanding of audit certification by shareholders as they do not have access to this document. Moreover, certain information included in the long form report may be useful for the company's supervisory board but is confidential and not disclosed to shareholders. For instance some adjustments under materiality thresholds that have to be reported to the company's supervisory board are not publicly disclosed as they do not impact the company's financial statement. Therefore, the communication of the long form to shareholders, in its current version has limitations.

[157] JORF n°239 du 14 octobre 2006 page 15276 texte n° 34

French « Justification des appréciations »

According to a recent study ordered by the French professional body CNCC (Compagnie Nationale des Commissaires aux Comptes)[158], the "Justification des appreciations" measure is generally well perceived by the various stakeholders and more particularly by investors and shareholders.

Nevertheless, the "Justification des appreciations" offers room for improvement as it has numerous drawbacks:

- It is too short lacking enough information for stakeholders (e.g. supervisory board, journalist);
- It is too diplomatic and non-committal.

V.2.9.4.2 *Opinion of key stakeholders from the online survey*

Details on methodology in the audit report:

Stakeholders were surveyed about the disclosure of companies' choices or use of accounting method, of material or sensitive accounting estimates. Half of the respondents of the survey are favourable on disclosing more details on these issues.

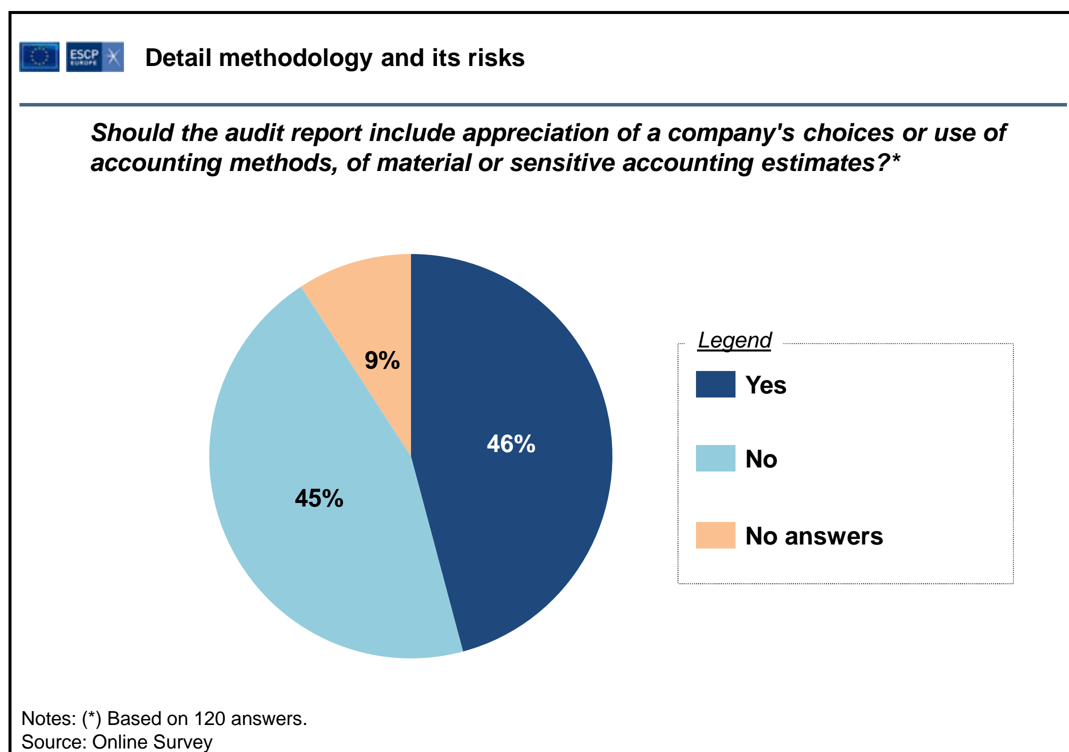
The main arguments against this measure by the respondents are:

- Specific methodology issues should be discussed directly with the audit committee and do not need to be mentioned in the audit report:
  - *"The auditor should discuss the specific audit methodology with the audit committee and if necessary include the main elements in the audit report."* Audit firm
- Key risks and going concern assessments should not be disclosed by auditors, only the management is able to disclose such information:
  - *"More could be done by management and those charged with governance to report the assumptions which underpin their judgement on a company's ability to continue as a going concern, as well as to disclose key risks associated with a company's long-term business model. In turn, auditors could report on the quality and transparency of these additional management disclosures."* Professional body
  - *"The auditor cannot disclose information that comes within the competence of the management."* Governmental body / Ministry Official
  - *"Disclosures should be made by management (rather than the auditor) with the auditor providing assurance over the disclosures provided by management. In either case, any disclosure should not be in the audit opinion since this might reduce the clarity of the opinion."* Audit firm
- Audit norms already address this issue (IFRS – ISA 1 and ISA 260)

[158] Etude sur la perception de la justification des appréciations des commissaires aux comptes, February 2011.

- *"IFRS and Lithuanian Business Accounting Standards already require disclosures on accounting methods used and material or sensitive accounting estimates."* Audit firm
- *"ISAs already specify certain matters to those charged with governance."* Professional body

Figure 37: Online survey answers regarding details on methodology in the audit report



Disclosure of details on methodology:

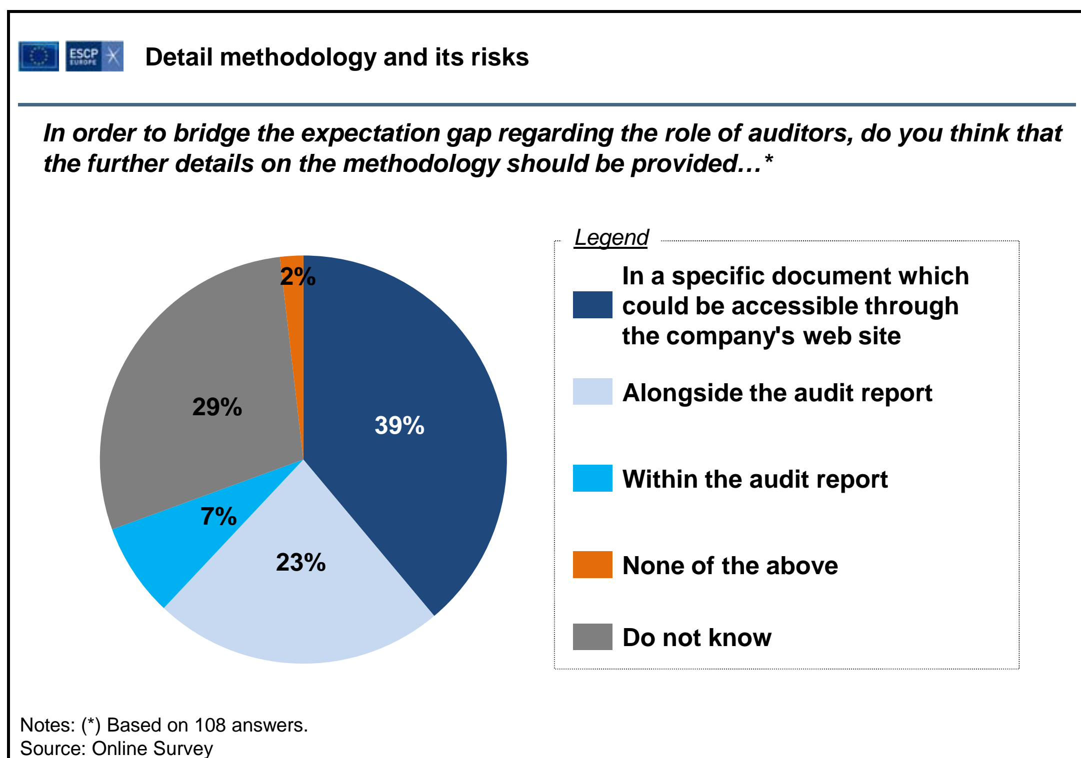
In case of mandatory details on methodology, 69% of respondents are favourable to a public disclosure as they believe shareholders and investors would benefit from such information:

- *"Certain stakeholders, especially investors, may be unaware of the limitations of an audit connected with the provision of reasonable, not absolute assurance."* Professional body
- *"It would be desirable that auditors enhance their communication towards shareholders."* Company

Yet, respondents are only 7% in favour of such a disclosure within the audit report:

- *"Information concerning accounting policies is included in the financial statements. There is no need to include it in the report - Providing details on methodology will not change the expectation gap, because nobody will read it."* Audit firm
- *"Audit reports should, on the contrary, become more concise and clearer."* Company

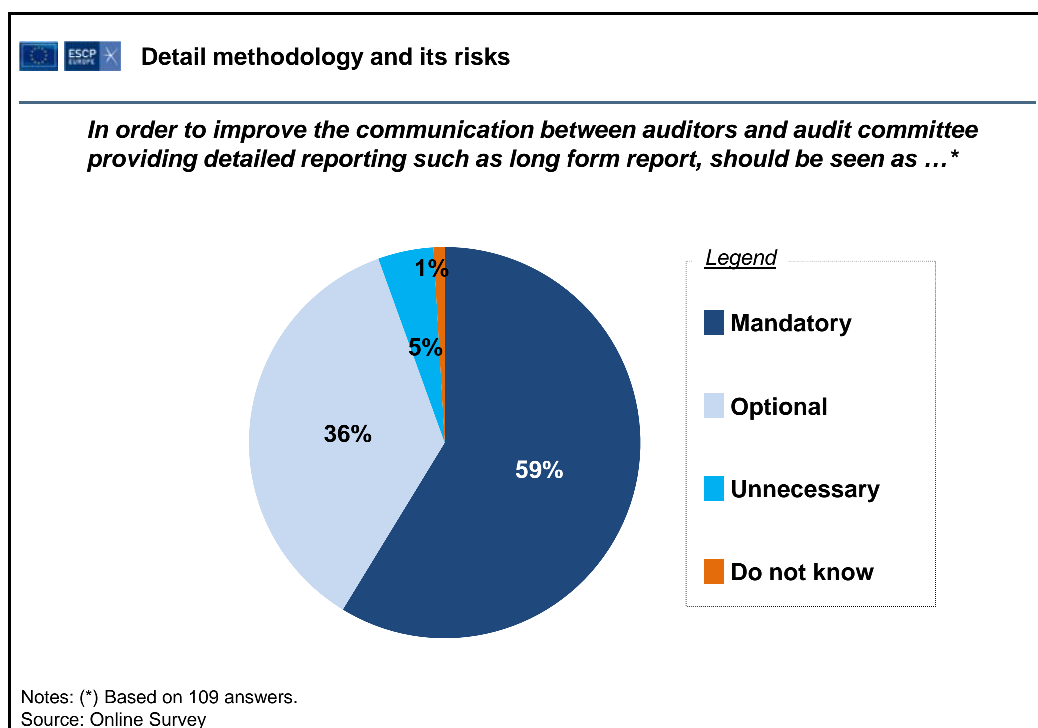
Figure 38: Online survey answers regarding location of details on methodology



Long form reporting

The principle of a long form report is widely accepted by respondents (59% of respondents even plead for a mandatory long form measure).

Figure 39: Online survey answers regarding a long form report



V.2.9.5 Conclusion

As a conclusion, we recommend the provision of detailed reports that include audit methodology and its limitations (e.g. levels of substantive testing, benchmarks used for balance sheet verification, etc.) along with main findings on the going concern or financial and operational risks facing the company.

Such a report would be a specific document publicly available and should take the shape of the German long form audit report as for the level of detail but should not disclose confidential information (which should be directly discussed with the company's supervisory board).

Such a report necessitates an extensive dialogue between auditors, on the one hand, and the company's management and audit committee, on the other hand.

V.2.10 Action step 10: Encourage consolidation or specialisation among mid-tiers

This potential measure would have a strong impact on concentration and barriers to entry for mid-tiers but incentives would have to be found at a national level to boost consolidation and specialisation among mid-tier audit firms.

V.2.11 Action step 11: Encourage consortia among mid-tiers

Two types of consortia are usually mentioned by stakeholders:

- Two audit firms responding jointly to a call for tenders;
- Having an audit firm focus on audit of the parent company or at group level, while the other focuses on subsidiaries.

Both concepts would have a potentially significant impact on concentration and barriers to entry for the mid-tiers, since two mid-tiers could join to reach critical size and be able to audit large or international companies.

Most stakeholders point out a significant limit: these models are not widespread among mid-tier audit firms.

V.2.12 Action step 12: Encourage appointment of mid-tiers by the public sector

This measure would have a strong impact on concentration and barriers to entry for mid-tier audit firms (since most public sector companies operate on an national basis, mid-tiers would most likely be able to carry out these mandates).

However, some Member States would likely resist this measure, considering it as an anticompetitive subsidization of mid-tier audit firms.

V.2.13 Action step 13: Introduce mandatory firm rotation

V.2.13.1 Definition and objective of audit firm mandatory rotation

The mandatory rotation of audit firms consists in requiring a company to change its audit firm after a determined (by law) maximum number of years.

By preventing companies from appointing the same audit firm for long periods of time, this measure is expected to positively impact:

- The audit market concentration and inertia;
- The overfamiliarity between a company and its auditor (which can lead to a low quality audit);
- The perceived independence of audit firms.

V.2.13.2 Description of current national requirements

V.2.13.2.1 *Existing national rotation rules*

Italy

Italy is the only EU Member State in which the rotation of audit firms is mandatory. This rule was adopted in 1974.

It was originally imposed upon listed companies and was progressively extended to other companies identified by law (e.g. insurance companies).

The maximum rotation frequency is 9 years corresponding to 3 three-year mandates. In addition, there is also a minimum cooling-off period of three years before the previous auditor can be re-appointed.

Other non-EU Member States

In Brazil, the mandatory audit firm rotation rule has been in place for banks since 2001 and for listed companies since 2004 (adopted in 1996 and 1999, respectively). The rotation period is five years, and regulators are currently discussing the extension of that period from five to ten years.

In South Korea, rotation rules were adopted in 2003 (effective since 2006) and apply to companies listed on the Korean Stock Exchange ("KSE") or registered with the Korean Securities Dealers Automated Quotations ("KOSDAQ"), except for foreign investment companies which are subsidiaries of foreign parent companies (and have appointed their parent companies' auditors) and companies listed on certain foreign stock exchanges (e.g. NYSE, NASDAQ, London Stock Exchange). The rotation period is six years.

In Singapore, the rotation rule enforced in 2002 concerns banks incorporated in Singapore (which excludes foreign banks operating in the Member State) and is set up with a five-year rotation frequency.

In India, the rotation rule is applicable for banks, private insurance companies and governmental companies (on the basis of a four-year period).

V.2.13.2.2 *Abandoned rotation rules*

Spain

A mandatory rotation rule adopted in 1989 was eventually dropped in 1995. The system was initially based on a maximum term period of nine years (corresponding to 3 three-year mandates) and included a mandatory cooling-off period of three years. The maximum period is no longer in place and an annual appointment is permitted after the initial three-year mandate.

Austria

A six-year rotation rule was adopted in 2004 and dropped a year later: *"the implementation of this rule was* [first] *postponed awaiting developments at EU level. In 2005 it was finally dropped by the company law (GesRÄG 2005) that changed the articles of Austrian Commercial Law on auditing (§ 271a HGB)."*[159]

Other non-EU Member States

Canada abandoned the rotation rule in 1991 (which only targeted banks).

V.2.13.3 Cost-benefit analysis

[159] SDA Bocconi School of Management [2005] – The audit firm rotation rule: a review of the literature.

The key advantages of a mandatory audit firm rotation mentioned by the advocates of audit firm rotation include:

- Enhanced auditor independence and avoidance of conflicts of interest that may arise from long-standing client relationships;
- Increased audit quality;
- The introduction of more "market dynamism" and capacity in the audit market, hence increased levels of competition;
- Positive financial market reaction.

Opponents to rotation often argue that it would result in the following:

- Incremental costs for companies;
- Increased costs for audit firms;
- Loss of company-specific knowledge leading to higher audit risk.

In order to perform an assessment of the above costs and benefits of the rotation rule, we reviewed the different stakeholders' opinions divided in four parts:

1. The first part is focused on the results of academic papers using empirical evidence from countries where mandatory rotation rules exist (Italy and Korea) or used to be in force (Spain);
2. The second part is based on the positions of regulators and professional bodies, considering that this category of stakeholders appears more independent and unbiased compared to both audit firms and client companies;
3. The third part is based on interviews conducted with mid-tier firms;
4. The fourth part consists of positions of participants to the focus groups.

This approach was chosen in order to mitigate the risk of bias related to the facts that many "*existing studies were typically conducted under a voluntary rotation regime, or under "forced" rotation settings, like the setting that followed Arthur Andersen's demise*"[160].

More specifically, we decided to use conclusions drawn from the Spanish case study with caution, since rotation was eventually abandoned. Biases in Spanish studies were highlighted by Gomez-Ruiz-Carrera-Humphrey [2006][161], who demonstrated that the Spanish situation had been largely used (and "mis-used") in the current international auditing arena.

Finally, we refer to the studies performed by the SDA Bocconi School of Management in 2002 and in 2005 (SDA Bocconi [2002] and [2005][162]) which both covered mandatory audit rotation issues.

[160] Cameran-Prencipe-Trombetta [2008] – Audit Tenure and Auditor Change: Does Mandatory Auditor Rotation Really Improve Audit Quality.
[161] Gomez-Ruiz-Carrera-Humphrey [2006] – Mandatory Audit Firm Rotation in Spain: a Policy that was never applied.
[162] SDA Bocconi School of Management [2005] – The audit firm rotation rule: a review of the literature, which includes the findings of SDA Bocconi School of Management [2002], an unpublished work conducted by a

SDA Bocconi [2002] focused on an analysis of the impact of mandatory rotation in Italy in terms of audit costs, audit market competition and audit quality. SDA Bocconi [2005] was a review of the existing literature which provided a unique summary of 34 academic studies and 26 reports by regulators and other representative bodies. It did not analyse the context in which reports were published (in terms of political or financing "influence" for example). However, when summarising reports published by regulators and professional bodies, it provided a breakdown of the supporting vs. opposing opinions for accounting vs. non-accounting bodies, in order to minimise the bias of accounting bodies, perceived as less independent. The non-accounting bodies considered in the study included independent governmental commissions, non-accounting professional bodies and independent non-accounting bodies (other than governmental commissions).

