Oxera

Celebrating 25 years

Ownership rules of audit firms and their consequences for audit market concentration

Prepared for DG Internal Market and Services

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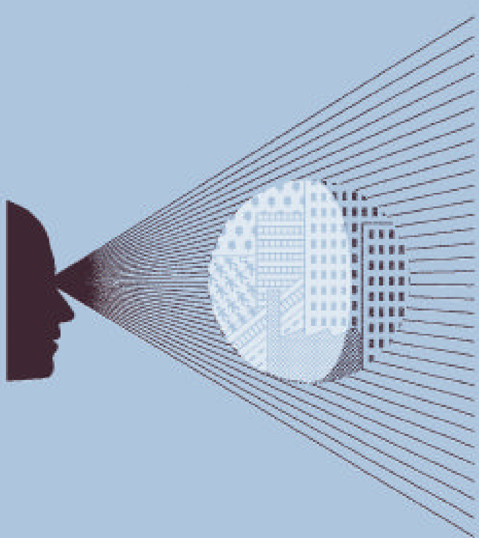

Executive summary

Over the past few years, the audit market has been subject to intense policy debates around the world, focusing in particular on the issues of concentration, choice and liability. Recently, commentators in both Europe and the USA have made the link between concentration and ownership restrictions on audit firms. This is a complex area that has not been analysed or debated in any depth to date. It is in this context that the European Commission (DG Internal Market and Services) commissioned this report from Oxera. The report aims to provide insight into the interactions between ownership and concentration, and to stimulate further policy debate.

Examining ownership and management rules related to audit firms, their corporate structures and their access to capital, the report considers the implications of these factors for the competitive landscape in the market for audit services to large companies. It contains an overview of the rules of Directive 2006/43/EC on Statutory Audits of Annual and Consolidated Accounts (the Eighth Company Law Directive), which came into force in June 2006, and in national legislation in the Member States.

The key question to be answered is to what extent the corporate structures adopted by audit firms, whether driven by the rules or by commercial factors, affect the market's ability to deliver a more open configuration that would reduce some of the concerns expressed about concentration and choice in the audit market. In this context, the main findings of the report are as set out below.

Current ownership rules and opportunities created by their potential relaxation
There is now considerable uniformity with respect to the specific rules on ownership structure and composition of the management board of audit firms across Member States. All Member States require a majority of voting rights in audit firms to be held by qualified auditors, as stipulated in the Eighth Directive. Some have interpreted these specifications more strictly than others by requiring 75% or more of the owners of audit firms to be qualified auditors. The requirement for a majority of members of an audit firm's management board to be suitably qualified has also been adopted by all Member States.

Relaxing these rules could create new investment and entry opportunities. This report has analysed the potential benefits of such relaxation as well as the potential costs (for example, in relation to auditor independence—see further below).

The menu of ownership and management structures available to European audit firms is constrained by the current rules and regulations. Nevertheless, it does not necessarily follow that audit firms might immediately choose a different ownership structure if, say, the current requirement of majority ownership by qualified auditors (Article 3.4(b) of the Eighth Directive) were relaxed.

A relaxation of the current ownership and/or management rules might therefore not result in an immediate change in ownership structures of audit firms. In the medium term it would, however, create a real possibility and provide incentives such that alternative structures might emerge over time. Such alternatives would need to combine the ability to retain human capital with an opportunity to raise capital at a lower cost from diversified, outside investors.

Such relaxation of the current ownership and/or management rules could thus create the opportunity for firms to explore alternative structures and choose the optimal one, given the various options that would become available. In contrast, under the current rules, audit firms, as well as potential investors, might be restricted in their ability to choose the optimal corporate structure and the preferred financing structure. By giving firms at least the possibility of access to cheaper, outside capital, new entry opportunities may be created.

Impact on access to capital

There is evidence from existing literature that several aspects of the employee-owned corporate form of ownership adopted by audit firms are likely to raise the required rates of return of audit firms, as well as restrict their ability to access capital in the first place.

