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RE: CESR's response to the consultation regarding Control Structures in Audit Firms and their Consequences for the Audit Market

The Committee of European Securities Regulators (CESR), through its standing committee on financial reporting (CESR-Fin), has considered the consultation document from the Directorate General for Internal market and Services regarding "Control structures in audit firms and their consequences on the audit market".

We thank you for this opportunity to comment on your consultation document and are pleased to provide you with the following general comments:

CESR supports the initiative of the Commission to stimulate the debate on the issue of audit market concentration and to seek suggestions for possible ways forward. Considering the problem of concentration in the audit market has developed over a number of years and depends on a range of factors, CESR believes that facilitating a more competitive environment will need to take a long-term perspective and will involve a number of different initiatives to deal with the variety of different aspects to the problem. Any such initiative should also give adequate consideration to the global aspects of the issue.

From the point of view of securities regulators and taking into consideration the public interest nature of the audit, CESR strongly recommends that any initiative aimed at creating less concentration should ensure both the independence and quality of the audit function are protected.

Our detailed comments are set out in the appendix to this letter but a summary of the main points made would be:

- The issue of concentration in the audit market is a complex one and the ownership structure of audit firms is only one aspect to consider.
- Easier access to financial capital could facilitate further integration of audit firms and merits further investigation.
- Any new models of ownership proposed need to be introduced alongside requirements for appropriate safeguards to deal with the consequential risk of conflicts of interest.
- Other catalysts need to be taken into account.

I would be happy to discuss any of these issues further with you.

Yours sincerely,

Eddy Wymeersch

Appendix: Answers to the questions included in the consultation document

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

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

CESR believes that a better balance between the level of integration of the internal European market for audit services on the supply side, and the level of integration of capital markets on the demand side is desirable. Looking at the supply of audit services to multi-national companies there are only a few audit networks which are able to operate at a global level and it is the potential risk of a further reduction in their number that makes the situation serious. In this respect, a greater number of players capable of competing in the international audit market might better safeguard the efficient functioning of the markets and therefore be in the public interest.

The issue of concentration in the audit market is a complex one and the ownership structure of audit firms is only one aspect to consider. CESR believes that in order to deal with the concentration issue thoroughly and effectively other factors should not be lost from sight: factors such as those that have led to the current market situation and to the process of firms merging in the recent past seeming to have stopped. Thought should consequently be given to whether and how another larger player could be supported sustainably by a market for audit services in which demand seems to be stable.

On the supply side, the reasons should be investigated as to why mid-tier firms have appeared reluctant to date to respond to perceived concentration at the multi-national end of the audit market and whether such firms are willing to accept the increased risks associated with operating at this end of the market.

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

CESR concedes the possibility that easier access to financial capital could facilitate further integration of audit firms particularly at the mid-tier level and might help these firms subsequently to expand and enter the international market and as such merits further investigation. However, auditing would not appear to be a capital-intensive business and therefore it would seem more likely that a combination of factors is needed to stimulate the emergence of another large player. Alongside the role of capital, CESR believes that amongst other aspects a firm's reputation and its human capital (skill and competence, professionalism) remain key factors. These are the factors that, in the long run would ensure the stable growth of a new player and serve to guarantee audit quality.

CESR is of the view that, in principle, competing models might be helpful in opening up the market to new participants and as a means of addressing the concentration issue this does merit further investigation. However the suggestion in the Commission's paper of a possible prohibition at an EU level of reserving voting rights for certain parties (e.g. for a majority of auditors) should only be considered after carefully weighing up whether such a model does in fact have true benefits over that existing currently.

Furthermore CESR believes auditor independence is paramount for the conduct of effective audits and for the consequent role played by the audit function in maintaining public confidence in the markets. Any possible solutions must therefore ensure that this independence of the audit function is not compromised. The consultation paper states that in the long-term there should be no reason why the interests of the auditor and the interests of an external investor in protecting audit independence should be fundamentally different. Nevertheless it is important to bear in mind that in the short-term such interests may diverge - and it is not uncommon for financial markets and investors to take a short-term view.

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

Other models could negatively affect auditors' independence and audit quality as they might increase the possibility for conflicts of interest to arise. CESR is of the view that this could harm public confidence by creating a higher perceived risk of compromised auditor independence and audit quality. These considerations represent serious risks which CESR believes should be thought about carefully, especially in the context of the current financial crisis.

With regard to the issue of audit quality, CESR feels there could be a higher risk that an external investor might seek to cut costs within an audit firm with which it is associated and hence compromise audit quality (e.g. by limiting the budgets for technical training and the internal monitoring of the audit function). Any new model would therefore need to address issues of this nature.

Alongside the issue of preserving audit quality a debate is probably needed on how audit quality can be objectively measured including the development of reliable and consistent indicators of audit quality which could also be made transparent to buyers of audit services so that they are in a better position to make informed choices about the firms they hire.