V.2.13.3.1 *Lessons to be learned from existing experiences*

This section is dedicated to assessing empirical evidence on the relevance of the most frequently used arguments related to the costs and benefits of mandatory audit firm rotation, i.e.:

- Audit costs;
- Audit market competition;
- Audit quality.

Italy – Sources

The impact of mandatory audit firm rotation in Italy was studied by the independent academics of SDA Bocconi School of Management in 2002 and in a 2005 update (SDA Bocconi [2002] and [2005][163]).

Italy – Audit costs

Based on interviews and questionnaires, the findings of SDA Bocconi [2002] show that both auditors and listed companies face start-up costs in the first year of engagement:

- All interviewed company managers stated that in the first year, the time dedicated to auditors increased;
- Big 5 auditors (i.e. including Arthur Andersen, just before its demise) said that it was necessary to spend more hours (about 40%) on the job;
  - Yet, audit firms also stated that this increase in audit time spent was usually not "transferred" into higher audit fees in the first year of the engagement.

group of independent academics; it should be mentioned that the Bocconi study was partly financed by the European Contact Group (BDO, Deloitte, Ernst & Young,Grant Thornton, KPMG and Pricewaterhousecoopers.

[163] SDA Bocconi School of Management [2005] – The audit firm rotation rule: a review of the literature, which includes the findings of SDA Bocconi School of Management [2002], an unpublished work conducted by a group of independent academics.

Based on empirical research from Arrunada and Paz-Ares [1997][164] in Italy and Spain, the authors mention that an increase in fees of 4% to 15% occurs. Indeed the phenomenon of "low-balling" under which audit fees are set to decrease in the first year of engagement, is considered illusory, because it is offset by price increases in subsequent years.

Italy – Audit market competition

The analysis of the Italian market performed by SDA Bocconi [2002] shows that the market shares are stable in the segment where the rotation rule is enforced, because the new auditor is chosen among the same group. Mandatory rotation is said to lead to higher market concentration in the larger client segment because there is a high probability that a large size company will appoint as auditor one of the "the Big 5 firms".

The authors, together with Arrunada and Paz-Ares [1997], also conclude that mandatory rotation increases the probability of collusion among audit firms in order to coordinate acquisition of the client.

The negative effect of mandatory rotation on the Italian audit market seems to be supported by the concentration analysis we performed:

- Italy has one of the highest HHIs for listed companies (HHI above 2,000 and CR4 of 86%), which is the segment on which the rotation rules are in place.

Italy – Audit quality

SDA Bocconi [2002] investigated the quality of audit and independence, from both an effective and perceived point of view. The effectiveness is analysed using criteria such as partner suspensions, qualified opinions and auditor changes, data being collected from the Italian market and more specifically the audit segment where the rotation rule is compulsory. The main results are as follows:

- The greatest number of partner suspensions occur during the first year of appointment;
- The highest number of qualified opinions occurs in the third year of the engagement. This supports the idea that three years is the period required for an audit firm to achieve complete knowledge of the audited entity.

The perceived impact of mandatory audit firm rotation is analysed through questionnaires and interviews of managers, internal auditors and Big 5 leading to the following results:

- On one hand, the responses state that mandatory rotation enhances the perceived independence;
- On the other hand, the responses state that it produces a decrease in the quality of the issued opinions due to the lower knowledge of the client in the first years of the engagement.

[164] Arrunada and Paz-Ares – Mandatory Rotation of Company Auditors: A Critical Examination - 1997

Cameran-Prencipe-Trombetta [2008] tested the effects of audit tenure and auditor change on audit quality in the Italian environment. Regarding audit tenure, their results show that audit quality, measured in term of earnings management, tends to improve rather than worsen over time. Then, considering the effects of voluntary auditor change vs. those resulting from mandatory changes, their results suggest that a voluntary change of the auditor tends to improve audit quality while a mandatory change tends to deteriorate audit quality.

Spain – Sources

Even though the mandatory rotation rule was abandoned in 1995 in Spain, various academic studies have been undertaken using the Spanish example as a setting to get empirical evidence.

Spain – Audit market competition

Arranuda and Paz-Ares [1997][165] performed a critical examination of the mandatory rotation based on both relevant literature and empirical evidence. They concluded that the rotation rule drastically alters competition patterns in the audit industry, by creating a system of turns and an artificial division of the market which can favour collusion among audit firms. It also reduces the incentive to invest and compete because firms find themselves obliged to periodically relinquish their audit clients.

Spain – Audit quality

Ruiz-Gomez-Carrera [2008][166] analysed the impact of mandatory rotation of audit firms on audit quality by testing the impact of a removal of mandatory rotation on the likelihood of auditors issuing going-concern modified audit opinions. The sample consists of Spanish listed and financially stressed companies observed in a regime with mandatory rotation (period 1991–1994) versus a regime without this rule (1995–2000). Their findings suggest that the removal of mandatory rotation led to an increase in the likelihood of auditors issuing going-concern opinions, i.e. a higher level of quality. Nevertheless, these results should be considered with caution as the two periods used in the comparison have different lengths and the audit quality is mechanically lower for a shorter period (as stated by the SDA Bocconi study).

South Korea – Sources

As previously mentioned, South Korea is one of the few countries in the world where audit firm rotation is mandatory (since 2006).

An analysis of the effect of mandatory firm rotation on audit hours, audit fees and audit quality has been performed in a study undertaken by a team from Korea University and University of New South

[165] Arrunada and Paz-Ares [1997] Mandatory Rotation of Company Auditors: A Critical Examination

[166] Ruiz-Gomez-Carrera [2009] Derogacion de la Rotation Obligatoria de Auditores y Calidad de la Auditoria

Wales [167] which aimed at a better understanding of the costs and benefits of such a measure. They use a final sample consisting of 5,557 firm-years (corresponding to 1,202 firms listed on the KSE or KOSDAQ) observations in Korea between 2000 and 2007 in order to examine the rotation-related costs to clients and audit firms. The study provides evidence for the incremental effect of mandatory audit changes over voluntary changes on auditor efforts, fees, and discretionary accruals.

South Korea – Audit costs

In terms of auditor hours, the regression analysis of the impact of mandatory audit firm rotation on audit hours shows consistent results with prior analysis which indicated that auditors invested additional effort because of start-up costs. It also suggested that newly appointed auditors work more hours than retained incumbent auditors only when they were appointed under mandatory rotation requirements.

The findings of the study suggest that “low-balling” of initial audit fees do not happen under the mandatory rotation regime, contrary to voluntary rotations. The bargaining power would appear to switch from companies to the audit firm as the rotation does not come from a company’s decision but from a legal requirement. An analysis of audit fees in the final engagement year also indicates that fees increased in the mandatory rotation period (2006-2007) compared to 2000-2005.

South Korea – Audit quality

Following prior studies, Kwon-Lim-Simnet [2010] employed discretionary accruals as a proxy for earnings quality by observing whether they tend to decrease or not in the initial audit engagement year. Their findings suggest that no obvious conclusion on the increase or decrease of audit quality following a mandatory auditor change can be drawn. The propensity to issue going-concern opinion for financially distressed companies, which constitutes an alternative measure of audit quality, is also analysed and the results suggest a minimal effect of mandatory audit firm rotation.

South Korea – Audit market competition

The study also measured the impact of mandatory firm rotation on audit concentration. Based on the 174 auditor changes due to mandatory audit firm rotation, they concluded that such a measure does not appear to be an effective mechanism to mitigate the dominance of the Big 4:

- Out of 112 Big 4 clients, 86 (77%) chose another Big 4, and the remaining 26 clients (23%) a non-Big 4;
- On the other hand, out of the 62 non-Big 4 clients, 27 clients (44%) switched to a Big 4, and 35 clients (56%) remained with a non-Big 4.

[167] Kwon-Lim-Simnet [2010] Mandatory Audit firm Rotation and Audit Quality: Evidence from the Korean Audit Market

In consequence, the number of mandates held by Big 4 eventually did not dramatically change (increase from 112 to 113).

The overall findings of the rotation specific studies discussed above are also supported by other academics as reported by the SDA Bocconi [2005] which analysed at 34 academic studies (9 opinion-based and 25 based on empirical evidence) and concluded as follows: "*The majority did not support mandatory audit firm rotation. It is noticeable that studies based on empirical evidence had a larger majority against firm rotation (76%) than opinion based studies (56%).*"

The PCAOB reviewed several studies on the relationship between auditor tenure and audit quality between 2002 and 2010 (i.e. until more recently compared to SDA Bocconi [2005]). It also states that: "*Many, though not all, tend to support the view that engagements of short tenure are relatively riskier. A limitation of this literature is that studies tend to focus on environment where auditor rotation is voluntary rather than mandatory*" whereas *"voluntary rotation may be associated with auditor-issuer disagreements, other financial reporting issues or economic issues*".

Therefore, the impact of audit rotation and audit tenure on audit quality and independence seems highly debated. Analysed studies point out different risk associated with mandatory audit rotation and shorter tenure:

- increase the risk of audit failures;
- Reduce the risk that audited companies use abnormal accruals to manipulate their financial results.

V.2.13.3.2 *Views from regulators and other relevant professional bodies*

This section aims at identifying the different positions that regulators and other relevant professional bodies have taken over the past 10 years in regard to mandatory audit firm rotation.

V.2.13.3.2.1 Views from regulators and other professional bodies dated from the "pre-financial crisis" period

SDA Bocconi [2005] provides a unique summary of 26 reports conducted by 19 regulators and other professional bodies and deals mainly with the relation between the independence of the auditor and the rotation rule. Although they all dated back to the "pre-financial crisis" period, it is important to bear in mind that about 88% were issued during the 2001-2005 period, i.e. straight after the Enron collapse, a distressed time for audit.

The results can be summarised as follows:

Table 78: Stance of regulators and professional bodies on mandatory rotation, by region (SDA Bocconi, [2005])

	FOR	AGAINST	TOTAL
Europe	2	9	11
USA	1	3	4
Other area	1	2	3
Universal	0	1	1
Total	**4**	**15**	**19**

Within all geographical areas, the vast majority of regulators or professional bodies were against mandatory rotation.

It should be noted that the stakeholders who are in favour of the rotation rule come from countries that had enforced this rule, i.e. Italy and Singapore. The Conference Board of Commission on Public Trust and Private Enterprise (US) was in favour of the rotation rule but under the specific “post-Enron” context: it favoured the “investors point of view” to the detriment of companies and audit firms considering that “the costs that mandatory rotation implies are significantly lower than the ones faced by investors in capital market when a loss of confidence in the financial statements occurs.

Table 79: Accounting and Non-accounting: position on rotation rule (SDA Bocconi, [2005])

	FOR	AGAINST	TOTAL
Accounting	1	4	5
Non-accounting	3	11	14
Total	**4**	**15**	**19**

It should be noted that accounting bodies (i.e. professional bodies), which might be qualified as less independent when considering a degree of propinquity with accounting firms, represent only 5 out of the 19 stakeholders. The proportion of opposing opinions (around 80%) is however the same between accounting and non-accounting bodies.

Aside from the positions expressed by professional bodies in response to the European Commission's Green Paper on Audit Policy, two position papers should be further analysed regarding the relation between rotation and audit quality and independence. Both papers were issued in the

same period by the Federation of European Accountants (FEE) in 2004[168] and the US Government Accountability Office (GAO) in 2003 and are quoted by most stakeholders and academic studies.

While one of the main arguments raised by mandatory rotation advocates regarding its impact on audit quality is "*the opportunity for a fresh approach to the audit*"[169], FEE has highlighted the challenges faced by an auditor during the first two years of its mandate:

- *"The auditor may not have developed a full understanding of the business. This requires both understanding of the industry and detailed knowledge of the client's activities. This process takes time, as the learning curve for the key decision makers in the audit team cannot be accelerated simply by allocating more resources. Without this knowledge, it is very difficult to identify unusual transactions whose purpose may not be fully apparent to the auditor or to assess audit risk effectively"*
- *"When disagreements arise between management and auditor, they are most effectively dealt within the context of an open, straight-talking relationship. This relationship also takes time to develop and it is understandably more difficult to deal with an area of disagreement in the early stages"*
- *"Teamwork between the members of the worldwide audit team of a multi-national company needs to be developed. This is not simply a matter of appointing partners in each location, but more a task of developing relationships so that there is a shared understanding of audit risks and open communication of audit conclusions and concerns. Formal inter-firm reports and reviews of working papers will only cover the tangible results of the audit work at subsidiaries. A deeper relationship is needed before those involved will be comfortable sharing tentative concerns which are often the first sign of something amiss."*

Another frequently raised argument regarding the impact of mandatory audit firm rotation is "*the avoidance of over-familiarity with the client and its management*"[170], which is indeed a relevant concern for both investors and regulators as situations where an audit firm has served as the auditor of the same company for more than 20 years are far from being an exception. However the US GAO's conclusions on the impact of mandatory audit firm rotation on auditors' independence were mixed:

- *"GAO believes that mandatory audit firm rotation may not be the most efficient way to strengthen auditor independence and improve audit quality considering the additional financial costs and the loss of institutional knowledge of the public company's previous auditor of record, as well as the current reforms being implemented following the Sarbanes-Oxley Act."*
- *"In that respect, we reported that audit committees, …, can play a very important role in enhancing auditor independence and audit quality. For example, if audit committees*

[168] FEE study – Mandatory Rotation of Audit Firms – October 2004
[169] The Institute of Chartered Accountants in England and Wales - Mandatory rotation of audit firms – Review of current requirements, research and publications - July 2002
[170] The Institute of Chartered Accountants in England and Wales - Mandatory rotation of audit firms – Review of current requirements, research and publications - July 2002

regularly evaluate whether audit firm rotation would be beneficial, given the facts and circumstances of their companies' situation, and are actively involved in helping to ensure auditor independence and audit quality, many of the intended benefits of audit firm rotation could be realised at the initiative of the audit committee rather than through a mandatory requirement."

V.2.13.3.2.2 Views from regulators and other professional bodies dated from the "post-financial crisis" period

As mentioned previously, one might expect that incidents such as the Enron collapse or the financial crisis would change the views of regulators and other professional bodies on mandatory rotation.

In the light of a continuing effort to increase audit quality and more specifically auditor independence, James Doty, Chairman of the PCAOB, has announced his decision for the PCAOB to undertake an in-depth analysis about firm tenure and audit firm rotation[171]:

- *"The PCAOB's efforts to address these problems through inspections and enforcement are ongoing. But considering the disturbing lack of scepticism we continue to see, and because of the fundamental importance of independence to the performance of quality audit work, the Board is prepared to consider all possible methods of addressing the problem of audit quality — including whether mandatory audit firm rotation would help address the inherent conflict created because the auditor is paid by the client.";*
- *"Based on this work, I believe it is incumbent on the PCAOB to take up the debate about firm tenure and examine it, with rigorous analysis and the weight of evidence in support and against. I don't have a predetermined idea as to whether the PCAOB ultimately should adopt term limits. My only predilection is that the PCAOB deepen the analysis of how we can better insulate auditors from client pressure and shift their mindset to protecting the investing public. ".*

As outlines PCAOB quoting the AICPA's Cohen Commission report[172], the idea of audit firm rotation to limit long audit tenure is not new, and benefits of this measure are well-known:

- *"The Cohen Commission identified two potential benefits of such a requirement. First, '[s]ince the tenure of the independent auditor would be limited, the auditor's incentive for resisting pressure from management would be increased.' Second, 'a new independent auditor would bring a fresh viewpoint'".*

Concerns regarding the threats on auditors' independence that long-standing client relationships understandably arise from observations on the average audit tenure:

[171] James Doty, Chaiman of the PCAOB – Rethinking the Relevance, Credibility and Transparency of Audits – 2 June 2011
[172] *"The Commission on Auditor's Responsibilities, Report, Conclusions, and Recommendations 108"*, AICPA's Cohen Commission, (1978).

- According to CFO World, a recent survey undertaken by the Financial Executives Research Foundation from nearly 250 executives who represent both US publicly held companies and private companies, along with some non-profit organisations and foreign companies shows that "*auditor tenure seemed to register as somewhat proportional to the size of the company. While the weighted average auditor tenure for public companies was 21 years, companies with more than $25 billion in revenues reported keeping the same auditor an average of 50 years, and the smallest companies in the survey - with revenues of less than $25 million - had auditors with tenure of less than 10 years*";
- The House of Lords [2011] also highlights this situation in its report[173]: "*A FTSE 100 auditor remains in place for about 48 years on average; for the FTSE 250 the average is 36 years.*" The House of Lords did not mention mandatory audit rotation in its conclusions and recommendations, but recommended mandatory tendering as mitigation against a very long tenure of audit firms:
    - *"175. The very long tenure of auditors at large companies is evidence of the lack of competition and choice in the market for the provision of audit services. A regular tender, with a non-Big 4 auditor invited to participate, should promote greater competition to the benefit of both cost and quality. We recommend that FTSE 350 companies carry out a mandatory tender of their audit contract every 5 years. The Audit Committee should be required to include detailed reasons for their choice of auditors in their report to shareholders.".*

Even though *"preliminary analysis of that data appears to show no correlation between auditor tenure and number of comments in PCAOB inspections"*, the effective duration of audit tenure is perceived by both the market and the regulators as a strong signal regarding the auditors' independence.