The employee-owned nature of audit firms' corporate forms may lead to members requiring additional returns due to their exposure to risk unique to the audit firm (due to lack of diversification), the fact that the auditor is making a personal financial investment in the audit firm, and the fact that the ownership stakes are illiquid. Furthermore, the cost of capital for audit firms (including the international networks) may be higher than that of multinational companies of similar size, as audit firms tend to raise capital at the national rather than global level.

This, combined with the regulatory limits on the size of the ownership stake held by outside shareholders and the representation of outsiders on the management board, is likely to increase the return required to undertake the investment in an audit firm.

The employee-owned audit firms are likely to require additional returns which are unique to this corporate form—potentially around 6 percentage points or more above those of a diversified benchmark. In addition, the cost of capital for the audit firms may be 2–3 percentage points greater than that for similar-sized multinational companies owing to the way in which audit firms raise capital. Overall, the evidence broadly suggests that required returns for audit firms could be approximately 10 percentage points higher than those of a diversified benchmark. The above figures are only approximate estimates, as there is no empirical data available to quantify the exact magnitude of this differential in the required return.

Impact on entry and expansion into the market for large audits

Restrictions on access to capital represent one of several potential barriers to entry into the market for large audits. In general, Oxera's analysis reveals that financial capital is often of limited use for the majority of audit firms that have limited investment plans, as most firms have some degree of financial buffer to fund current operations, to withstand limited business shocks, and to fund expansion in their current market.

In particular, capital was found to be critical only for those firms seeking to expand into the market for larger audits. This suggests that the specific barriers to raising financial capital, resulting from the ownership rules, may refer to types of capital that might be of secondary importance to audit firms. This is especially relevant given that human capital might be seen as one of the key value drivers in this market.

Oxera's research indicates that there are barriers to entry other than access to capital, which include reputation, need for international coverage, and liability risk. This implies that the economic impact of the ownership rules on access to capital and potential entry needs to be considered in conjunction with, and relative to, other barriers. For example, the impact of liability risk on the cost of capital might be significant, and may lead to capital rationing, to the extent that outside capital is unwilling to take on liability risk. The Oxera study suggests that liability exposure cannot typically be addressed with capital. This is because it is likely to be more expensive for audit firms to use their capital as a buffer against liability risk than to pool idiosyncratic risks through the insurance market. Therefore, liability risk might constitute a barrier to raising external as well as internal financing.

Oxera has developed a stylised investment appraisal model to assess the dynamics of potential expansion by a mid-tier firm into the market for large audits in a single jurisdiction.

The results indicate that audit firms with partnership-like structures are unlikely to undertake the required initial investment for this type of expansion.

In contrast to employee ownership, investor ownership might be more supportive of the decision to expand, as external investors derive additional value from a longer investment horizon. The model suggests that, for an employee-owned firm, expansion into the market for large company audits would not be profitable as rates of return are below the assumed cost of capital, given the profile of returns that could be realised by the employees. For an investor-owned firm, the model suggests that gaining an initial foothold in the market would require substantial entry costs, but further expansion might become economically profitable, provided that human capital can be retained.

As noted above, employee ownership is seen to provide important benefits to audit firms, although there are some indications that the importance of human capital may be diminishing to some extent. If audit firms perceived there to be clear benefits from continuing to use corporate structures based on employee ownership, the removal of legal ownership restrictions would still allow firms to adopt this model of ownership. In addition, the removal of the restrictions provides opportunities for a change in the composition of the owners—for example, from a majority of qualified auditors to a more heterogeneous mix of partners, reflecting the skills required to run the firm in totality.

Impact on auditor independence

The main rationale for ownership and management restrictions is related to their impact on the independence of auditors from potentially negative outside influences. It has long been acknowledged that the independence of the auditor is essential for the efficient functioning of capital markets. However, even though the link between such restrictions and independence has historically been cited as justification for them, the Oxera survey and interviews among stakeholders indicate that there is little agreement on exactly what drives auditors' independence, or the importance of the ownership and management restrictions for ensuring the independence of the audit.

Oxera's research has found that there is a perception among some stakeholders that the current ownership restrictions do have a positive influence on independence. However, a closer analysis of the decision-making processes within audit firms indicates that alternative ownership and management structures, where the control over the audit firms is with external investors (non-auditors), are unlikely to significantly impair auditor independence in practice.