Any new models of ownership being proposed need to consider a requirement for appropriate safeguards to deal with the increased risk of conflicts of interest and other governance issues arising and in particular to ensure that the shorter- term desires of investors do not conflict with the longer-term public interest. More stringent independence requirements along with the creation of specific legal or regulatory controls could be necessary. To this end, audit regulators and public oversight bodies should also enhance their supervision of and require stricter controls within audit firms. However it should be borne in mind that additional regulation on its own cannot always guarantee that increased risks are fully mitigated.

Without any pretention of being exhaustive, and merely in order to stimulate debate, CESR suggests such measures might include:

Measures to safeguard independence

- When implementing Article 24 of the 8th Directive, requirements should be such that they address the more stringent demands for guarding against independence risks that may ensue from opening up the ownership of audit firms.
- Requiring firms to maintain specific documentation regarding decisions they have made about managing conflicts of interest and making audit oversight bodies take greater responsibility for reviewing and assessing situations of conflict of interest.

Measures to safeguard audit quality

- Greater transparency and generally more rigorous systems for ensuring audit quality within audit firms (e.g. monitoring the workload of each audit partner setting limits to the number of engagements or the working hours a single partner within a firm can take responsibility for; ensuring consistent application of the same high quality audit methodology across a firm etc.).

Other areas that might also deserve consideration would be:

Measures regarding financial requirements

- Imposing sufficient minimum capital and/or insurance requirements to ensure audit firms have adequate resources to deal with any potential claims or legal actions arising out of the risks taken.

Measures regarding governance

- Creating an enhanced corporate governance model for audit firms, with independent boards of management, which might involve the use of non-executive directors, having a minimum number of independent members in the Board of Directors as well as setting a limit on the number of members "capital-provider" shareholders may appoint to the Board.
- Setting limits on the number of non-audit partners within a firm and introducing rules limiting the extent to which non-audit partners may have management responsibilities or a role in the maintenance of audit quality.

However the costs of requiring firms to introduce such measures in an environment where jurisdictional variations still exist would need to be considered carefully. As the governance landscape that might exist following a change in the permitted ownership structures of audit firms is unknown, it is very difficult to evaluate whether the above mentioned measures would be adequate or indeed the only ones that may be necessary.

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

CESR is of the view that the Commission should indeed examine other catalysts which might make audit firms more willing to access the international audit market as consideration of one catalyst does not necessarily exclude others. Other catalysts that should be taken into account might include how to retain and even increase human capital resources within firms, how to improve firms' reputations (e.g: by increasing the level of transparency regarding resources, internal quality controls, ethical standards applied etc.) and what the potential impact is of liability risk on the cost of firms' capital. CESR considers all these factors to be very important in expanding audit firms' activities.

In addition the Commission should examine the possibility of harmonising regulatory requirements (e.g. auditing standards and the independence rules applicable to audit engagements) across all jurisdictions to facilitate the entrance of new global players into the international audit market and enhance cross-border networks.

Finally the Commission, as part of the corporate governance rules, might consider measures concerning how listed companies in particular appoint audit firms. Companies could be encouraged to appoint auditors in a more transparent way, through clear procedures that involve audit committees and a public tendering process. This might allow a larger number of audit firms to have more visibility to listed companies and in the process perhaps facilitate their access to the end of the market dominated by the big networks.

Further and to the same ends, the Commission may also want to consider other measures that have been suggested by some market commentators, such as joint audits, rotation of auditors or the setting of more stringent limits on the ability of audit firms to provide non-audit services to their audit clients (which generally aim to protect auditor independence) with a view to exploring to what extent such measures might also contribute to opening up the market.

Question 6:

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

CESR believes it is probable that the current partnership control structure applied by audit firms has worked well to date in retaining and promoting the development of human capital resources but does not necessarily consider this kind of structure indispensable for this purpose. CESR is of the view that other investor ownership structures could offer remuneration schemes sufficiently attractive to retain intellectual capital and to preserve audit quality.

However CESR also feels that staff may well look at other factors besides pure economic incentives, such as training, own prospects and the audit firm's reputation, in making a decision whether or not to stay with a particular firm. In this regard the incentive value of becoming a partner (i.e. an owner in the business in which a person works) should not be under-estimated in assessing how audit firms under the current ownership structure retain quality intellectual resource. Consideration would therefore need to be given to how equivalent incentives could be created effectively under other forms of ownership structure.

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

We consider that capital both human and financial is required to expand internationally. Nevertheless it is safe to say that audit firms that have earned themselves a good reputation because of their depth and quality of human capital resource and/or the professional history of the firm are usually better placed to expand internationally.

CESR does not see any significant aspect in the current regulation of the audit profession relating to human capital that might prevent further integration of audit firms.