The summary of responses to the Green Paper (*"Audit policy: Lessons from the Crisis"*) also provides an overview of positions from professional bodies and public authorities (i.e. corresponding mostly to the same category of stakeholders than regulators and other professional bodies) which do not seem to have changed fundamentally by the financial crisis as regards their position towards mandatory rotation.

Responses to question 18 of the Green Paper "Should the continuous engagement of audit firms be limited in time? If so, what should be the maximum length of an audit firm engagement?"

Professional bodies and associations linked to the profession

"There is a general rejection of mandatory firm rotation. A few respondents consider that there should be a limitation of engagement for Public Interest Entities (PIEs) (a 10 year limitation was suggested)."

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

Public Authorities

"Many public authorities did not support the introduction of mandatory rotation. Others stated, however, that such a measure would be beneficial, some suggesting that the audit firm should rotate at the same time as an audit partner."

Responses to question 29 of the Green Paper "From the viewpoint of enhancing the structure of audit markets, do you agree to mandatory rotation and tendering after a fixed period? What should be the length of such a period?"

Professional bodies and associations linked to the profession

"There is strong rejection of mandatory rotation but support for tendering on a regular basis (e.g. every 3 or 5 years mentioned) or even mandatory tendering; the audit committee should review appointment on a regular basis and should have a policy for retendering and clear criteria for selection, more transparency on reappointment."

Public Authorities

"Mandatory rotation of audit firms may have the opposite effect to saving cost and enhancing audit quality. It might also increase the probability of collusion among audit firms in order to coordinate acquisition of clients. However, there were some who supported mandatory audit firm rotation, suggesting that the maximum period of engagement should be the same as for audit partners.

There is broad support for mandatory re-tendering.

None of CESR, CEIOPS and CEBS see mandatory rotation of audit firms as a significant measure that would substantially open up the audit market, although they see value in debating its possible contribution to auditor's independence."

V.2.13.3.3 *Views from mid-tier firms*

This section aims at presenting the mid-tier firms representatives' opinions collected through interviews:

- Overall, mid-tier firms are opposed to mandatory rotation for the same reasons as those reported above from professional bodies and public authorities (i.e. additional financial costs and the loss of knowledge of the client's industry and activities). Yet, should rotation be mandatory, they would prefer long mandates (e.g. 7+7 years mandates) to absorb rotation costs;

- Instead of enforcing mandatory rotation, mid-tier firms representatives would prefer that international standards encourage rotation and call on boards or audit committees to consider rotation and report at AGM the reasons for keeping the same auditor or changing auditors.

V.2.13.3.4 *Views from focus groups*

This section aims at presenting the opinions of participants to the focus groups:

- Focus groups' participants are mainly opposed to mandatory rotation:
    - They consider that mandatory rotation does not necessarily address the audit independence issue. *"Partner rotation is currently in place in many EU Member States and is enough to prevent collusion."*[174] Audit firm;
    - Furthermore, this measure would imply high administrative and financial costs for both companies and auditors. *"It takes two to three years for an audit team to understand how a company operates."* Company;
    - *"Audit firm rotation would not have any significant impact on concentration levels, since the largest companies are likely to rotate with different Big 4 only."* Professional body;
- However, a substantial minimum mandate duration is perceived as a relevant measure to ensure auditors' independence:
    - *"Conversely, substantial minimum mandate duration appears as a guarantee of independence. Indeed, if a company is able to easily break its auditor's mandate, this might encourage the audit firm not to issue an unpleasant report in order to be reappointed."* Audit firm;

- Mandatory audit firm rotation may lead to an Increase in incremental audit costs for both audit firms and companies:
    - Loss of efficiency gains developed by the auditor, the effect of this being a potential increase in costs to maintain the level of quality, or a decrease in quality;
    - As an example on audit quality, the Canadian Public Accountability Board175 stressed the risk of lower quality being the consequence of a pressure on audit fees: *"Audit Committees may also want to consider the pressure being placed on firms to reduce audit fees, and what impact this pressure may have on audit quality [...]Viewing the audit as a commodity, differentiated primarily based on price, has the potential to negatively affect audit quality"* Audit firm;
    - Recurring internal costs incurred at both group and subsidiaries level due to the expenses and time involved when changing its audit firm (potential tendering

[174] Partner rotation is a requirement in the Statutory Audit Directive but we chose to report the exact quote from the focus group member.
[175] Canadian Public Accountancy Board – Enhancing Audit Quality its Report on the 2010 Inspections of the Quality of Audits conducted by Public Accountants Firms – April 2011

process selection of auditor, kick-off meetings to launch the audit with new staff, etc.);
    - Risk of collusion among audit firms in order to coordinate acquisition of clients;
    - Barriers to implement such a measure in specialised industries or remote locations due to lack of expertise, staffing levels and/or independence.
- Yet, the impact on audit quality seems difficult to clearly assess at this stage: there is no proof of a decrease in audit quality when measured in terms of abnormal discretional accruals, going-concern motivated opinions.

V.2.13.3.5 *Conclusions on cost-benefit analysis*

In the light of the above analysis, the impact of enforcing mandatory audit firm rotation would be as follows:

- No favourable impact on capital market concentration;
- Possible increase in incremental audit costs for both audit firms and companies.

However, in the actual context (very low switching rates by companies of their audit firm, audit tenure that can last decades, mistrust of some investors regarding the perceived audit quality and the independence of the auditors), mandatory rotation is a measure worth studying, as it could boost the audit market.

The benefits of mandatory audit firm rotation should not be underestimated as it could improve the independence of auditors and audit firms. As stated in the PCAOB release No 2011-006, audit firm rotation might "*significantly enhance the auditor's ability to serve as an independent gatekeeper*" in the context of long audit tenure.

V.2.13.4 Potential accompanying or substituting measures

Should mandatory audit firm rotation be enforced, stakeholders plead in favour of:

- The enforcement of the measure in priority for largest companies and PIEs, for which long audit tenure and overfamiliarity appear as not critical;
- The terms of the implementation (including the maximum mandate duration) should be within the audit committee's province and part of an improved appointment process (ref. to detail below);
- A long maximum mandate duration to cover entry costs (ref. to details below);
- A strict enforcement of audit partner rotation at the same time in order to prevent partners from switching from the incumbent audit firm to the incoming audit firm;
- The possibility to rely on "*enhanced inspections, perhaps focused particularly on professional scepticism, that would serve as a substitute in cases in which it would be unusually costly,*

disruptive or otherwise impracticable to rotate auditors" as proposed in the PCAOB release No 2011-006;

- Inclusion of the relevant regulator in the pre-approval process with a veto power, however limited to certain categories of companies:
  - Financial institutions as a minimum;
  - Companies listed on the main index;
  - Companies which have been red-flagged by the financial market regulators.

Concerning the mandate duration, the opinion of key stakeholders expressed in the online survey on mandate is as follows:

- If audit firm rotation would become mandatory, stakeholders would favour long mandates:
  - 28% of the population surveyed ranked the 6+6 years mandate n°1 or n°2;
  - 19% ranked the 4+4 years mandate n°1;
  - 19% ranked the 3+3 years mandate n°1.
- Even if respondents to the survey do not usually support audit firm rotation, they would prefer long mandates to absorb costs.

As high switching costs are the main reason why stakeholders plead for long mandates, it could be interesting to consider a first relatively long mandate (6 or 7 years) followed by a maximum of two shorter mandates of 4 years. Total maximum period for rotation would therefore be between 14 to 15 years.

V.2.14 Action step 14: Introduce mandatory joint audit

V.2.14.1 Definition: what is joint audit?

"Joint" audit (sometimes referred to as "shared" or "co-audit") can be defined as the audit of a legal entity by two or more auditors, producing a single audit report (in the case of joint audit), or two separate reports (in the case of co-audit). Both firms are thereby sharing responsibility for the audit, though at different levels, depending on how work is split among different firms.

Joint audit can either be mandatory or be decided voluntarily by a company ("voluntary joint audit").

A joint audit model can be analysed under four dimensions:

1. Is joint audit mandatory or voluntary?
2. What is the scope of joint audit?
   - E.g. mandatory for all companies vs. for certain specific segments;
3. Who appoints or chooses auditors?
   - Choice made by the client company or by external entities such as regulators or public supervisory boards;
4. How is responsibility shared?
   - Shared (including joint report signed by the different partners) vs. non-shared (materialised by separate reports).

V.2.14.2 Current market situation: joint audit in the Member States

Joint audit has limited application across Europe, since only France has made it mandatory on a large scale (by law, imposing joint audit only for companies that prepare consolidated (group) financial statements).

Other Member States have either:

- Never implemented joint audit (majority of Member States covered);
- Abandoned it (e.g. Denmark dropped mandatory joint audits for listed companies in 2005);
- Or implemented it on a relatively limited scale (e.g. joint audit used to be compulsory in Sweden for the financial sector only, and it is no longer mandatory, but the Swedish Financial Supervisory Authority still has the right to appoint a second auditor, in financial companies).

The description of the three different joint audit models currently in place in Europe is presented below.

Table 80: Member States where joint audits are practiced

	Mandatory or voluntary joint audit and scope of joint audit	Choice of auditors	Responsibility between auditors
France	Mandatory for all publicly listed companies that prepare consolidated (group) financial statements	Client company	Each company is responsible for the audit
Germany	Voluntary for all companies (mainly used in the public sector)	Client company	Each company is responsible for the audit

Sources: Local standards setters.

V.2.14.3 Case studies

V.2.14.3.1 *The withdrawal of joint audits in Denmark*

In Denmark, joint audit dates back to the 1930's, and had been implemented to develop or strengthen the Danish audit profession, build up small audit firms and tackle the issue of "independence" of auditors vis-à-vis their clients.

According to a representative of a Danish mid-tier alliance of independent audit firms, the main reasons why joint audit was made voluntary in 2005 (subsequent to new company legislation in 2001) are the following:

- Costs or audit fees were considered too high;
- The usual "pairs" of auditors were a Big 4 and a much smaller firm (often an individual accountant), and the latter had no effective role in the audit work (which, in essence, limits the above assertion on audit fees being "too high");
- In relation to the previous point, cases of corporate or financial scandals that implied low quality of the work of the smaller audit firm.

In consequence, the Danish experience provides interesting insights on potential costs and deviations of joint audit, which are analysed below.

V.2.14.3.2 *The French case*

The objective of this section is to give an overview of joint audit as currently practiced in France.

As noted earlier in terms of methodology, the main sources used to identify the auditors of listed companies are reference databases Thomson Research/One Banker/Financial and Bureau Van Dijk (Amadeus and Osiris databases).

The French audit firms were classified into three categories:

1. The Big 4:
    - Deloitte;
    - Ernst & Young;
    - KPMG;
    - Price Waterhouse Coopers;
2. The mid-tier audit firms (and their affiliates):
    - AGN International;
    - Baker Tilly International/MCR;
    - BDO (ATRIO Réviseurs d'entreprises, ABPR and Marque & Gendrot);
    - BKR International;
    - Crowe Horwath International;
    - Grant Thornton;
    - Horwath Audit France;
    - Kreston International;
    - Mazars;
    - Members of Eura Audit International;
    - Members of TIAG (The International Accounting Group);
    - Moore Stephens International/SYC;
    - Nexia International;
    - PKF International;
    - Polaris;
    - RSM International;
3. The small audit firms: all other audit firms.

In France, a vast majority of companies prepare consolidated (group) financial statements. This explains the high percentage of listed companies using joint audits in the table below.

Table 81: Share of listed companies currently using joint auditors (2009)

	All listed Companies		Regulated market Companies		Main index Companies	
	By number of mandates	By turnover (M€)	By number of mandates	By turnover (M€)	By number of mandates	By turnover (M€)
Companies with joint auditors	**77%** (587)	**95%** (1 619)	**88%** (485)	**95%** (1 614)	**95%** (38)	**95%** (1 095)
Companies with a single auditor	**23%** (174)	**5%** (80)	**12%** (65)	**5%** (78)	**5%** (2)	**5%** (53)
Total number of companies and total turnover	**761**	**1699**	**550**	**1692**	**40**	**1148**

Sources: ESCP Europe analysis based on data from Thomson and Bureau Van Dijk.

The analysis of joint audit in France therefore covers a highly significant share of French companies (and almost all companies for the main index). In other words, the 174 French companies using a single auditor do not prepare consolidated (group) financial statements, and appear to be both a minority (23% of total mandates) and relatively smaller when compared to their peers (since they account for only 5% of total turnover).

The different "pairs" of auditors are split as follows:

Table 82: Distribution of joint auditor combination types for French listed companies (2009)

	All listed Companies		Regulated market Companies		Main index Companies	
	By number of mandates	By turnover (M€)	By number of mandates	By turnover (M€)	By number of mandates	By turnover (M€)
Two Big 4	17%	56%	19%	56%	61%	64%
One Big 4, One mid-tier	15%	26%	18%	26%	29%	24%
One big 4, One small audit firm	35%	9%	35%	8%	3%	1%
Other types of combination *	33%	10%	28%	10%	8%	11%
Total number of companies and total turnover	**587**	**1619**	**485**	**1614**	**38**	**1095**

Sources: ESCP Europe analysis based on data from Thomson and Bureau Van Dijk.

** Includes companies using three auditors.*

As a reference, detailed auditor pairs by listed market segment are outlined below:

Table 83: Type of joint auditor pairs for all French companies (by number of mandates, 2009, detail)

Type of auditor pair	Number of companies	%
1 Big 4, 1 small audit firm	206	**35%**
2 Big 4	99	**17%**
2 small audit firms	93	**16%**
1 Big 4, 1 mid-tier audit firm	89	**15%**
1 mid-tier audit firms, 1 small audit firm	72	**12%**
2 mid-tier audit firms	12	**2%**
Number of companies with 2 auditors	**571**	**97%**
1 Big 4, 1 mid-tier, 1 small audit firm	2	**0%**
1 Big 4, 2 mid-tier audit firm	1	**0%**
1 Big 4, 2 small audit firm	5	**1%**
2 Big 4, 1 mid-tier audit firm	3	**1%**
2 Big 4, 1 small audit firm	2	**0%**
2 mid-tier audit firms, 1 small audit firm	1	**0%**
3 Big 4	1	**0%**
3 mid-tier audit firms	1	**0%**
Number of companies with 3 auditors	**16**	**3%**
Number of companies with joint audit in the French listed market	**587**	**100%**

Sources: ESCP Europe analysis based on data from Thomson and Bureau Van Dijk.

Table 84: Type of joint auditor pairs for French companies listed on regulated markets (by number of mandates, 2009, detail)

Type of auditor pair	Number of companies	%
1 Big 4, 1 small audit firm	171	**35%**
2 Big 4	90	**19%**
1 Big 4, 1 mid-tier audit firm	87	**18%**
1 mid-tier audit firm 1 small audit firm	57	**12%**
2 small audit firms	51	**11%**
2 mid-tier audit firms	13	**3%**
Number of companies with 2 auditors	**469**	**97%**
1 Big 4, 2 small audit firms	5	**1%**
1 Big 4, 1 mid-tier audit firms, 1 small audit firm	2	**0%**
1 Big 4, 2 mid-tier audit firms	1	**0%**
1 mid-tier audit firms, 2 small audit firms	1	**0%**
2 Big 4, 1 mid-tier audit firm	3	**1%**
2 Big 4, 1 small audit firm	2	**0%**
3 Big 4	1	**0%**
3 mid-tier audit firms	1	**0%**
Number of companies with 3 auditors	**16**	**3%**
Number of companies with joint audit in the French regulated market	**485**	**100%**

Sources: ESCP Europe analysis based on data from Thomson and Bureau Van Dijk.

Table 85: Type of joint auditor pairs for French companies listed on the main index (by number of mandates, 2009, detail)

Type of auditor pair	Number of pair	%
1 Big 4, 1 mid-tier audit firm	11	**29%**
1 Big 4, 1 small audit firm	1	**3%**
2 Big 4	23	**60%**
Number of companies with 2 auditors	**35**	**92%**
2 Big 4, 1 mid-tier audit firm	3	**8%**
Number of companies with 3 auditors	**3**	**8%**
Number of Companies with joint audit in the French main index	**38**	**100%**

Sources: ESCP Europe analysis based on data from Thomson and Bureau Van Dijk.

Four comments can be made on the tables above:

1. Most listed companies choose a Big 4 and a small audit firm in terms of number of mandates, except on the main index;
2. Big 4 audit firms appear dominant considering the turnover of companies audited, as Big 4 audit the most important companies listed in France;
3. On the main index, the mid-tier firms (i.e. mainly Mazars) appear to have a higher market footprint than the European average, both in terms of number of mandates (29%) and in terms of turnover of the companies audited (24%);
4. Small audit firms might have benefited from mandatory audits to develop on the listed companies segment, as they have 35% of the mandates, representing 9% of the total turnover of the companies audited.

Therefore, joint audit seems to have enabled mid-tier and small audit firms to corner a relatively significant share of the market: they are paired with a Big 4 on respectively 15% and 35% of the mandates on the all listed companies market segment[176], representing 26% and 9% of the total turnover of the companies audited. Considering the market dominance of the Big 4 across Europe, most companies currently using a Big 4 and a smaller audit firm would probably choose only a Big 4 if they had been able to have only one auditor.

[176] See table 82 for detail.

V.2.14.4 Cost-benefit analysis

Given the limited application of joint audit across Europe (whether mandatory or voluntary), finding objective data on costs and benefits of joint audit is difficult.

In order to be as "fact-based" as possible, our cost-benefit analysis relies on three main sources:

- Insights from the French and Danish examples;
- A number of studies on joint audit that have been conducted since 2005;
- 14 interviews with mid-tier audit firms' representatives.