Assessing the impact of a relaxation of ownership restrictions on auditor independence is made difficult by the lack of any significant market that approximates an EU national market (in terms of oversight, development of the capital market, etc). Furthermore, very few, if any, of the stakeholders have experience of an audit market without the existing type of ownership and management controls. Nevertheless, in some Member States, there are examples of professional services firms with audit practices that have used alternative corporate structures (to the extent permitted by law and current regulations), and which at the same time have put in place the necessary safeguards to ensure independence.

Opening up ownership and control to non-auditors does create the potential for additional specific conflicts of interest to arise in this context—for example, where the audit firm supplies an audit to a company owned by the same parent company. However, there seems to be no apparent reason why these could not be dealt with through specific legal or regulatory controls, other than ownership restrictions. There is also an important role for the public oversight bodies in the Member States to safeguard quality and independence.

In all, therefore, Oxera's analysis suggests that several potential negative effects from changes to the ownership rules on auditor independence could be mitigated.

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1 Introduction

1.1 Remit of the Oxera study

This report constitutes Oxera's final report on the 'Study on Ownership Rules Applying to the Audit Firms and their Consequences on Audit Market Concentration', as commissioned by the European Commission (DG Internal Market and Services) in November 2006. Part of the research for this study was carried out in conjunction with the Trans European Law Firms Alliance (TELFA), a European network of law firms with members in 18 EU Member States.

At the EU level, the ownership rules applying to audit firms have been set out in Directive 2006/43/EC on Statutory Audits of Annual and Consolidated Accounts—commonly known as the Eighth Company Law Directive—which came into force in June 2006,[1] and in national legislation in each of the Member States.

The Commission set out the following objectives for the study:

– to analyse the importance of ownership rules (at both the EU and national level) as a barrier to entry to the market for the provision of audit services to publicly listed companies and larger unlisted companies;

– to obtain a complete picture of the options chosen by Member States in relation to the voting rights, ownership structure and management composition of audit firms;

– to analyse how different assumptions on voting rights, ownership structure and management composition can affect competition in the audit market and the independence of audit firms.

The Commission is also seeking to identify policy options to enhance the ability of audit firms to raise capital—and thereby increase competition in the audit market—while at the same time safeguarding the independence of audit firms. Based on the results of the study, the Commission intends to initiate a discussion with Member States on the optimal implementation of the Eighth Directive, focusing on opening up the audit market to greater competition.

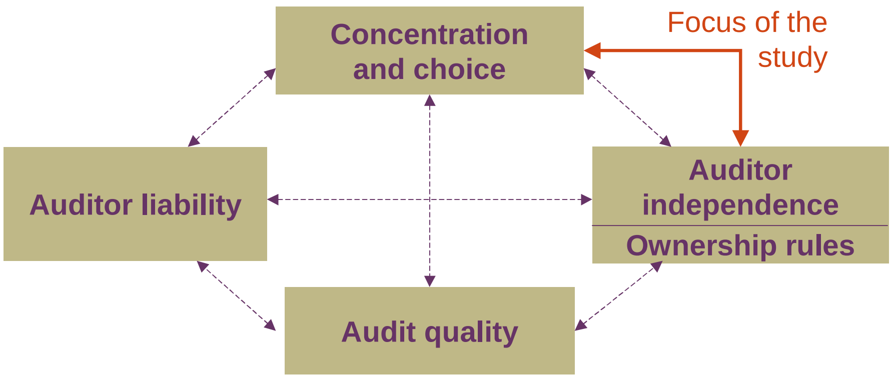
It is important to emphasise that issues concerning the role of capital and the importance of ownership rules have not tended, in the past, to be at the forefront of the debate surrounding competition and choice in the audit market. Therefore, in many cases, the views of market participants may not be fully developed and will continue to evolve as the consequences of any potential reform of the rules are discussed and debated further—indeed, this report aims to stimulate that discussion and debate. As a result, the views of market participants approached to take part in this study, either through interviews or in the survey, need to be treated with a degree of caution at this point.

