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Centre for Financial Market Integrity

Jürgen Tiedje
European Commission
DG MARKT – Unit F4
Rue de Spa/Spastraat 2
1000 Brussels
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London, 25th February 2009

DG MARKT Working Paper: Consultation on control structures in audit firms and their consequences on the audit market

Dear Mr. Tiedje,

The CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre") welcomes the opportunity to comment on DG MARKT Consultation Paper on Control structures in audit firms and their consequences on the audit market (the "Consultation"), which addresses the need for a more integrated audit market with more suppliers.

The CFA Institute Centre promotes fair and open global capital markets and advocates for investors' protection. Accordingly, we support efforts aimed at opening a market that currently bears inherent systemic risks and potential damage to investors.

The current degree of concentration loads the audit market with a high degree of systemic risk: if another failure on the scale of Arthur Anderson were to occur, the market would be left with three providers. Such an event would inevitably have a destabilizing effect on investor confidence.

Another audit failure would be very disruptive to issuers. Not only because of the requirement to produce audited financial statements on a regular and timely basis (which requires an embedded relationship between auditor and client) but also because of the lack of alternative audit supply.

The restrictions on audit company ownership and control, as described by the 8th Directive restrict this business' access to capital. We feel that this measure, designed to protect auditor independence, is redundant when compared to other safeguards within the Directive. We particularly draw your attention to safeguards on auditor governance, appointments and audit quality. Further, the Oxera[1] report's observation that an auditor's business depends on a healthy reputation, shows that independence and audit quality are ingrained tenets of the business.

[1] Found at this link - http://ec.europa.eu/internal_market/auditing/docs/market/oxera_report_en.pdf

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We identify two steps to help create an environment where new players will enter the market and thereby provide increased auditor choice for large companies. These are summarised below and discussed in the body of our response:

1. Opening the audit business to non-audit capital is required to integrate the European audit market and encourage the emergence of new players. The partnership model finds it difficult to cope with investment in tangible assets. The dynamics in return on and return of investment in a partnership discourage partners from undertaking substantial capital investment projects.

2. The harmonisation of auditor obligations and duties to clients and third parties, and the enforcement of those obligations across the EU. Currently these vary across Member States. Harmonisation to a rigorous standard would significantly help in the development of a single market for audit services. We consider this as a necessary and equally important precondition, along with access to non-audit capital, to integrating the market and encouraging the emergence of new players.

Given the nature of this market and its level of concentration we do not see the concentration of the audit market changing radically in the near term, bar some catastrophe within the big four. However, we believe that the Commission's proposals would help create a much more favourable competitive environment. One that encourages the entry of new players, who will eventually compete amongst the large incumbents.

Overall, we believe that the proposals set out herein will help to produce a more coherent proposal, and will add value to its provisions.

We attach our response that addresses the questions of the Consultation. Please do not hesitate to contact us, should you wish to discuss any of the points raised.

Yours faithfully,

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The CFA Institute Centre[2] is part of CFA Institute[3]. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, London and Brussels, CFA Institute is a global, not-for-profit professional association with over 100,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom nearly 87,000 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

Our responses to the Consultation's questions are set out below.

Q1. Do you see a need for opening up the market for audit of international companies in order to have more European wide audit service providers compared to the existing situation? Do we need a more integrated audit market? If yes, why?

Yes, we do see a need for more players in the audit market. There are currently only four firms perceived by multinational companies of being able to supply their audit needs. Such exceptional market concentration naturally builds a high degree of systemic risk within the audit services market.

At the macro level a failure of one of the big four akin to Arthur Anderson's could not only destabilize investor confidence in the market for audit services. Given the key role of auditors in the relationship between companies and investors, it could also entail a widespread crisis of confidence in financial markets with possible undesirable domino effects in other industries.

At the micro level another major failure would be very disruptive to the clients of the failed firm. This is not only because of the requirement to produce audited financial statements on a regular and timely basis, which requires an embedded relationship between auditor and client. Our additional concern is the lack of alternative supply. Such a failure may temporary taint all the existing staff of the failed firm, and completely discount the value of their services. We therefore question whether under this scenario the remaining players have enough spare capacity to serve this hypothetical void.