V.2.14.4.1 *Overview of main benefits of joint audits*

The main benefits of joint audits are:

1. Lowers the level of concentration on the listed companies segment and favours the development of mid-tier and small audit firms:
    - As demonstrated earlier, France is one of the least concentrated Member State (among the listed companies segment, and for Member States covered at this stage), with respective HHIs of 599 in number of mandates (low level of concentration) and 1,831 in turnover (moderate concentration, only Member State not appearing as concentrated);
    - The French case study suggests that joint audit helped mid-tier and small audit firms in obtaining a significant share of the listed companies market;
    - 43% of mid-tier firms interviewed perceive joint audit as offering significant opportunities (to take on larger mandates and develop technical expertise, e.g. on IFRS);
    - According to a representative of a mid-tier alliance of independent audit firms in Germany, joint audits could also indirectly contribute to lowering the M&A activity: a mid-tier firm is not as attractive a target when a Big 4 shares clients with them;
    - Strengthens the image and perception of mid-tier and small audit firms by allowing them to use flagship companies as references, hence a higher ability to convince new clients and to recruit more easily and to increase staff retention rates.
    - The impact of joint-audit on concentration levels will be detailed below (Benefit n°1).

2. Favours auditor rotation by lowering entry costs for a new entrant, since both auditors know the company and its sector and intrinsic characteristics extensively.
    - Stakeholders would value a firm rotation on two different years, as show results from the online survey:
        - 56% of the respondents think the rotation of the two auditors should be on different years;

    - 16% of the respondents think the rotation of the two auditors should be on the same year;
    - 28% of the respondents do not know or did not answer the questions.

3. Minimises the risk of demise of one of the Big 4 (since the joint auditor would much more easily take on its counterpart's work than a new entrant).

4. Improves audit quality by increasing the overall number of cross-checks, provided audit firms challenge each other's diligences:
    - Several mid-tier firms, participants from focus groups and audit clients consider that to the joint-audit fosters audit quality: *"Technical and complex issues arising from the accounts can be resolved more convincingly when more than one auditor is consulted".*

5. Reinforces the independence of auditors and lowers the overfamiliarity:
    - Noel [2005][177] concludes that in the majority of the cases, based on relative fees (and therefore even in the case of differences in audit fees paid to the joint auditors), the second auditor does not appear to act as a "subordinate" auditor, but rather as a legitimate counterweight that offers a concomitant view of the fairness of the financial statements;
    - Piot and Janin [2007][178] suggest that the joint audit is widely viewed as enhancing auditors' independence by providing a reciprocal check on the diligence of each auditor;
    - Mid-tier interviewees underline:
        - The higher weight of audit firms and the improved ability to challenge the company's management and to resist any potential pressure;
        - The higher level of effort in investigating technical issues identified by the client company or one of the audit firms, since both auditors need to reach a common view based on facts.

6. Enhances financial reporting quality
    - In Sweden, national statistics provided evidence on the higher level of rigour of joint audits (when they used to be mandatory, in the financial sector): the latter are associated with a lower number of income-increase abnormal accruals and a higher degree of earnings conservatism; which is commonly viewed in academic studies as evidence of earnings quality: all things being equal, earnings with relatively larger amounts of accruals are presumed to be inherently less reliable and more likely the result of opportunistic discretion by manager in applying accrual-based accounting.

[177] Noel – Le co-commissariat aux comptes à la française: Réponse aux doutes soulevés par Julien Le Maux – Revue Française de Comptabilité – Avril 2005

[178] Piot – Janin – External auditor, audit committees and earnings management in France – European Accounting Review (16) -2007

V.2.14.4.2 ***Overview of main costs and risks***

The main costs and risks of joint audits are:

1. Audit fees could increase:
    - This potential increase in costs will be detailed below (Cost-Risk n°1).

2. Joint audit makes auditor choice and audit process more complex for client companies, that perceive joint audit rather negatively:
    - In Denmark in 2009 (four years after joint audit was dropped), only 19 companies out of 182 had more than one auditor;
    - In a recent survey that polled 120 large businesses across Europe (*"European Audit Committee Chair and CFO Poll"*, YouGovStone, June 2011), 99% of interviewees declared being against mandatory joint audit;
    - The limited international coverage of smaller audit firms appear to be a challenge for international or large companies, since smaller audit firm networks are inconsistently structured from one Member State to another.

3. Joint audit makes audit process more complex for auditors (audit methodologies not fully compatible, competition between auditors in front of clients, difficult coordination and sharing of the work to be done, unclear communication, etc.):
    - A representative of a mid-tier network of independent audit firms pointed out the *"competition between audit firms, communication issues between the audit firms and the client, and complex planning and scheduling of the work"*.

4. Joint audit increases the risk of inconsistencies in methodologies or levels of substantive testing (e.g. benchmarks for balance sheet verification used), depending on the nature of the pairing, which could be potentially damaging for the largest firms, operating a high number of subsidiaries in many different Member States.

5. Joint audit lowers the level of "pressure" on audit firm partners, since responsibilities (and potential liabilities) are harder to identify.

6. It could affect audit quality depending on the components of the joint-auditor pair, according to Francis, Richard & Vanstraelen [2009][179], whose findings suggest that, based on an analysis of the level of abnormal working capital accruals of 467 French companies in 2003, "*clients of Big 4 auditors have smaller income-increasing abnormal working capital accruals and that the earnings of these companies are therefore likely to be affected by opportunistic managerial discretion that overstates earnings*", the evidence suggesting the following hierarchy in audit quality delivered:
    - Two Big 4 (highest quality level);

[179] Francis-Richard-Vanstraelen – Assessing France's Joint Audit Requirement: Are Two Heads Better than One? - 2009

  - A Big 4 paired with a non-Big four auditor;
  - Two non-Big 4 auditors, with "*evidence of a greater constraint on income-decreasing earnings management by companies with large French auditors relative to companies with small French auditors*".

7. Joint audit limits the ability of clients to choose among different potential audit suppliers, since two audit firms need to be appointed:
   - This could be a serious threat to competition in the most concentrated industries that require specific technical expertise.

8. Joint audits could have a limited impact on the functioning of the market:
   - Studies (e.g. Le Meaux, [2004] and [2006]) and interviewees point out the strong asymmetry in task allocation, with one audit firm often taking on much more tasks or responsibilities than the other;
   - Some interviewees mention an unbalanced sharing of responsibilities, with a "leading" audit firm focusing on the parent company and a few key subsidiaries, while the other audits smaller-scale or insignificant subsidiaries (e.g. with a much lower turnover/total balance sheet).

9. Joint audits could be complex to implement to have a well-balanced repartition of responsibilities and thus fees between the co-mandates:
   - This can be shown analysing the repartition of the fees perceived by co-mandates in France. Considering companies from the SBF 250[180]: when in co-mandate with a Big 4, mid-tiers firms perceive on average 28% of the total audit fees.

[180] Analysis on the audit fees of 101 companies of the SBF 250 in 2009.

V.2.14.5 Benefit n°1: Impact of joint audit on concentration levels

This sections aims at assessing the potential impact of joint audits on concentration levels.

The following simulation consists in evaluating the market share points that mid-tier audit firms would need to gain over the Big 4 for the audit market to reach a “moderate” concentration level. This simulation has been conducted on all listed companies for the three most concentrated Member States (in turnover of audited companies), which are Spain, Sweden and Germany.

Member State	Current HHI (by turnover)	Market shares to be captured by mid-tier firms to reach the “moderately concentrated” level
Spain	4050	33 points
Sweden	3437	29 points
Germany	3244	22 points

Sources: ESCP Europe analysis based on data from Thomson and Bureau Van Dijk.

Taking Spain as an example, moving from the current 4,050 HHI to an HHI below 2,000 (i.e. considered as moderately concentrated) would require the Big 4 market share to go down 33 points.

The analysis above demonstrates that joint audit could not be enough for the most concentrated Member States to reach a moderately concentrated market, since mid-tier firms would need to capture 22 to 33 market share points over the Big 4. Other measures might need to be looked at as well, in combination with joint audit.

V.2.14.6 Cost- Risk n°1: Relationship between joint audits and audit fees

The following analysis aims to assess the potential impact of joint audits on audit fees. We have therefore compared audit fees (and audit-related fees) paid by companies on the national main indexes:

- Audit fees have been obtained from annual accounts (except for France[181], Spain[182] and the United Kingdom[183]);
- Turnovers have been obtained from reference databases (Thomson Research/One Banker/Financial and Bureau Van Dijk databases) or annual reports where databases were not available;
- Ratios have been calculated for 2009 (2008 for Spain and the United Kingdom).

Please note that the non-audit fees were not taken into account.

Table 86: Current level of audit fees by Member State

Audit and audit-related fees in EU statutory audit markets - Main index companies					
Member State	**Number of surveyed companies in the Member State's main index**	**Total Turnover of Main indexes companies in 2009 (M€)**	**Total audit fees and audit-related fees in 2009 (M€)**	**Audit fees (€)/ turnover (M€)**	**Average audit fees (M€)**
Austria	20	94,850	44	**387**	2.2
Belgium	19	262,074	207	**792**	10.9
Bulgaria	1	n.a.	n.a.	**n.a.**	n.a.
Cyprus	5	n.a.	n.a.	**n.a.**	n.a.
Czech Republic	11	37,588	27	**707**	2.4
Denmark	20	139,919	41	**295**	2.1
Estonia	3	n.a.	n.a.	**n.a.**	n.a.
Finland	25	149,597	62	**414**	2.5

[181] Audit fees and audit-related fees for France have been retrieved from the AMF Study: Etude relative aux honoraires versés aux commissaires aux comptes et à leur réseau au titre de la période 2009 par les groupes du CAC 40. 2010.
[182] Audit fees and audit-related fees for Spain have been retrieved from the article of la "expansion, Madrid", Nº y fecha de publicación: 90511 - 11/05/2009- La crisis rebaja un 5% la factura de las grandes empresas a sus auditores.
[183] Audit fees and audit-related fees for the United Kingdom have been retrieved from the audit fees survey published in 2009 from The financial director.

France	39	1,163,131	689	**592**	17.7
Germany	30	1,091,009	503	**461**	16.8
Greece	10	42,610	25	**598**	2.5
Hungary	3	n.a.	n.a.	**n.a.**	n.a.
Ireland	17	64,594	48	**739**	2.8
Italy	37	498,382	234	**470**	6.3
Latvia	7	n.a.	n.a.	**n.a.**	n.a.
Lithuania	7	n.a.	n.a.	**n.a.**	n.a.
Luxembourg	7	24,752	17	**693**	2.5
Malta	17	2,475	2	**638**	0.1
Netherlands	23	533,596	222	**416**	9.6
Poland	19	63,766	14	**214**	0.7
Portugal	16	54,500	27	**496**	1.7
Romania	4	n.a.	n.a.	**n.a.**	n.a.
Slovakia	3	759	0.5	**655**	0.2
Slovenia	6	8,334	2	**267**	0.4
Spain (2008)	33	474,444	192	**405**	5.8
Sweden	29	283,377	153	**539**	5.3
UK (2008)	95	1,800,454	837	**465**	8.8
UK (2008) – 40 companies only	40	647,130	256	**395**	6.4

Sources: ESCP Europe analysis based on data from AMF, Financial Director and Annual Reports.

Audit fees presented above includes audit and audit-related fees as defined in each Member States and presented in the annual reports.

Considering the above ratios, the joint audit system seems to have a limited influence on price levels. Indeed, when comparing average audit fees per million turnover:

- Audit fees per million turnover vary from €214 per million turnover in Poland to €792 per million turnover in Belgium;

- France, with an average of €592 per million turnover, does not stand out from the other Member States (European average: €512 per million turnover);
- Germany, with an average of €461 per million turnover, appears to have slightly lower average fees than France;
- The UK (considering an index with the 40 most important companies) appears to have lower fees than both France and Germany.

According to qualitative interviews and focus groups, joint audit is perceived as slightly more expensive:

- 50% of mid-tier firms interviewed think that the enforcement of joint audit would increase costs;
- Focus groups think that joint audit could be responsible for an increase from 4% to 10% in audit prices, 10% being probably overstated:
  - *"Joint audit could imply perceived 10% higher cost, but this is probably overstated or even untrue."* Focus Group Participant.

In conclusion, opinions from the different stakeholders and quantitative analysis differ. No data were acquired on this issue, but companies and audit firms estimate that the added cost to range from 4% to 10%, 10% being probably overstated.

V.2.14.7 Conclusion and potential steps to mitigate identified risks and costs

In conclusion, joint audit clearly needs to be considered as a serious option to enhance the European audit market:

- The analysis of its benefits demonstrate that it could contribute to address several key issues identified, i.e. concentration levels, audit quality and auditor independence;
- In terms of negative perceptions on joint audits, two main points have been made: first, the increased audit cost and, secondly, the complexity of organizing an effective audit plan or programme and the allocations of work or responsibilities between the different audit firms.

Therefore, to avoid overfamiliarity, improve audit quality and have positive effects on concentration levels, we recommend:

- To enforce mandatory joint audit for listed companies:
  - In France, every company that prepares consolidated financial statements must have joint audit, but some of these companies are small in size. However, for these companies audit concentration is not an issue. Imposing joint audit for listed companies only should be thus more efficient;
  - Mandatory joint audit should be enforced at least for Public Interest Entities;

- To facilitate the tasks and responsibilities to be carried out by the co-mandates and avoid joint audit in appearance only:
  - The audit committee should play an active role in the audit planning process and repartition of the audit work between the co-mandates;
- Having staggered or overlapping appointments (instead of appointing both auditor at once), as it would ensure a safe transition and lower entry costs for new auditors;
- A “consortium” option under which responsibilities would be balanced around subsidiaries, business units and/or geographical locations (which was, for example, the solution usually preferred by mid-tiers firms in the qualitative interviews conducted).

Yet, two issues could hinder the positive effects of the mandatory joint audit:

- The resistance against this measure mentioned by stakeholders interviewed and focus groups participants
- The complexity to implement it.

V.2.15 Action step 15: Introduce mandatory joint audit with a ban on the appointment of two Big 4

This measure could have a strong impact on concentration and barriers to entry for mid-tiers. However, it could also have a negative impact on audit quality, as it is not clear whether mid-tier audit firms have the capacity to audit the largest international companies.

V.2.16 Action step 16: Introduce mandatory tendering

According to the responses to the EC Green Paper on Audit Policy, the positions of the various stakeholders are quite mixed regarding a mandatory tender process.

A frequent and transparent tendering process is broadly supported. However mid-tier firms, preparers, business and organisations of companies do not favour the fact that it should become mandatory.

The main drawbacks that were identified during our interviews are related to costs for both companies and audit firms and would likely penalise mid-tier firms for their lack of critical size compared to Big 4 audit firms to cover costs of the tendering process.

Moreover, as reported by key stakeholders during focus groups, such a measure could lead to a decline of audit quality as mandatory tendering might generate price wars:

- Participants pointed out that such a measure could lead to the decline of audit prices of about 20% as it would generate fierce competition between auditors and clients might take advantage of the situation to negotiate lower prices. Consequently, audit quality could suffer;
- A solution mentioned during the focus group could be to force audit committees to justify each audit prices evolution (above certain thresholds) to shareholders.

As already mentioned[184], the impact on audit quality of pressure on fees has become a concern not only for audit firms but also for audit regulators. This has been clearly stated by the AMF, the French financial market regulator, in its latest study on audit fees[185]. It is reported that, over the 2007 to 2009 period and among companies listed on the main index, audit fees decreases between 10% and 30% have been observed at the time of mandate renewals. The AMF reminds that, in accordance with AMF instruction n°2006-10, and in case of significant decrease in audit fees, issuers should

[184] See section 8 Focus on fourth key issue: quality of audit

[185] AMF [July 2011] - Etude relative aux honoraires versés aux commissaires aux comptes et à leur réseau au titre de la période 2010 par les groupes du CAC 40, de l'EUROSTOXX 50 et d'un échantillon de 42 sociétés des compartiments B et C d'Eurolist

provide all useful information that would explain the reasons for such decrease (as a comment to the mandatory schedule which discloses audit and non-audit fees).

Should tendering become either recommended or mandatory as part of the auditor appointment process for PIEs, the following accompanying measures could be considered:

- Tendering process without Big 4-specific clauses;
- Increased transparency in audit committee choice which would include the documentation of their proposed choice of auditors by providing qualitative information such as geographical coverage, fees, quality of technical answers, reputation, made available to both regulators and shareholders;
- Audit committee could report to shareholders and/or to regulators the reason why they consider that a reduction in fees will not go against quality (when a potentially high decrease in audit fees, above a certain threshold, is observed);

Mandatory tendering could be a useful measure to boost audit market "dynamics" in the short term, considering the currently low switching rates. In this perspective, it could be introduced for a three to five-year period only.

V.2.17 Action step 17: Implement ISAs

International Accounting Standards develop guidelines on the auditor's intrinsic role and the procedures to be followed in order to ensure that the auditor will deliver an appropriate professional opinion supported by the necessary evidence and objective judgments.

As previously stated, high quality auditing standards are key contributor to audit quality at both national and European level. The implementation of ISAs across the EU would serve two purposes:

- Harmonising audit practice and to a certain extent audit market across the EU;
- And therefore enhancing audit quality from both an intrinsic and a perceived point of view, as it would provide assurance to stakeholders that the audit of all relevant financial statements has been performed accordingly to the same widely recognised set of auditing standards.

However the mandatory implementation of ISAs does not address the others issues related to the audit market, such as concentration and barriers to entry.

V.2.18 Action step 18: Limit the provision of non-audit services to statutory audit clients

The main benefits of this potential measure are:

- To tackle the issue of auditor independence and the linked issue of investor mistrust by ensuring that auditors' opinions are not influenced by a conflict of interest that could result from providing consulting or non-audit services to audit clients;
- To lower a potential barrier to entry of mid-tier firms with clients that have very strong (i.e. audit and non-audit) relationship with their clients;
- To ensure audit fees are not low because of potential cross-subsidisation from non-audit services.

The main disadvantage of this measure is the risk of weakening the market position and sector expertise of mid-tier firms, since non-audit services account for a significant share of their revenues.