[1] Directive 2006/43/EC of the European Parliament and of the Council, May 17th 2006. This Directive amends the original Eighth Directive of 1984 (Eighth Council Directive 84/253/EEC of 10 April 1984 based on Art.54(3)(g) of the Treaty on the approval of persons responsible for carrying out the statutory audits of accounting documents).

1.2 Broader policy context

Over the past five years, the audit market has been subject to intense policy debates around the world. These debates have focused on several different, but inter-related, areas—in particular, concentration and choice among audit firms globally, auditor independence, auditor liability and audit quality (see Figure 1.1 below). Some of these have been covered by various recent studies, and several jurisdictions are undertaking policy initiatives to address the areas. It is therefore important to make clear where this current study on ownership rules fits into this broader policy context.

Figure 1.1 Focus of this study within the broader policy context of the audit market



1.2.1 Concerns about concentration and choice among audit firms

A prime policy concern has been the increase in concentration in the audit market globally, and the corresponding decrease in choice for listed companies, in particular. The 'Big Four' audit firms—Deloitte & Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers (PwC)—are by far the largest auditors both globally and in most individual jurisdictions. They are followed by a group of audit firms loosely referred to as the 'mid-tier' firms, some of which also have significant international networks, but are overall much smaller in size. The 'systemic' concerns about the broader impact of the lack of choice on the soundness of major financial markets naturally relate more to the larger listed companies.

Concerns about concentration have existed since at least 1989, when two mergers reduced the then Big Eight accounting firms to the Big Six,[2] while in 1997 Price Waterhouse merged with Coopers & Lybrand to form PwC,[3] leaving a Big Five. However, the dissolution of Arthur Andersen in 2002, which led to the current situation of the Big Four, significantly increased the concerns about concentration.[4] In 2003, the US General Accounting Office published a study on consolidation and competition among accounting firms.[5] Competition authorities also looked into this at the time. Having reviewed the acquisition by the UK division of Deloitte of the UK division of Arthur Andersen,[6] the Commission considered that collective

[2] In 1989 Ernst & Whinney merged with Arthur Young to form Ernst & Young, and, in the USA, Deloitte Haskins & Sells merged with Touche Ross to form Deloitte & Touche. (In the UK, this latter transaction was different, with Coopers & Lybrand merging with Deloitte, and Touche Ross later changing its name to Deloitte & Touche.) A third proposed merger in 1989, between Arthur Andersen and Price Waterhouse, was abandoned.

[3] Another proposed merger in 1997, between Ernst & Young and KPMG, was abandoned.

[4] The competition authorities in France allowed Deloitte to merge with BDO Marque et Gendrot in 2006/07. Source: DGCCRF (2007), 'C2006-91 / Lettre du minister de l'économie, des finances et de l'industrie du 15 décembre 2006, au conseil de la société Deloitte, relative à une concentration dans les secteurs de l'audit, de l'expertise comptable et du conseil', *Bulletin Officiel de la Concurrence, de la Consommation et de la Répression de Fraudes*, March 23rd.

[5] US General Accounting Office (2003), 'Public Accounting Firms: Mandated Study on Competition and Consolidation', July. The study was mandated under the Sarbanes-Oxley Act 2002.

[6] Commission of the European Communities (2002), 'Deloitte & Touche/Andersen (UK)', Case No COMP/M.2810, July 1st.

dominance (ie, combined market power between the four firms) could not be excluded. Nonetheless, it allowed the acquisition on the basis that the reduction from five to four global accounting firms was 'inevitable', and that no other Andersen dissolution scenario could be established in which competition would be harmed to a lesser extent.