Finally on the need for a more integrated audit market, as we will put forward in our responses to Q3 and Q4, we perceive this as prerequisite for more competition and in particular for the emergence of stronger mid-tier EU players.

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[2] The CFA Institute Centre develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards ("GIPS®"), and the Asset Manager Code of Professional Conduct ("AMC"). It represents the views of investment professionals and investors before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the transparency and integrity of global financial markets.

[3] CFA Institute is best known for developing and administrating the Chartered Financial Analyst curriculum and examinations and issuing the CFA Charter.

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Q2. Do you believe that the current number and structures of audit firms' networks are sufficient?

When it comes to players able to offer services at the international level, there is a clear lack of competition in the market. There are many small firms offering audit services, but very few that can serve the needs of large listed companies.

The fundamental problem is that only a few firms are prepared to make the necessary investments to scale up their operations in order to meet the needs of multinational clients. In a situation where the principle input is human capital the partnership model is the most appropriate.

However, in order to provide the technical capability to service an international client, audit partnerships must make considerable investments in tangible assets such as computer systems and software. The return on such investments, whose uncertainty is augmented by the oligopolistic market structure, exceeds the investment horizon of partners, and hence rarely occurs.

Q3. Is access to financial capital a key factor to accelerate further integration of audit firms and emergence of new players? Do you share the view that allowing for competing models (e.g. partnership model, investor model …) will create the opportunity for more investments resulting in more global player? Are other models conceivable?

Access to financial capital is not the sufficient condition for the emergence of new players. Access to financial capital is just one of several facets that could accelerate the integration of existing mid-tier audit firms and bring about the emergence of new players. As stated above the partnership model finds it difficult to cope with investment in tangible assets. The dynamics in return on and return of investment within the partnership make it difficult for partners to enter into capital investment projects.

The business is run for cash generation on the human assets in hand, not for the present value of possible future returns. This becomes clear if one considers that the average working life of a partner could be 20 years, that most partners borrow to make their initial partnership investment, and that the return of that investment is generally the same amount again adjusted for inflation. Together these factors reduce the partners' propensity to invest and take risk, before consideration of the endogenous risks and returns of the business.

Hence, the investor model is more appropriate to suit the larger client audit market, though this could happen through a mixed attribute model of an infrastructure company financed by investor capital and a pure audit firm of partners. In such a scenario the latter would lease services from the infrastructure company.

Q4. Would models other than the current one negatively affect auditors' independence? Is there a need for additional safeguards at European level to protect independence? If so, what safeguards should be strengthened?

The CFA Centre finds the existing safeguards in the 8th Directive, excluding the clauses prescribing ownership and control, to be more than adequate to protect auditor

independence. An eventual opening of the audit market to external capital would simply require an update of those rules in order to prevent the emergence of conflict of interests. We appreciate in particular the principle-based approach, which would make a hypothetic evolution of the audit market framework easier than under a prescriptive and detailed regulation such as the Sarbanes-Oxley Act.

However, as we often do when it comes to expressing our views to the Commission, we are concerned that through the European Union there lacks a common agreement on the obligations and duties to clients and third parties, and the enforcement of those obligations and duties. In essence a lack of harmonization between national legislations.

This issue gains additional importance as harmonisation to a rigorous common standard would significantly help in the development of a single market for audit services. This would create the conditions for strong national players in the mid-tier market to gradually build their cross-border presence without the need for difficult adjustments in their legal and corporate governance structure.

Q5. Should the Commission examine other catalyst accelerating access to the international market? If so, which ones and why?

Yes, we think there other important factors to be taken into account in order to impact on the structure of the market. These factors both relate to the perception bias in Big4's clients.

We find of particular importance the presence of a strong gap between client perception and the reality of the structure of audit firms. The large audit firms are generally (and loosely[4]) organised into national partnerships, with overseas affiliates.