To meet the investors' expectations, modified measures could also be considered:

- To limit the provision of non-audit services on principle-based requirements, e.g. which could partly be based on the IFAC 2009 revised Code of Ethics, since it includes strengthened requirements on auditor independence and a broader scope of non-audit services that are identified as threats to the auditors' independence (bearing in mind that the IFAC Code of Ethics was issued by IFAC members, that is to say auditors, and can only be taken as a practical source of information);
- To redefine the role of audit committees regarding the pre-approval of non-audit services on a case-by-case basis (following the US framework) and to introduce controls by the audit committee on the respect of non-audit regulation;
- To publicly disclose the share on non-audit services provided by the statutory auditors for each listed company, and the type of work that has been carried out per type of non-audit service.

These measures could ensure auditors' independence (intrinsic and perceived), while enabling mid-tier firms to continue to develop through this type of services.

V.2.19 Action step 19: Limit the proportion of fees an audit firm can receive from a single client

There are currently no binding rules concerning the maximum weight of a client in an audit firm portfolio. However, most market experts interviewed argue that informal professional standards among auditors *de facto* limit the weight of a single client to 10% to 15% of the audit firm turnover.

Even if already in place in the majority of the audit firms in Europe, this limitation needs to be assessed with regards to the possible associated overfamiliarity: 15% of the turnover of an audit client equals to two months of its annual activity.

This rule is thus an efficient mean to avoid any overfamiliarity.

However, market experts argue that the implementation of such a rule could disadvantage the smallest players, as the fees of any important company would represent more than 10% to 15% of their turnover.

The following analysis tries to evaluate the impact of such a measure on the ability of mid-tiers to audit major listed company:

- The average audit fees and the minimum audit fees on each main index were compared to the revenues of top mid-tiers firms identified in a selection of Member States.

The following table shows the results for France, Germany, Ireland, Italy, the Netherlands, Poland, Spain, Sweden and the UK (where mid-tier firms' revenues were available).

Table 87: Weight of the average and minimum fees on main index compared to mid-tier firms revenue in 2009

Member State	Total number of mid-tier firms identified	Total number of mid-tier firms for which minimum fees on the main index remains under 15% of their revenues
France	24	17
Germany	24	24
Ireland	23	21
Italy	23	17
Netherlands	24	22
Poland	24	24
Spain (2008)	24	24
Sweden	13	13
UK (2008)	24	24

Sources: ESCP Europe analysis based on data from IAB, AMF and Annual reports.

The analysis shows that most mid-tier firms would be able to audit the smallest companies of the main index, should the rule be implemented. The minimum fees on the main index represent less than 15% of the revenue of:

- Every identified mid-tier firms in Germany, Poland, Spain, Sweden and the UK;

- Almost every firm in the other studied Member States (17 out of 24 firms in France, 21 out of 24 firms in Ireland, 17 firms out of 23 in Italy, 22 firms out of 24 in the Netherlands).

In conclusion, we recommend limiting the proportion of fees an audit firm can receive from a single listed client for all audit firms as it is an efficient way to limit a possible overfamiliarity between the auditor and the company.

The way to implement this rule could be to introduce the threshold of 15% set in the IFAC Code of Ethics. An auditor of a Public Interest Entity should disclose when the fees from the client represent more than 15% of the total fees received by the audit firm.

V.2.20 Action step 20: Establish contingency plans for the potential demise of a Big 4 audit firm (living will)

This measure would tackle the systemic risk of demise of a Big 4 and the Big 4 firms appear to be currently working on the subject.

The details of potential living wills remain to be discussed, and appear too vague to take a clear position at this stage. Yet, despite a high acceptability among stakeholders, it could prove complex to shape and take long before being implemented all across Europe.

V.2.21 Action step 21: Publicly disclose loan agreement to regulators

Two countries, the UK and the US, have recently taken action on loan agreements.

In the US, listed companies now have to disclose loan agreements to the regulator.

In the UK, the Financial Reporting Council (FRC), encourages companies to disclose[186] *"contractual obligations to appoint certain audit firms"* and states that *"when explaining auditor selection decisions, boards should disclose any contractual obligations to appoint certain types of auditing firms".*

On the basis of these two examples, the main benefits and costs identified are outlined below.

Benefits:

1. Would have an impact on the covenant issue as the regulator would have a clear view of the scope and frequency of restrictive covenants in the market;
2. Appears relatively easy to implement.

Costs and Limitations:

3. Would have a limited impact on the functioning of the market:
   - Some interviewees[187] mention that "*the disclosure of the loan agreements will not have any impact on the limitation of market concentration*."

Despite its limited impact on the competitive issue, loan agreements' disclosure should be encouraged. This measure would permit the regulator to have a clear understanding of restrictive covenants, their frequency and extent.

[186] Financial Reporting Council (October 2009), Choice in the UK Audit Market, 4th Progress Report, page 4.
[187] Interviews with the Chairman of EGIAN and mid-tier audit firms.

V.2.22 Action step 22: Increase the number of public interest entities that need to be audited

The audit of the public sector has been identified as an opportunity to increase competition and choice in national audit markets.

The public sector is comprised of a wide range of entities (from hospitals, universities, museums to large state-owned companies operating on an national basis, public-private partnerships and public bodies and institutions in charge of health, welfare, unemployment or pensions). Depending on Member States, some of these entities are not currently audited (in France, the recent "State Modernisation Program" has strongly encouraged the implementation of both external and internal audit of public institutions) or are audited by state-related bodies (for example, the "Cour des Comptes" in France, or the Audit Commission in the UK).

Encouraging the audit of the public sector could represent an opportunity to strengthen the non-Big 4 firms capacity to audit relatively large institutions. Indeed, international reach, as previously discussed, has been identified as a barrier to entry for mid-tier firms: this barrier does not play any role in the audit of public entities, that operate on a national basis. The requested range of work would not be "*quite so requiring of a global network as traditionally auditing a big international company has been supposed to do*" as highlighted by Baroness Hogg expressing her views on the opportunity to abolish the Audit Commission and the development of a risk committee to the Lords Select Committee on Economic Affairs. This The Committee on Legal Affairs of the European Parliament goes one step further in its "Report on audit policy: lessons from the crisis": "*58. […] consider that the public procurement sector should aim to use non-Big 4 firms and that public bodies should set a benchmark percentage for use of such firms*".

Such a measure would increase the cost of audits for Member States. This might not be favoured option by Member States given the current debt context. Yet:

- The largest public institutions (i.e. the most expensive audits) are usually already audited on a relatively regular basis;
- Audits could help in improving the functioning of public institutions (e.g. in terms of public procurement), hence resulting in benefits offsetting the audit cost.

This action step merits further consideration as it would have an impact on lowering barriers to entry for mid-tier audit firms in the audit market of relatively large institutions:

- In the short term, this would progressively increase the market share of mid-tier audit firms in each Member State;
- In the mid-term, the measure could strengthen the capacity of mid-tier audit firms to compete with Big 4 audit firms on the audit of larger multinational companies.

V.2.23 Action step 23: Reinforce the role of the audit committee

The role played by the audit committee, in terms of responsibility and transparency, in both the financial reporting and audit processes can impact two different issues:

- The auditors' independence;
- The level of transparency between the company and the investors.

After a summary of the main features of an audit committee under the EU Directive th[188] on the statutory audit of annual accounts and consolidated accounts published in May 2006 (the "Statutory Audit Directive"), this section will focus on the analysis of five fields of action in which the audit committee is the key player at company level regarding the audit process:

- Choice of the auditor;
- Monitoring the independence of the auditor, especially on the provision of non-audit services to audit clients;
- Control the audit work;
- Increase the transparency, for example regarding level of fees or auditor's appointment process;
- Communicate in a transparent manner with other key stakeholders, especially on the risks the company faces.

V.2.23.1 Definition of audit committee in EU legislation and of independence of audit committee members

V.2.23.1.1 *Definition and role of the audit committee*

The audit committee is part of the corporate governance structure of a company and usually consists of non-executive members of the administrative body and independent members of the board of directors. Audit committees have the oversight responsibility for the auditing and the financial reporting process. Considering their mandate of being responsible for the oversight of the financial reporting and audit process, the members of the committee are required to have competences in accounting or auditing.

At European Union level, the role of the audit committee is defined in Article 41 of the Statutory Audit Directive:

- *"Each public-interest entity shall have an audit committee. The Member State shall determine whether audit committees are to be composed of non-executive members of the administrative body and/ or members of the supervisory body of the audited entity and/or members appointed by the general meeting of shareholders of the audited entity. At least*

[188] Directive 2006/43/EC.

one member of the audit committee shall be independent and shall have competence in accounting and/or auditing. […]

- *[…] the audit committee shall inter alia:*
    - *a) monitor the financial reporting process;*
    - *b) monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;*
    - *c) monitor the statutory audit of the annual and consolidated accounts;*
    - *d) review and monitor the independence of the statutory auditor or audit firm and in particular the provision of additional services to the audited entity;*
- *In a public-interest entity, the proposal of the administrative or supervisory body for the appointment of a statutory auditor or audit firm shall be based on a recommendation made by the audit committee*
- *The statutory auditor or audit firm must report to the audit committee on key matters arising from the statutory audit, in particular on material weaknesses in internal control in relation to the financial reporting process […]."*

In the United States, audit committees have existed for a long time but their roles have changed significantly over the years, especially since the Enron scandal. By reviewing the corporate governance structure in companies, the Sarbanes-Oxley Act which was adopted in 2002 as a response to the public demand for a stricter legislation, aiming at restoring investors' confidence in the audit, modified the key tasks and responsibility of the audit committee.

Section 301 of the Sarbanes-Oxley act defines:

- The rules for the composition of the audit committee;
- The responsibility of the audit committee in appointing, compensating and overseeing the work of the chosen auditor;
- The audit committee's authority to engage independent counsellors where necessary;
- The audit committee's responsibility in dealing with complaints procedures.

The Sarbanes-Oxley Act not only gives the audit committee the authority to appoint the auditor, but also increases its responsibilities and weight in the audit process.

V.2.23.1.2 *Definition of independence regarding audit committee membership: case studies in the United Kingdom, Germany and France*

The Statutory Audit directive states that at least one member of the audit committee should be independent but does not provide further criteria for independence. The definition of the criteria varies significantly from one Member State to another. One of the main reasons for the differences in Member States' legislation is the assessment of the independence criteria in relation to "significant", "major" or "controlling" shareholders as members of the audit committee.

V.2.23.1.2.1 Case: the United Kingdom

In the UK, where dominant shareholders are rare, the UK Corporate Governance Code published in June 2010 by the FRC proposes the following detailed guidelines regarding the "independence" of an audit committee member:

"B.1.1 The board should identify in the annual report each non-executive director it considers to be independent. The board should determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the director:

- *Has been an employee of the company or group within the last five years;*
- *Has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;*
- *Has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;*
- *Has close family ties with any of the company's advisers, directors or senior employees;*
- *holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;*
- *Represents a significant shareholder; or*
- *Has served on the board for more than nine years from the date of their first election."*

V.2.23.1.2.2 Case: Germany

In Germany, where the existence of dominant shareholders is quite common, the "independence" criteria regarding audit committee members defined in the German Corporate Governance Code as amended in May 2010 are not so detailed compared to other countries and do not specifically mention the status of "significant shareholder". The Corporate Governance Code states that:

- *"The Supervisory Board shall set up an Audit Committee"*
- *"The chairman of the Audit Committee shall have specialist knowledge and experience in the application of accounting principles and internal control processes. He should be independent and not be a former member of the Management Board of the company whose appointment ended less than two years ago"*

The concept of independence is briefly defined as follows:

- *"A Supervisory Board member is considered independent if he/she has no business or personal relations with the company or its Management Board which cause a conflict of interests. Not more than two former members of the Management Board shall be members of the Supervisory Board and Supervisory Board members shall not exercise directorships or similar positions or advisory tasks for important competitors of the enterprise."*

V.2.23.1.2.3 Case: France

In France, where the range of shareholding structures is quite varied, the Commercial Code only provides a single criterion for independence of audit committee members: they must be board members, since audit committee members must not perform any management functions. This provision is a way of requiring a minimum of independence for all audit committee members.

A detailed set of criteria is however suggested in the AFEP[189]-MEDEF[190] Corporate Governance Code published in December 2008:

"*The criteria to be reviewed by the committee and the Board in order to have a director qualify as independent and to prevent risks of conflicts of interest between the director and the management, the corporation, or its group, are the following:*

- *Not to be an employee or executive director of the corporation, or an employee or director of its parent or a company that it consolidates, and not having been in such a position for the previous five years;*
- *Not to be an executive director of a company in which the corporation holds a directorship, directly or indirectly, or in which an employee appointed as such or an executive director of the corporation (currently in office or having held such office going back five years) is a director;*
- *Not to be a customer, supplier, investment banker or commercial banker: that is material for the corporation or its group, or for a significant part of whose business the corporation or its group accounts;*
- *Not to be related by close family ties to an executive director;*
- *Not to have been an auditor of the corporation within the previous five years;*
- *Not to have been a director of the corporation for more than twelve year;*

As regards directors representing major shareholders of the corporation or its parent, these may be considered as being independent, provided that they do not take part in control of the corporation. In excess of a 10% holding of stock or votes, the Board, upon a report from the appointments committee, should systematically review the qualification of a director as an independent director, having regard to the make-up of the corporation's capital and the existence of a potential conflict of interest."

This overview of the definition of the independence of audit committee members highlights the lack of uniformity in this definition in EU Member States.

[189] AFEP (Association Française des Entreprises Privées) is an association of France's top listed companies
[190] MEDEF is france's leading federation of employers

V.2.23.2 Improve auditor independence by being the key player in the appointment process

V.2.23.2.1 *Description of current situation*

Although the definition of the audit committee is provided in the Statutory Audit Directive, the role played by audit committee in the appointment of the auditors varies between the 27 Member States, depending on national legislation.

- In most cases, auditors are effectively chosen by the management, who strongly influence the selection by the audit committee:
- According to the online survey conducted for this study, audit firms are chosen (in terms of influence and not in terms of formal choice) by the management of the audited company (management and/or CFO and/or CEO and/or executive board). Only 29% of respondents think that the audit committee has a real influence on the audit firm choice. In certain Member States, the appointment process varies according to the types of companies. For example in the case of financial institutions the financial regulator may have a certain influence in the auditor's appointment:
    - In France, the Autorité de Contrôle Prudentiel has to express its opinion on the choice of the auditor for financial institutions;
    - In Slovakia, financial institutions have to report their choice of auditor to the financial regulator who has a veto right in case of disagreement with the company[191];
    - In Luxembourg, financial institutions and insurance companies have to inform the financial regulator about the appointed auditor; the financial regulator may recommend another auditor to the company.
- In Sweden, the audit committee has an important role in evaluating candidates and preparing the appointment of the auditor; however, the proposal to the shareholders is made by a nomination committee which, under the Swedish system, is not a Board committee but a committee within the General Meeting and consists out of a majority of representatives from the shareholders.

The analysis of the current situation shows that there is no harmonised binding rule assuring auditor independence vis-à-vis the company. The current role given to the audit committee does not appear to be efficient, as it has only a limited influence on the appointment process.

V.2.23.2.2 *Case: Sweden*

The Swedish model which also exists in Norway differs from the approach implemented in other EU Member States or in the United States. Shareholding structure is highly concentrated in Sweden and as a consequence shareholders play an important role in the decision process of companies. A number of listed companies in Sweden are owned by one or just a few majority shareholders which participate actively in the company. This is the main reason why the Swedish model differs from models applied in other Member States.

[191] Article 22 of the Slovakian Banking Act.

In this model, both the audit committee and the nomination committee are involved in the auditor appointment process.

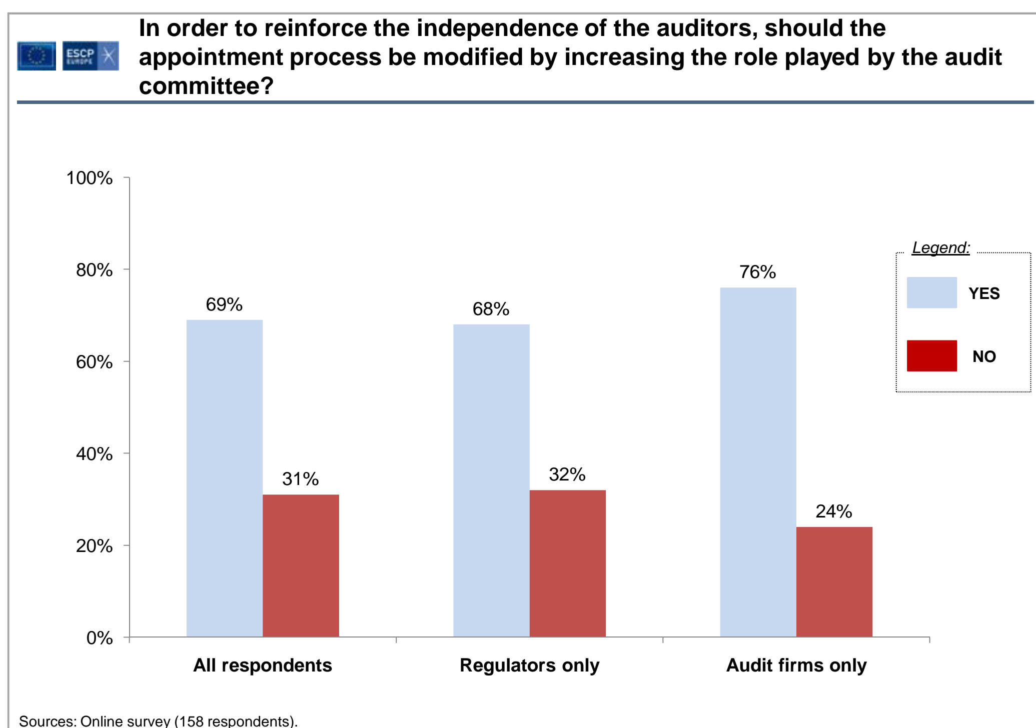
The audit committee is composed of at least two members, who have to be directors but cannot be employees of the company, and of members which should be independent from both the company and its controlling shareholders. One of the duties of the audit committee is to assist in the preparation of proposals to the shareholders' annual meeting concerning the future auditor.