During 2005, there was a concern (whether perceived or real) that KPMG's global network might collapse due to legal problems in the US market. These problems arose in relation to an alleged fraudulent tax shelter scheme under investigation by the US Department of Justice. In August 2005, a settlement between KPMG and the Department of Justice was announced, with only certain individuals being prosecuted, thereby removing concerns about a collapse of the firm as a whole.[7]

Nevertheless, the KPMG episode highlighted the potential systemic risk to the efficient functioning of capital markets if any of the Big Four firms were to go out of business. While the legal arrangements in place might prevent direct cross-border claims and recourse to other partnerships around the world, the concerns are that a collapse of a partnership in a main financial market, such as the USA, might result in the unravelling of the global structure of a particular firm (as happened to Arthur Andersen). The episode also reportedly led to the outgoing chair of the US regulatory body, the Public Company Accounting Oversight Board (PCAOB), remarking that regulators would not know what to do if one of the Big Four failed.[8]

In September 2005, the UK Department of Trade and Industry (DTI) and the Financial Reporting Council (FRC) jointly commissioned a study on competition and choice in the UK audit market. Oxera published its findings from this study in April 2006, which included the following.[9]

– The Big Four audit firms audit all but one of the FTSE 100 companies, and represent 99% of audit fees in the FTSE 350. In addition, switching rates are low (around 4% per annum on average for all listed companies, 2% on average for FTSE 100 companies), and competitive tendering does not occur frequently.

– In the perception of most FTSE 350 companies, the Big Four are better placed than the mid-tier firms to offer two key components of the audit product: value-added services in addition to the audit itself, and a degree of reassurance against catastrophes and reputational risk. The Big Four are also perceived to have greater capacity and international coverage to deliver the third key component: the technical audit itself.

– Higher concentration has led to higher audit fees (in line with economic theory and with several other recent empirical studies). Evidence showed that, while there is a degree of price sensitivity among companies, and some bargaining on fees takes place during the annual audit firm reappointment process, in general audit committee chairs focus more on quality (and reputation) than on price. Separately from the impact of concentration, audit fees seem to have risen in recent years as a result of cost increases caused by factors such as changes in regulation.

– On the question of choice, Oxera found in the UK study that a limited number of UK-listed companies, primarily in the financial services sector of the FTSE 100, have no effective choice of auditor in the short run. This elimination of choice is driven by high market concentration, auditor independence rules, supply-side constraints, and the need for sector expertise.

[7] Department of Justice (2005), 'KPMG to Pay $456 Million for Criminal Violations in Relation to Largest-Ever Tax Shelter Fraud Case', press release, August 29th.

[8] *Financial Times* (2005), 'US audit watchdog warns about industry', September 28th.

[9] Oxera (2006), 'Competition and Choice in the UK Audit Market', report for the DTI and FRC, April.

– Analysis of the economics of entry/expansion by mid-tier firms into the FTSE 100 and FTSE 250 segments indicated that the current market structure is likely to persist. Substantial entry is unlikely to be attractive, due to significant barriers, including the perception bias against mid-tier firms, high entry costs, a long payback period for any potential investment, and significant business risks when competing against the incumbents in the market.

– The loss of another Big Four firm (the four-to-three scenario) would exacerbate problems around auditor choice, requiring regulators to make exceptions to auditor independence rules. A lack of audited accounts in the event of exit by a Big Four firm would be a significant concern for investors, who are also concerned about the consequences for audit quality of a further increase in audit market concentration. In the event of a four-to-three scenario, Oxera's previous analysis indicated that only if the existing barriers, in terms of perception/reputation and low switching rates, could be reduced might substantial market entry by mid-tier firms become feasible.

Since the publication of the Oxera report, the FRC has held consultations and created a Market Participants Group to address the issue of choice (see further below—section 1.2.5).

The present study for the European Commission is very closely related to the issue of concentration and choice, as it specifically analyses ownership rules as one of the factors that could have an impact on competition and entry in the audit market.

1.2.2 Reforms to rules on auditor liability

On January 18th 2007, the Commission launched a public consultation on whether there is a need to reform the rules on auditor liability in the EU.[10] Again, the issue of liability is closely related to that of concentration and choice. In the words of the Internal Market and Services Commissioner, Charlie McCreevy:

> There is an increasing trend of litigation against auditors, but often they cannot obtain sufficient insurance to cover the risk. So there is a real danger of one of the 'Big Four' being faced with a claim that could threaten its existence. There are many ways to improve this situation: some Member States already have capped auditors' liability, while others are introducing proportional liability combined with some limitations on who can sue auditors. However, given the differences between national markets, there is probably no one-size-fits-all approach. I want to ensure a thorough debate on the possible ways forward, and I encourage interested parties to give us their views.