Through an umbrella organisation, customers perceive auditors offer a seamless international service. We are convinced that more should be done to increase audit committees' awareness of these structures. In reality, the franchise structure of large audit firms is vulnerable to the failure of a national affiliate and to the risk of liability spreading through the entire network.

The recent ruling[5] on Deloitte Touché Tohmatsu in the US concerning the falsification of the Parmalat audit, demonstrates the systemic risk to the individual firm, let alone its reputation and survival. This decision explicitly indicates that the US firm had some form of direct financial and managerial control over its Italian member firm, therefore holding US partners responsible for the economic damage incurred by their clients due to the misconduct of the Italian auditors. A clear link between the partner firms of the umbrella organization was established, identifying DT-Italy as an agent of DTT and DT-US.

While it is still too early to assess the consequences of this decision, this could pose a serious threat to the current model and bring audit firms to restructure in order to further shield them from liability, rather than establish more effective policing mechanisms among their member firms. The case highlights that the current franchise

[4] See the Oxera Report, par 5.3.1
[5] See the decision in *re Parmalat Securities Litigation*, Judge Lewis Kaplan of the U.S. District Court for the Southern district of New York, January 27 2009.

structure of partnerships cannot assure quality through the network. Hence our preference for direct control, through a hierarchy found under the investor model.

The misconception about Big 4's international reach plays an important role in shaping audit committees' choices. Audit committees should do more to reduce their discriminatory bias against mid-tier firms. Moreover, it is plausible to consider that as smaller listed firms grow and become included into major stock indices they will acquire non-executive directors of increasing status. Through previous relationships with the larger audit firms, and a desire to add value, these new directors may push for a switch from an existing mid-tier auditor to one of the big four on the basis of reputation and perceived risk reduction. While this may add value to the share price in the short term, it is disruptive and costly to the organisation and reinforces the position of the leading audit firms. Further, given the systemic risk presented by the Big 4, such a switch indicates incomplete inclusion of all the associated risks.

Another effective catalyst, assuming that mid-tier firms could become serious competitors to the Big 4 only in the long term, would be the inclusion of medium firms in public fora, committees and regulatory bodies' participants. Such an involvement would help reducing the bias towards established firms by raising these firms' profile and investors' confidence in them. Such inclusion would also be consistent with the overall policy goal of promoting quality in the audit market and come at no regulatory cost.

Finally, there is the lack of incentives for mid-tier firms to enter the audit market for larger companies. As discussed above the partnership structure maybe the underlying factor. Hence facilitating the creation of the investor model may act as a catalyst for mid-tier firms to entre this market.

Q6. Are the current partnership forms of ownership indispensable in order to recruit, retain and further develop human capital? Could alternative structures under revised control rules allow audit firms to retain human capital and preserve audit quality?

We do not believe that the current partnership structure is indispensable in order to recruit, retain and develop human capital. If the reward and status are competitive, human capital will migrate to either partnership or investor model.

The main problem to overcome is the transition of a firm from partnership to an investor model. Some partners will wish to sell their interest, which would need to be quantified, whereas remaining partners would need to be comfortable under a new remuneration structure. However, this would not necessarily prove excessively difficult, as outside investment is likely to come with a lower cost of capital that provides scope to benefit existing auditors and outsiders.

Finally, the main reason for which we do not see this as a compelling argument is the absence of a direct link between partners and the audit work performed. It is worth noting that most of the audit employees are not partners, and they do conduct most of the audit work. Additionally, the lower levels of audit firms' human capital witness one of the highest turnovers in the job market for young professionals. As such, we fail to see a straight link between audit quality and the partnership structure.

Q7. Is human capital a factor more important than financial capital to expand internationally? Do you see in the current regulation for the audit profession any obstacles related to human capital preventing further integration of audit firms?

As discussed above the diversity of obligations, duties and enforcement across EU Member States makes it difficult for auditors to operate at more than a franchise/affiliate structure. Hence, human capital is not fully fungible from one European State to the next.

We therefore reiterate our support for a harmonisation of obligations, duties and enforcement across the European Union. A harmonization of national legislation could be a powerful and effective catalyst for the entry of new players in the large audits market.

25th February 2009.