The nomination committee is subordinated to the annual general meeting; shareholders elect its members. About three quarters of the nomination committees in Sweden consist of members representing certain shareholders, primarily Swedish institutional shareholders. This differs from the usual model where nomination committee is subordinated to the Board (and therefore not to the annual general meeting); its members are board members which are independent of the major shareholders of the companies. The Swedish nomination committee's role also differs from its foreign equivalent as its duties also include the proposal of an auditor as well as its fees, aside from its usual role of proposing chairman and other directors.

V.2.23.2.3 *Opinion of the online survey on the role of audit committee in the appointment of the auditors*

158 key stakeholders from 27 Member States were consulted on the way to reinforce auditor independence by modifying the appointment process. A summary of their responses is shown in figure 40:

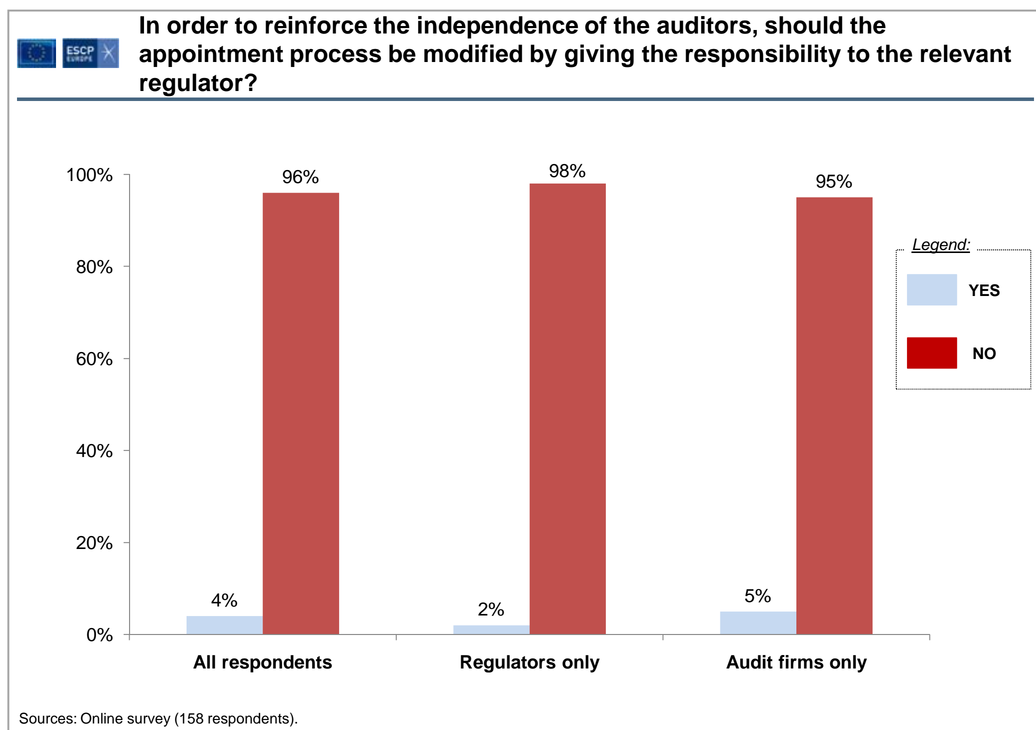
Figure 40: Should the appointment process be modified by increasing the role of the audit committee?



The online survey shows a positive opinion from all stakeholders with 69% of the respondents favouring the reinforcement of the audit committee, including regulators and audit firms.

These results can be compared to the opinion of the respondents on the increase in the role of the relevant regulator in the appointment process:

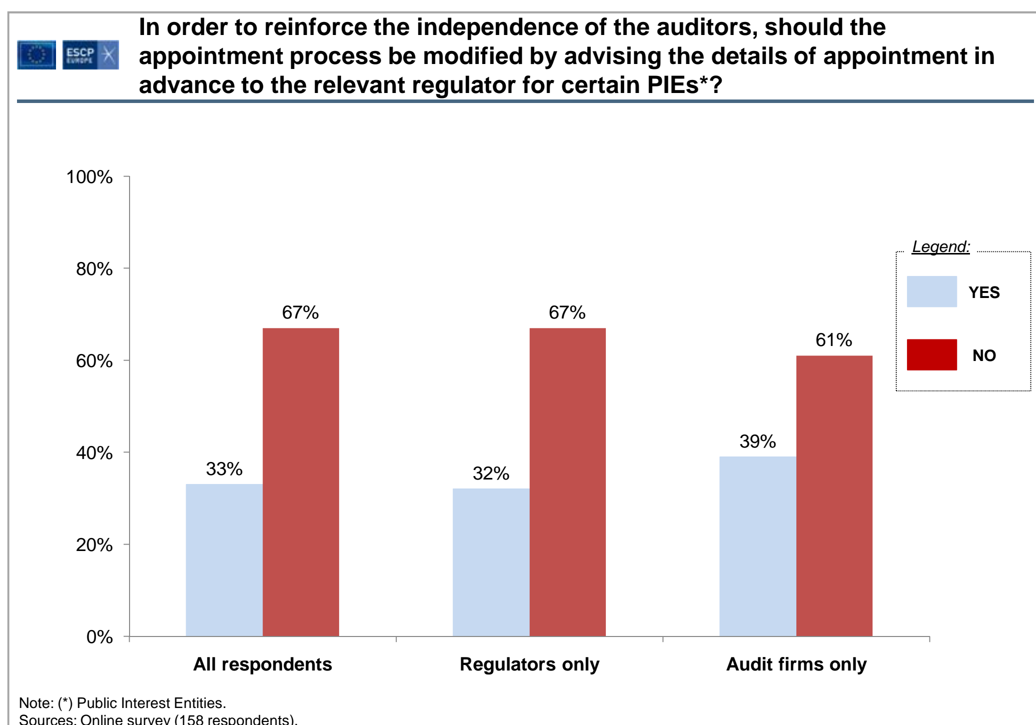
Figure 41: Should the appointment process be modified by giving the responsibility to the relevant regulators?



No category of respondents favours the modification of the appointment process by giving the responsibility to the relevant regulator, also not regulators.

However, regulators can be involved in the appointment process for certain types of companies:

Figure 42: Should the appointment process be modified by advising the details of the process in advance to the relevant regulators for certain Public Interest Entities such as bank and financial institutions?



Even if key stakeholders are not entirely favourable to involving regulators in the auditors' appointment process, one third of them would value the advice of the regulator in the choice of the auditor for Public Interest Entities such as banks and financial institutions.

The three figures above show that key stakeholders are in favour of increasing the role of the audit committee in the appointment process of the auditor instead of increasing the role of the regulator.

The next figures present the opinion of the respondents on the way the audit committee should communicate to increase transparency on the market:

Figure 43: Regarding the process of appointment in "PIEs", should it be recommended that Audit Committee document their proposed choice of auditors by providing qualitative information such as geographical coverage, fees, quality of technical answers, reputation, to the shareholders?

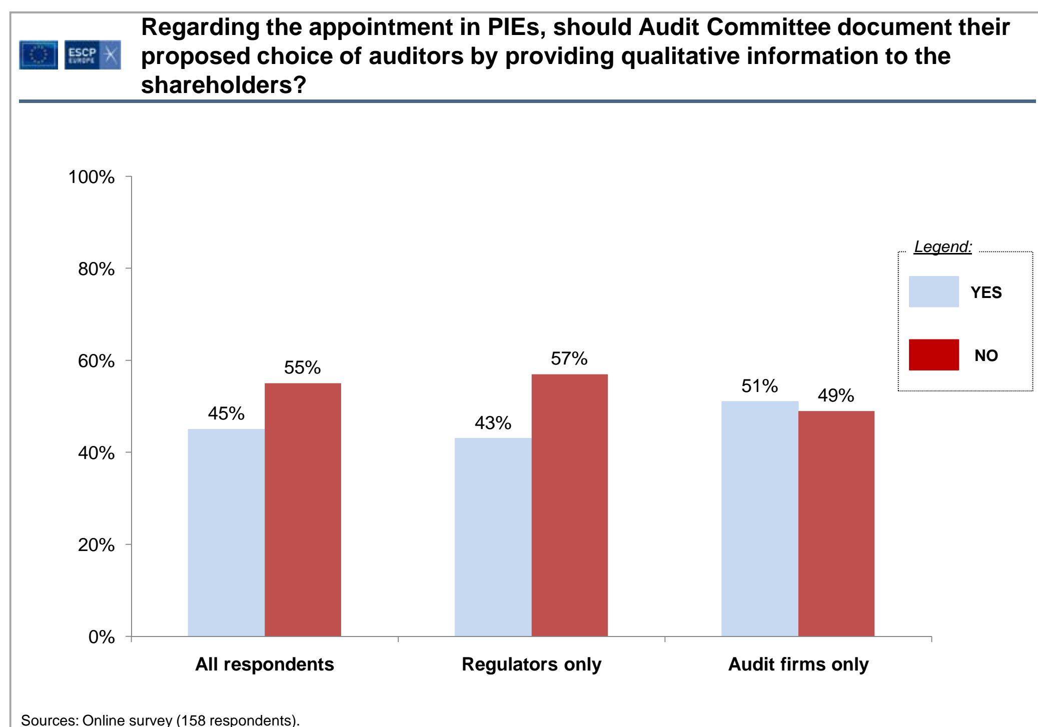


Figure 44: Regarding the process of appointment in "PIEs", should it be recommended that Audit Committee document their proposed choice of auditors by providing qualitative information such as geographical coverage, fees, quality of technical answers, reputation, to the relevant regulator?

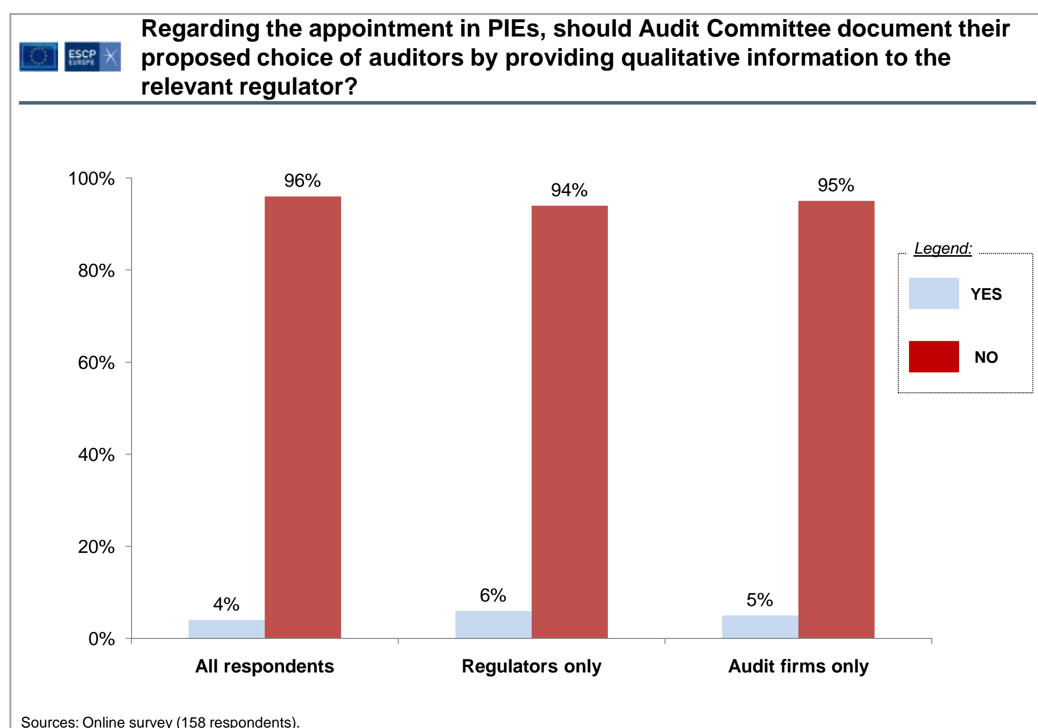
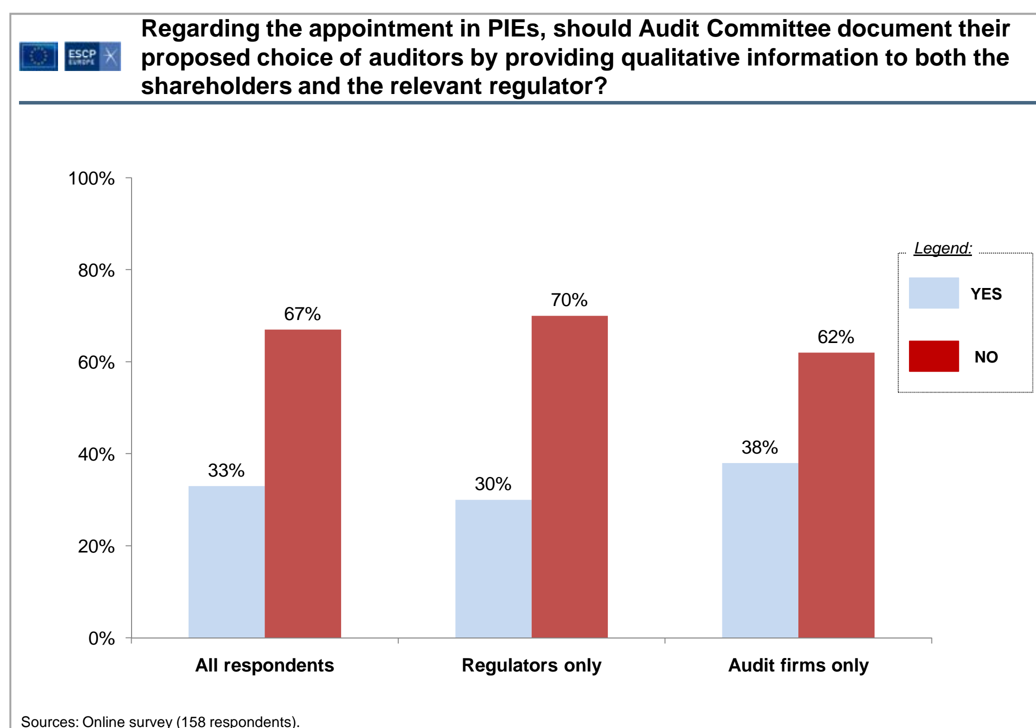


Figure 45: Regarding the process of appointment in "PIEs", should it be recommended that Audit Committee document their proposed choice of auditors by providing qualitative information such as geographical coverage, fees, quality of technical answers, reputation, to both shareholders and the relevant regulator?



The different types of stakeholders interviewed agreed that the audit committee should document its choice regarding the appointment auditor in case of a Public Interest Entity: 45% of the respondents want the choice to be justified to the shareholders, and 33% of the respondents want it to be disclosed to both the shareholders and the relevant regulator.

V.2.23.2.4 *Auditor appointment process: accountability of the audit committee and involvement of investors*

As already mentioned the requirements for the audit committee composition and the varied range of shareholding structure have a direct impact on the auditor appointment process.

The Swedish model is quite unique as it enables an enhanced involvement of shareholders in the auditor appointment process. The propositions made by the FRC in this respect are worth considering as they serve two purposes[192]: "*Audit Committees should be required either:*

[192] FRC [2011] – Effective Company Stewardship – Enhancing Corporate Reporting and Audit

- *To report on the process by which they reached their recommendation to appoint or re-appoint (as the case may be) the company's external auditors and the reason for their recommendation; or*
- *To discuss with a number of principal investors the approach to be taken to the appointment or re-appointment of its auditors, including the merits or otherwise of putting its audit out of tender and their report on that consultation to shareholders generally."*

V.2.23.2.5 *Conclusion*

To conclude, the review of the current role played by the audit committee in the auditor appointment process shows that it could clearly be improved towards existing models, such as the one in Sweden, or other similar models. An increase of the role of the audit committee in the auditors' appointment process is strongly favoured by the key stakeholders interviewed, including the audit firms.

This improvement of the appointment process, however, needs to be completed with a clear statement by the audit committee. It should explain the reason of its choice at least in case of Public Interest Entities (should it be in case of a new mandate or a renewal) to increase transparency on the the auditor appointment process and improve investors' confidence in the audit work.

Transparency on the auditor appointment would be increased through an enhanced involvement of shareholders in the appointment process:

- Either via shareholder representation in a Swedish-type nomination committee;
- Or via a formalised process of discussions with the audit committee.

V.2.23.3 Monitor the independence of the auditor regarding the provision of non-audit services to audit clients

As shown the analysis on the independence of the auditors, the provision of non-audit services to audit clients could have an impact on investor trust and thus on the functioning of the audit market.

To improve the level of confidence of the investors in audit work, audit committees should play a role in the pre-approval process of non-audit services to audit clients, as a guarantee for auditor independence.

Our recommendation is to:

- Empower the audit committee to monitor and approve the provision of non-audit services above a fixed threshold by the statutory auditor;

- Require the audit committee to justify its choice if the provision of non-audit services by the auditor represents more than 20% of total fees in case of an audit client (20% being the current European average).

V.2.23.4 Control the audit work

As provided for in the Statutory Audit Directive, audit committees have to *"oversee the statutory audit of the annual and consolidated accounts".*

To perform efficient oversight voer the statutory audit, the audit committee has to be aware of the key decisions taken by the auditor, and to give its recommendations to the auditors. This cannot be done without regular exchanges and discussions and formalised communication between the auditor and the audit committee.

The IAASB proposes an enhanced model of corporate governance reporting under which the audit committee would issue a report to users of financial statements with information about its oversight of the financial reporting process and the audit. A more detailed report from the auditor to the audit committee or board of directors about the audit scope and findings (e.g. the German long-form report) could provide useful input to the audit committee (See also Action step 9 – Detail audit methodology and its risks).

Therefore, we recommend:

- Mandatory meetings between the audit committee and the auditors (at least one meeting should take place without management being present);
- An extended reporting from the auditors to the audit committee.

This would allow the audit committee to express its opinion, through a dedicated report with information about its oversight of the financial reporting process and the audit, and reassure the investors on the implication and the level of acknowledgements of the audit committee on the audit process.

V.2.23.5 Increase the transparency regarding fee levels

As shown in our previous analysis:

- A significant decrease in fee levels may represent a threat to audit quality;
- On the other hand, a strong increase in fee levels:
  - Could be perceived if not justify as threat to auditors' independence; or
  - Could be a sign of a high level of concentration in a particular sector in specific Member States.

To avoid both a threat to audit quality and independence and excessive concentration, the audit committee should monitor fee levels, and in case of a significant change, justify it in the above-mentioned report to shareholders.

V.2.23.6 Increase transparency by providing its opinion on the level of risk of the company

The benefits from the different oversight bodies monitoring and assessing the risks on the financial markets are seen as crucial after the past economic and financial scandals.

In order to diversify the sources of these alerts, the audit committee, at company level, should be involved.

Indeed, the audit committee, through its supervisory role of the financial reporting process, has a certain responsibility to ensure that operational and financial risks of the company have been identified and mitigated. Therefore, it could express its opinion in its report to the shareholders on the company's internal control system, the different risks faced by the company and identified weaknesses of the company.

V.2.23.7 Conclusion

The audit committee should be placed at the core of the audit process at company level, because it should be the guardian of auditor independence and the advocate of transparency on the market. To reinforce its role and deal with the implications of the varied range of shareholding structures in the EU, the audit committee should be granted more responsibilities and more duties concerning the justification of its choices.

Therefore, we recommend:

- To reinforce the role of the audit committee in the auditors' appointment process by increasing the transparency through:
    - Documentation of their proposed choice of auditors by providing qualitative information such as geographical coverage, fees, quality of technical answers, reputation, made available to both regulators and shareholders;
    - Regular disclosure of the reasons for not changing the auditors;
- To enhance the involvement of investors in the auditor appointment process (through either their representation in a Swedish-type nomination committee or a formalised process of discussions with the audit committee);
- To give authority to the audit committee on monitoring the provision of non-audit services by the auditor to the audit client by approving the provision of non-audit services by the auditor above a certain threshold;
- Mandatory meetings between the audit committee and the auditors (with at least one meeting taking place without the management being present), to be certain that the communication between them is optimal;
- An extended reporting from the auditors to the audit committee;

- A dedicated report from the audit committee to the shareholders, with information about its oversight of:
    - The financial reporting process, including its assessment of the level of risk faced by the company;
    - The audit process, including the monitoring of non-audit services provided by the auditor and relevant information in respect of audit fees evolution.

Last but not least, the above mentioned measures could also be accompanied by a more standardised definition of the concept of independence as criteria of audit committee membership.

V.2.24 Action step 24: Review audit firms ownership and partnership rules

Ownership and partnership rules did not come up as key barriers to entry for mid-tier audit firms on the listed company market segment.

V.2.25 Action step 25: Submit audit fees at AGMs (for approval)

This measure would have positive impact on audit quality, but the effect would be limited.

This measure is already implemented in some Member States or companies.

V.2.26 Action step 26: Submit audit fees to regulators (for approval)

No real impact on the issues was identified.

This measure could be quickly implemented, but could face opposition from stakeholders.

V.2.27 Action step 27: Limit liability

The issue of limiting auditor's liability is discussed in the London Economics study published in 2006: “Study on the Economic Impact of Auditors’ Liability Regime”.

The Commission Recommendation of 5 June 2008 concerning the limitation of the civil liability of statutory auditors and audit firms lists the measures to be implemented by Member States to address this issue.

V.3 Combination of possible measures

Out of the 26 action steps which are analysed in this study, five stand out as being interrelated, each measure affecting the impact of the other if implemented together:

- Mandatory rotation of audit firms;
- Mandatory joint audit;
- Mandatory tendering;
- Prohibition of certain non-audit services to statutory audit clients;
- Pure audit firms (i.e. ban on the provision of non-audit services to all clients, irrespective of their size).

They therefore need to be analysed as a package, since the impact of a measure along with another could change potential costs and benefits identified in our analyses.

Some of these measures have also been identified as key steps by some regulators and public authorities, for example:

- The House of Lords in the UK recommends mandatory tendering and the prohibition of certain non-audit services to audit clients and also recognises the possible interest of mandatory joint audit as a mean to reduce barriers to entry for non-Big 4 firms;
- The PCAOB has issued a concept release on audit firm rotation in which it propose mandatory joint audit or mandatory tendering as alternative measures to mandatory rotation.

Given the significant impact of these measures on the market, and their relative complexity of implementation, limiting these combinations to PIEs, or even large PIEs (the threshold of which would need to be defined by legislators), could be considered.

This section aims at analysing the costs and benefits of the following combinations of measures:

- Combination n°1: Mandatory rotation, mandatory joint audit and prohibition of certain non-audit services to audit clients;
- Combination n°2: Mandatory rotation, mandatory joint audit and pure audit firms;
- Combination n°3: Mandatory tendering, mandatory joint audit and prohibition of certain non-audit services to audit client;
- Combination n°4: Mandatory tendering, mandatory rotation and prohibition of certain non-audit services to audit client.

These combinations are assessed taking into account:

- The criteria specifically analysed in the study:
    - Independence;
    - Quality;
    - Concentration;
    - Costs / audit price;
    - Barriers to entry and development of mid-tier firms;
    - Risk of demise of a Big 4;

    - M&A activity;
- And three additional criteria:
    - Choice: the number of eligible auditors among which companies can select;
    - Inertia: the lack of rotation in auditors' mandates;
    - Complexity: the complexity in terms of both initial implementation and on-going functioning.

Ratings for tables below range from -2 to +2, and add up in the "combination" column on the right.

V.3.1 Combination n°1: Mandatory rotation, mandatory joint audit and prohibition of certain non-audit services to audit clients

Table 88: Assessment of combination n°1

	Mandatory rotation	**Mandatory joint audit**	**Prohibition of certain, but not all non-audit services to audit clients**	**Incremental effects of the combination**	**Combination n°1**
Independence	2	2	2		6
Quality	0	0		1	1
Concentration		1			1
Costs / audit price	-1	-2		-1	-4
Barriers to entry and development of mid-tier firms		2	0		2
Risk of demise of a Big 4		1			1
M&A activity					
Others					
Choice	-1	-1		-1	-3
Inertia	1				1
Complexity	-1	-1		-1	-3
Total	**0**	**2**	**2**	**-2**	**2**

The main benefits of combining these measures could be:

- To lower the potential risk of audit quality induced by rotation in the case of "staggered" appointment of joint auditors, as it would ensure continuity in the auditor process, and lower entry costs for the new entrants;
- To significantly tackle the independence issue, both by lowering the overfamiliarity (with higher/forced switching rates) and by limiting the risk of a perceived lack of independence (with a stricter control of non-audit services).

On the other hand, the main costs include:

- Complexity of implementation, since this would deeply change the structure of the market;

- The potential difficulties for large companies requiring specific sector expertise to find experienced auditors in the short to mid-term, which may result in companies systematically rotating with two Big 4;
- A consequent risk on audit quality, emphasised by the high number of new entrants in the short term.

Note: considering the importance of independence in the audit of "systemic" banks (following the Lehman Brothers bankruptcy), limiting this package of measures to systemic banks could be considered.

V.3.2 Combination n°2: Mandatory rotation, mandatory joint audit and pure audit firms

The benefits of this combination would be the same as for combination #1; however, it would present additional costs related to pure audit firms:

- The positive impact on perceived independence could be offset by the issues that it would raise in terms of quality, mainly due to the loss of technical expertise;
- The presumed positive impact on choice could be erased as some of the multi-disciplinary network (Big 4 or large mid-tier) could strategically decide to leave the segment of audit market that would be concerned by the measure, which would have the same impact as the demise of a Big 4 and negatively affect concentration.

V.3.3 Combination n°3: Mandatory tendering, mandatory joint audit and prohibition of certain, but not all, non-audit services to audit client

Table 89: Assessment of combination n°3

	Mandatory tendering	**Mandatory joint audit**	**Prohibition of certain, but not all, non-audit services to audit client**	**Incremental effects of the combination**	**Combination n°3**
Independence		2	2	1	5
Quality		0			0
Concentration	1	1			2
Costs / audit price	-1	-2			-3
Barriers to entry and development of mid-tier firms	0	2	0		2
Risk of demise of a Big 4		1			1
M&A activity					
Others					
Choice		-1			-1
Inertia	1				1
Complexity		-1			-1
Total	**1**	**2**	**2**	**1**	**6**

This combination does not lead to any other cost than those of these measures taken separately and offers the benefit of lowering the risk of proximity with audit clients which may arise.

V.3.4 Combination n°4: Mandatory tendering, mandatory rotation and prohibition of certain, but not all, non-audit services to audit client

Table 90: Assessment of combination n°4

	Mandatory tendering	**Mandatory rotation**	**Prohibition of certain, but not all, non-audit services to audit client**	**Incremental effects of the combination**	**Combination n°4**
Independence		2	2	1	5
Quality		0			0
Concentration	1				1
Costs / audit price	-1	-1			-2
Barriers to entry and development of mid-tier firms	0		0		0
Risk of demise of a Big 4					
M&A activity					
Others					
Choice		-1			-1
Inertia	1	1			2
Complexity		-1			-1
Total	**1**	**0**	**2**	**1**	**4**

This combination does not lead to any other cost than those of these measures taken separately and offers the benefit of ensuring that the rotation process goes transparent and favours a real competition, i.e lowers the risk of collusion among audit firms in acquiring new clients.

List of tables in this report

TABLE 1: EXAMPLES OF SERVICES TYPICALLY OFFERED BY AUDIT FIRMS PER CATEGORY 13
TABLE 2: STACKELBERG TABLE - MAIN MARKET STRUCTURE 16
TABLE 3: MAIN CONCENTRATION INDEXES 16
TABLE 4: CONCENTRATION RATIOS EXAMPLE 18
TABLE 5: HHI EXAMPLE 19
TABLE 6: GINI COEFFICIENT EXAMPLE 20
TABLE 7: ROSENBLUTH/HALL-TIDEMAN INDEX EXAMPLE 21
TABLE 8: CONCENTRATION MEASURES RETAINED AND RATIONALE 22
TABLE 9: MEASURES THAT WERE USED TO DESCRIBE AND ASSESS THE FUNCTIONING OF THE AUDIT MARKET IN EACH MEMBER STATE 24
TABLE 10: AVAILABILITY OF TURNOVER OF LISTED COMPANIES FOR 2009 VS. 2010 27
TABLE 11: KEY ANALYSES PERFORMED ON THE BASIS OF DATA COLLECTED 28
TABLE 12: SURVEY RESPONSES PER TYPE OF STAKEHOLDER 32
TABLE 13: EXPECTED TARGET SAMPLE AND RESPONSE RATE PER STAKEHOLDER CATEGORY 39
TABLE 14: ISAS ADOPTION PROCESS PER MEMBER STATE (2009-2010) 53
TABLE 15: SCOPE OF STATUTORY AUDIT BY MEMBER STATE 57
TABLE 16: KEY REGULATORY CHARACTERISTICS PER MEMBER STATE 62
TABLE 17: MARKET SIZE - SOURCES AND AVAILABLE DATA FOR COMPANIES UNDER NACE CLASS M69.2 67
TABLE 18: NUMBER OF AUDIT FIRMS ACCORDING TO LOCAL AUDIT REGULATORS AND FINANCIAL AUTHORITIES 72
TABLE 19: HISTORICAL EVOLUTION OF THE M69.2 MARKET SIZE IN TURNOVER PER MEMBER STATE (2005-2010) 73
TABLE 20: HISTORICAL EVOLUTION OF THE M69.2 MARKET SHARE IN GDP PER MEMBER STATE (2005-2010) . 74
TABLE 21: HISTORICAL EVOLUTION OF THE NUMBER OF M69.2 FIRMS PER MEMBER STATE (2005-2010) 76
TABLE 22: 2009 REVENUES OF THE TOP 10 AUDIT FIRMS IN FRANCE, GERMANY AND ITALY 80
TABLE 23: 2009 REVENUES OF THE TOP 10 AUDIT FIRMS IN THE NETHERLANDS, SPAIN AND SWEDEN 80
TABLE 24: 2009 REVENUES OF THE TOP 10 AUDIT FIRMS IN IRELAND, POLAND AND THE UNITED KINGDOM... 81
TABLE 25: 2009 REVENUES OF THE BIG 4 IN BELGIUM, AUSTRIA AND GREECE 81
TABLE 26: 2009 REVENUES OF THE BIG 4 IN DENMARK, FINLAND AND PORTUGAL 82
TABLE 27: 2009 REVENUES OF THE BIG 4 IN CZECH REPUBLIC, ROMANIA AND HUNGARY 82
TABLE 28: 2009 REVENUES OF THE BIG 4 IN SLOVAKIA, LUXEMBOURG AND SLOVENIA 82
TABLE 29: 2009 REVENUES OF THE BIG 4 IN BULGARIA, LITHUANIA AND LATVIA 83
TABLE 30: 2009 REVENUES OF THE BIG 4 IN MALTA, CYPRUS AND ESTONIA 83
TABLE 31: COMPARISON OF NUMBER OF M&A TRANSACTIONS PER TYPE OF ACQUIRER (MID 1998-2004, 2005-MID 2011) 86
TABLE 32: COMPARISON OF NUMBER OF M&A PER TYPE OF TARGET ACTIVITY (MID 1998-2004) 88
TABLE 33: COMPARISON OF NUMBER OF M&A PER TYPE OF TARGET ACTIVITY (2005-MID 2011) 88
TABLE 34: DATA AVAILABLE PER MEMBER STATE 92
TABLE 35: OVERALL MARKET SHARE OF THE BIG 4 IN 2009 95
TABLE 36: TOP 20 MID-TIER BREAKTHROUGH ON THE OVERALL MARKET 96
TABLE 37: CONCENTRATION LEVELS IN EU STATUTORY AUDIT MARKETS FOR ALL LISTED COMPANIES IN 2009 (BY NUMBER OF MANDATES) 98
TABLE 38: CONCENTRATION LEVELS IN EU STATUTORY AUDIT MARKETS FOR ALL LISTED COMPANIES IN 2009 (BY TURNOVER) 100

TABLE 39: CONCENTRATION LEVELS IN EU STATUTORY AUDIT MARKETS FOR COMPANIES LISTED ON REGULATED NATIONAL STOCK EXCHANGES IN 2009 (BY NUMBER OF MANDATES)................................ 101
TABLE 40: CONCENTRATION LEVELS IN EU STATUTORY AUDIT MARKETS FOR COMPANIES LISTED ON REGULATED NATIONAL STOCK EXCHANGE IN 2009 (BY TURNOVER).. 103
TABLE 41: NUMBER AND LIST OF COUNTRIES WITH NO AVAILABLE DATA BY CATEGORY OF INDUSTRY.......... 105
TABLE 42: AVERAGE CONCENTRATION RATIOS IN EU STATUTORY AUDIT MARKETS FOR COMPANIES LISTED ON REGULATED NATIONAL STOCK EXCHANGE IN 2009 BY CATEGORY OF INDUSTRY 106
TABLE 43: CONCENTRATION LEVELS IN EU STATUTORY AUDIT MARKETS FOR ALL COMPANIES IN MAIN INDEX OF MAIN NATIONAL STOCK EXCHANGES IN 2009 (BY NUMBER OF MANDATES) 107
TABLE 44: CONCENTRATION LEVELS IN EU STATUTORY AUDIT MARKETS FOR ALL COMPANIES IN MAIN INDEX OF MAIN NATIONAL STOCK EXCHANGE IN 2009 (BY TURNOVER).. 109
TABLE 45: DATA AVAILABLE PER MEMBER STATE 112
TABLE 46: EVOLUTION OF CONCENTRATION LEVELS IN EU STATUTORY AUDIT MARKETS – ALL LISTED COMPANIES 114
TABLE 47: EVOLUTION OF CONCENTRATION LEVELS IN EU STATUTORY AUDIT MARKETS - ALL LISTED COMPANIES (BY TURNOVER)... 115
TABLE 48: EVOLUTION OF CONCENTRATION LEVELS IN EU STATUTORY AUDIT MARKETS – COMPANIES LISTED ON REGULATED NATIONAL STOCK EXCHANGES (BY NUMBER OF MANDATES)....................................... 116
TABLE 49: EVOLUTION OF CONCENTRATION LEVELS IN EU STATUTORY AUDIT MARKETS – COMPANIES LISTED ON REGULATED NATIONAL STOCK EXCHANGES (BY TURNOVER) 118
TABLE 50: EVOLUTION OF CONCENTRATION LEVELS IN EU STATUTORY AUDIT MARKETS – COMPANIES IN MAIN INDEX OF MAIN NATIONAL STOCK EXCHANGES (BY NUMBER OF MANDATES)....................................... 121
TABLE 51: NUMBER OF MID-TIER FIRMS' WITH AT LEAST ONE MANDATE ON THE LISTED MARKET SEGMENT127
TABLE 52: MARKET SHARE OF MID-TIER FIRMS WITH LISTED COMPANIES BY MEMBER STATE, IN NUMBER OF MANDATES AND IN TURNOVER.. 128
TABLE 53: NUMBER OF LISTED COMPANIES BY MEMBER STATE 129
TABLE 54: RANKING OF THE BARRIERS TO ENTRY ACCORDING TO THE ONLINE SURVEY RESPONDENTS 131
TABLE 55: RANKING OF THE CRITERIA TO SELECT AN AUDIT FIRM ACCORDING TO THE ONLINE SURVEY RESPONDENTS 133
TABLE 56: EVOLUTION OF THE NON-AUDIT SERVICES' SHARE IN MID-TIERS' TURNOVER, 2005-2009 135
TABLE 57: HHI THRESHOLDS USED TO ASSESS HORIZONTAL MERGERS 137
TABLE 58: NUMBER ONE BIG 4 PER MEMBER STATE ON REGULATED MARKET 138
TABLE 59: RANKING OF THE BIG 4 ON EU REGULATED MARKETS... 139
TABLE 60: IMPACT OF THE DEMISE OF PRICEWATERHOUSE COOPERS (CONCENTRATION RATIOS BY NUMBER OF MANDATES) 141
TABLE 61: IMPACT OF THE DEMISE OF PRICEWATERHOUSE COOPERS (CONCENTRATION RATIOS BY TURNOVER)... 142
TABLE 62: IMPACT OF THE DEMISE OF THE NUMBER ONE BIG 4 IN A MEMBER STATE 143
TABLE 63: IMPACT OF THE DEMISE OF THE NUMBER ONE BIG 4 IN A MEMBER STATE (CONCENTRATION RATIOS BY TURNOVER).. 144
TABLE 64: COMPARISON BETWEEN AUDIT FEES AND CONCENTRATION LEVELS (2009).................................. 147
TABLE 65: CATEGORIES OF NON-AUDIT SERVICES 153
TABLE 66: REVENUE BREAKDOWN OF MAIN AUDIT FIRMS PER MEMBER STATE (2009) 162
TABLE 67: EVOLUTION OF THE REVENUE BREAKDOWN OF MAIN AUDIT FIRMS PER MEMBER STATE (2005-2009) 163
TABLE 68: BREAKDOWN OF MAIN INDEX COMPANIES' AUDIT FEES PER MEMBER STATE (2009)..................... 164
TABLE 69: SURVEYS ON THE IMPACT OF NON-AUDIT SERVICES ON AUDITORS' INDEPENDENCE 167

TABLE 70: SUMMARY OF THE OPINION OF KEY STAKEHOLDERS ON THE PROVISION OF NON-AUDIT SERVICES BY AUDITORS 168
TABLE 71: AVERAGE SWITCHING RATE OF AUDIT MANDATES FOR COMPANIES OF THE FTSE 100 AND FTSE 250 BETWEEN 1998 AND 2004 IN THE UK 170
TABLE 72: SATISFACTION OF THE RESPONDENTS OF THE ONLINE SURVEY IN TERMS OF QUALITY 179
TABLE 73: RANKING OF THE PERCEPTION OF FEES INVOICE OF DIFFERENT TYPES OF SERVICE PROVIDERS (IN TERMS OF HOURLY RATE) 186
TABLE 74: LINK BETWEEN AUDITOR'S FEES AND QUALITY OF THE AUDIT ACCORDING TO THE ONLINE SURVEY RESPONDENTS 186
TABLE 75: LINK BETWEEN THE POSSIBLE MEASURES TO ENFORCE AND THE CRITERIA FOR ASSESSMENT OF THE FUNCTIONING OF THE MARKET 192
TABLE 76: RATIONALE BEHIND THE ASSESSMENT OF ACTION STEPS' ATTRACTIVENESS AND FEASIBILITY 197
TABLE 77: NUMBER OF MID-TIER FIRMS WITH AT LEAST ONE MANDATE ON THE LISTED MARKET SEGMENT 202
TABLE 78: STANCE OF REGULATORS AND PROFESSIONAL BODIES ON MANDATORY ROTATION, BY REGION (SDA BOCCONI, [2005]) 218
TABLE 79: ACCOUNTING AND NON-ACCOUNTING: POSITION ON ROTATION RULE (SDA BOCCONI, [2005]) ... 218
TABLE 80: MEMBER STATES WHERE JOINT AUDITS ARE PRACTICED 227
TABLE 81: SHARE OF LISTED COMPANIES CURRENTLY USING JOINT AUDITORS (2009) 229
TABLE 82: DISTRIBUTION OF JOINT AUDITOR COMBINATION TYPES FOR FRENCH LISTED COMPANIES (2009) 229
TABLE 83: TYPE OF JOINT AUDITOR PAIRS FOR ALL FRENCH COMPANIES (BY NUMBER OF MANDATES, 2009, DETAIL) 230
TABLE 84: TYPE OF JOINT AUDITOR PAIRS FOR FRENCH COMPANIES LISTED ON REGULATED MARKETS (BY NUMBER OF MANDATES, 2009, DETAIL) 231
TABLE 85: TYPE OF JOINT AUDITOR PAIRS FOR FRENCH COMPANIES LISTED ON THE MAIN INDEX (BY NUMBER OF MANDATES, 2009, DETAIL) 232
TABLE 86: CURRENT LEVEL OF AUDIT FEES BY MEMBER STATE 238
TABLE 87: WEIGHT OF THE AVERAGE AND MINIMUM FEES ON MAIN INDEX COMPARED TO MID-TIER FIRMS REVENUE IN 2009 245
TABLE 88: ASSESSMENT OF COMBINATION N°1 266
TABLE 89: ASSESSMENT OF COMBINATION N°3 268
TABLE 90: ASSESSMENT OF COMBINATION N°4 269

List of figures in this report

FIGURE 1: OVERVIEW OF ANALYSIS MODULES 12
FIGURE 2: LORENZ CURVE 20
FIGURE 3: DIFFERENT MARKET SEGMENTS ON WHICH CONCENTRATION LEVELS WERE ASSESSED........ 24
FIGURE 4: ILLUSTRATIVE EXAMPLE OF DIFFERENT CRITERIA USED TO ASSESS THE FUNCTIONING OF THE AUDIT MARKET BY MEMBER STATE........ 30
FIGURE 5: ILLUSTRATIVE EXAMPLE OF A CROSS-COUNTRY ANALYSIS 30
FIGURE 6: VIEWS FROM THE WEB PLATFORM 36
FIGURE 7: VIEWS FROM THE WEB SURVEY 37
FIGURE 8: OTHER VIEWS FROM THE WEB SURVEY 38
FIGURE 9: INVITATION EMAIL TO THE ONLINE SURVEY 39
FIGURE 10: VIEWS FROM THE SURVEY RESULTS - GENERIC IDENTIFICATION QUESTIONS........ 41
FIGURE 11: VIEWS FROM THE RESULTS - AUDIT FIRM SPECIFIC IDENTIFICATION QUESTIONS 42
FIGURE 12: VIEWS FROM THE RESULTS - SINGLE CHOICE QUESTIONS 43
FIGURE 13: VIEWS FROM THE RESULTS - MULTIPLE CHOICE QUESTIONS 44
FIGURE 14: VIEWS FROM THE RESULTS - RANKING QUESTIONS........ 45
FIGURE 15: VIEWS FROM THE RESULTS - RATING QUESTIONS 46
FIGURE 16: SIZE OF THE M69.2 MARKET PER MEMBER STATE (2009)........ 68
FIGURE 17: TOTAL NUMBER OF M69.2 FIRMS PER MEMBER STATE (2009) 69
FIGURE 18: TOTAL M69.2 MARKET SHARE IN PERCENTAGE OF THE GDP (2009) 69
FIGURE 19: AVERAGE TURNOVER PER M69.2 FIRM PER MEMBER STATE (2009)........ 70
FIGURE 20: CORRELATION BETWEEN GROWTH OF THE M69.2 MARKET AND NUMBER OF M69.2 FIRMS (2005-2009)........ 78
FIGURE 21: RELATION BETWEEN THE DIFFERENT MARKET SEGMENTS STUDIED: OVERALL MARKET, ALL LISTED COMPANIES, REGULATED MARKET AND COMPANIES LISTED ON THE MAIN INDEX 90
FIGURE 22: TOP 20 MID-TIER BREAKTHROUGH ON THE OVERALL MARKET (IN TURNOVER)........ 97
FIGURE 23: OVERALL MARKET SHARE EVOLUTION FOR THE BIG 4 AND THE TOP 20 MID-TIER FIRMS BETWEEN 2005 AND 2009........ 113
FIGURE 24: ANNUAL GROWTH RATES FOR MID-TIER FIRMS (TURNOVER), THE OVERALL MARKET AND THE BIG 4 (TURNOVER)........ 125
FIGURE 25: ANNUAL GROWTH RATES FOR MID-TIER FIRMS (TURNOVER), THE MARKET AND THE BIG 4 (TURNOVER), BY MEMBER STATE........ 126
FIGURE 26: MAPPING OF CURRENT MARKET SHARE OF MID-TIER FIRMS AND THEIR TURNOVER GROWTH ... 130
FIGURE 27: COMPARISON BETWEEN THE SHARE OF NON-AUDIT FEES AND MID-TIER FIRMS' MARKET SHARE (2009)........ 134
FIGURE 28: AUDIT FEES PER TURNOVER VS. CONCENTRATION LEVELS (CALCULATED BY NUMBER OF MANDATES) 148
FIGURE 29: AUDIT FEES PER TURNOVER VS. CONCENTRATION LEVELS (CALCULATED BY TURNOVER) 149
FIGURE 30: AUDIT FEES VS. SHARE OF NON-AUDIT FEES (MAIN INDEX COMPANIES)........ 150
FIGURE 31: COMPARISON BETWEEN THE SHARE OF NON-AUDIT FEES AND THE DIFFERENCE BETWEEN AUDIT FEES FOR AUDIT CLIENTS ONLY AND FEES FOR CLIENTS OF AUDIT AND NON-AUDIT SERVICES PER MEMBER STATE 151
FIGURE 32: VARIATIONS IN STAKEHOLDER PERSPECTIVES........ 175
FIGURE 33: UNITED KINGDOM - AIU INSPECTION REPORT OVERALL FINDINGS FOR THE YEAR 2010/11........ 180
FIGURE 34: NETHERLANDS – AFM INSPECTION REPORT OVERALL FINDINGS FOR THE YEAR 2008........ 181

FIGURE 35: GERMANY – AOC INSPECTION REPORT OVERALL FINDINGS FOR THE YEAR 2010 181
FIGURE 36: PRIORITISATION OF POTENTIAL STEPS TO BE TAKEN ON THE BASIS OF THEIR ATTRACTIVENESS AND FEASIBILITY.. 196
FIGURE 37: ONLINE SURVEY ANSWERS REGARDING DETAILS ON METHODOLOGY IN THE AUDIT REPORT 207
FIGURE 38: ONLINE SURVEY ANSWERS REGARDING LOCATION OF DETAILS ON METHODOLOGY.................... 208
FIGURE 39: ONLINE SURVEY ANSWERS REGARDING A LONG FORM REPORT.. 208
FIGURE 40: SHOULD THE APPOINTMENT PROCESS BE MODIFIED BY INCREASING THE ROLE OF THE AUDIT COMMITTEE? 255
FIGURE 41: SHOULD THE APPOINTMENT PROCESS BE MODIFIED BY GIVING THE RESPONSIBILITY TO THE RELEVANT REGULATORS? 256
FIGURE 42: SHOULD THE APPOINTMENT PROCESS BE MODIFIED BY ADVISING THE DETAILS OF THE PROCESS IN ADVANCE TO THE RELEVANT REGULATORS FOR CERTAIN PUBLIC INTEREST ENTITIES SUCH AS BANK AND FINANCIAL INSTITUTIONS? 257
FIGURE 43: REGARDING THE PROCESS OF APPOINTMENT IN "PIES", SHOULD IT BE RECOMMENDED THAT AUDIT COMMITTEE DOCUMENT THEIR PROPOSED CHOICE OF AUDITORS BY PROVIDING QUALITATIVE INFORMATION SUCH AS GEOGRAPHICAL COVERAGE, FEES, QUALITY OF TECHNICAL ANSWERS, REPUTATION, TO THE SHAREHOLDERS?... 258
FIGURE 44: REGARDING THE PROCESS OF APPOINTMENT IN "PIES", SHOULD IT BE RECOMMENDED THAT AUDIT COMMITTEE DOCUMENT THEIR PROPOSED CHOICE OF AUDITORS BY PROVIDING QUALITATIVE INFORMATION SUCH AS GEOGRAPHICAL COVERAGE, FEES, QUALITY OF TECHNICAL ANSWERS, REPUTATION, TO THE RELEVANT REGULATOR? 258
FIGURE 45: REGARDING THE PROCESS OF APPOINTMENT IN "PIES", SHOULD IT BE RECOMMENDED THAT AUDIT COMMITTEE DOCUMENT THEIR PROPOSED CHOICE OF AUDITORS BY PROVIDING QUALITATIVE INFORMATION SUCH AS GEOGRAPHICAL COVERAGE, FEES, QUALITY OF TECHNICAL ANSWERS, REPUTATION, TO BOTH SHAREHOLDERS AND THE RELEVANT REGULATOR? 259

List of acronyms and glossary

Certain terms used throughout the report are defined below:

Association: An organization of independent, small and mid-tier firms, agreeing to cooperate on professional, technical and training issues.

AMF: Autorité des Marchés Financiers (the SEC in the US and the FSA in the UK).

*Audit liability risk**: The risk of a future liability claim against an audit firm related to its audit activities.

*Audit services**: In this report, audit services always refer to statutory audit services. A statutory audit is an independent examination of, and expression of opinion on, the financial statements of an enterprise and/or group by an appointed auditor, registered and approved by legislation.

*Non-audit services**: All services other than audit services provided by audit firms to companies, including, among others, advice on information technology, internal audit services, taxation, valuations, litigation, recruitment services and general business management.

*Audit and non-audit fees**: Remuneration for audit and non-audit services supplied by audit firms to companies.

Big-4 audit networks:* The networks include Deloitte Touche Tohmatsu, Ernst & Young, KPMG and PricewaterhouseCoopers.

CAGR: Compounded Annual Growth Rate.

CEBS: Committee of European Banking Supervisors.

CEIOPS: Committee of European Insurance and Occupational Pension Supervisors.

CESR: Committee of European Securities Regulators.

Company:* Any entity organised as a limited liability entity undertaking an economic activity other than the provision of audit services.

CNCC: Compagnie Nationale des Commissaires aux Comptes.

CSR: Corporate Social Responsibility.

DG MARKT: "Internal Market and Services Directorate General" is one of the Directorates General and specialised services which make up the European Commission.

ECG: European Contact Group composed of the member firms of the BDO, Deloitte, Ernst & Young, Grant Thornton, KPMG and PricewaterhouseCoopers' networks of firms.

Economic regulator: Agencies established by central governments for the control of or intervention in the operation of markets, according to public interest principles and criteria.

EGIAN: European Group of International Accounting Networks and Associations.

EU: European Union.

EU Competition Law: Regulating the exercise of market power by big companies, governments or other economic entities.

FEE: Federation of European Accountants.

GAO: US Government Accountability Office.

GICS: Global Industry Classification Standard.

Code	Sector	Subcode	Industry Group
10	Energy	1010	Energy
15	Materials	1510	Materials
20	Industrials	2010	Capital Goods
		2020	Commercial & Professional Services
		2030	Transportation
25	Consumer Discretionary	2510	Automobiles and Components
		2520	Consumer Durables and Apparels
		2530	Consumer Services
		2540	Media
		2550	Retailing
30	Consumer Staples	3010	Food & Staples Retailing
		3020	Food, Beverage & Tobacco
		3030	Household & Personal Products
35	Health Care	3510	Health Care Equipment & Services
		3520	Pharmaceuticals, Biotechnology & Life Sciences
40	Financials	4010	Banks
		4020	Diversified Financials
		4030	Insurance
		4040	Real Estate
45	Information Technology	4510	Software & Services
		4520	Technology Hardware & Equipment
		4530	Semiconductors & Semiconductor Equipment
50	Telecommunication Services	5010	Telecommunication Services
55	Utilities	5510	Utilities

*HHI: "*Hirschman-Herfindahl Index" is an indicator used to assess the concentration level of industry or sector.

IFAC: International Federation of Accountants.

IFRS: International Financial Reporting Standards.

ISA: International Standards on Auditing.

Joint-Audit: The audit of a company by two or more auditing-firms to produce one single audit report.

*Liability insurance**: The insurance against liability risks.

*Listed company**: A company whose transferable securities (shares, bonds or any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates yields, commodities or other indices) are admitted to trading on a so-called "regulated market" in the EU, within the meaning of the MiFID.

M&A: Mergers and Acquisitions.

MiFD: Markets in Financial Instruments Directive, 2004/39/EC, amended in 2008 by the Directive 2008/10/EC.

*Mid-tier audit firms**: This group includes audit firms other than Big-4 firms that belong to smaller networks and generally undertake statutory audits of medium-size companies or occasionally of larger companies.

NACE: "Nomenclature of economic activities." Classification of Economic Activities in the European Community.

*Network**: Larger, more structured organization of audit firms which practices under a common brand name with adherence to an uniform audit process and internal quality procedures. The network is centrally managed following an agreed business strategy on such matters as cost-sharing, pricing policies and cross –holding ownership structures.

OECD: Organization for Economic Co-operation and Development.

Overall Market: The market defined by NACE class M69.2 ("accounting, bookkeeping, auditing activities and tax consultancy").

PAYE: Pay-as-you-earn tax.

PCAOB: US Public Company Accounting Oversight Board.

PIE: Public Interest Entity.

SEC: United States Securities and Exchange Commission.

SME: Small and Mid-size Enterprises.

VAT: Value Added Tax.

All definitions followed by a (*) sign refer to definitions of the London Economics study[193].

[193] *Study on the Economic Impact of Auditors' Liability Regimes,* London Economics (2006).