In October 2006, the Commission published an economic impact study by London Economics on auditor liability, which confirmed the high degree of concentration and high entry barriers in audit markets in each of the EU Member States.[11] It also signalled a decline in the availability of liability insurance, while at the same time liability claims against audit firms in Europe have increased. On the basis of the London Economics study, the Commission is now consulting on four possible options for reforming auditors' liability:

– the introduction of a fixed monetary cap at the European level (the Commission considers that this might be difficult to achieve);
– the introduction of a cap based on the size of the audited company, as measured by its market capitalisation;
– the introduction of a cap based on a multiple of the audit fees charged by the auditor to its client;

[10] Commission of the European Communities (2007), 'Auditors' Liability: Commission Consults on Possible Reform of Liability Rules in the EU', press release, January 18th.
[11] London Economics (2006), 'Study on the Economic Impact of Auditors' Liability Regimes', report for DG Internal Market and Services, September.

– the introduction by Member States of the principle of proportionate liability, which means that each party (auditor and audited company) is liable only for the portion of loss that corresponds to the party's degree of responsibility.

The present study does not address the issue of liability directly. However, in the context of establishing the relative significance of various factors in acting as barriers to the expansion of mid-tier audit firms, it will take account of both liability and the nature of the market for professional indemnity insurance. As a smaller firm expands and takes on larger clients, the risk of claims for damages is likely to increase, and, therefore, the need to take out additional liability insurance at higher cost also rises. This prospect could act as a significant barrier to expansion.

1.2.3 Concerns about auditor independence

The dissolution of Arthur Andersen in 2002 also intensified the policy debate on auditor independence. During the 1980s and 1990s, the large audit firms significantly expanded their non-audit services (mainly tax advice, corporate finance, IT and management consultancy). A potential conflict of interest arises if these services are provided to audit clients, which could affect the independence and quality of the audit—several commentators have pointed to the role of Arthur Andersen in the Enron case as a prime example.[12]

The Sarbanes-Oxley Act 2002 was introduced in the USA soon after the dissolution of Arthur Andersen. Section 201 of the Act makes it unlawful for audit firms to provide any non-audit service to an audit client, including the following 'prohibited activities':

– bookkeeping or other services related to the accounting records or financial statements of the audit client;
– design and implementation of financial information systems;
– appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
– actuarial services;
– internal audit outsourcing services;
– management functions or human resources;
– broker/dealer, investment adviser, or investment banking services;
– legal services and expert services unrelated to the audit;
– any other service that is not permitted by regulation.

While some exemptions from the above are possible, overall the Sarbanes-Oxley Act is aimed at preventing conflicts of interest between audit and non-audit services. In addition, Section 203 of the Act makes it mandatory for the lead audit partner and the reviewing partner to be rotated every five years.

Although the Sarbanes-Oxley Act is US law, it has been put to Oxera that the Act has had an impact on auditing practice worldwide, for two reasons. First, many multinational companies have a US listing and are therefore directly affected by the Act. Second, regulators, auditors and companies in many other jurisdictions have adopted similar rules and practices. For example, one of the 'Ethical Standards' of the UK FRC's Auditing Practices Board prohibits audit firms from taking on certain types of non-audit work for the companies they audit, and requires certain safeguards to be put in place to isolate audit from non-audit work.[13]

[12] See, for example, Wyatt, A.R. (2003), 'Accounting Professionalism: They just don't get it!', speech at the American Accounting Association Annual Meeting, Honolulu, August 4th.
[13] Auditing Practices Board (2004), 'APB Ethical Standards 5: Non-audit services provided to audit clients', December.

1.2.4 Policy focus on ownership rules applying to audit firms

Ownership rules are traditionally associated with the issue of auditor independence. As is discussed in greater detail in section 3, within the European Community, the concept of auditor independence was encapsulated in a set of Fundamental Principles set out in 2002.[14] These emphasised the link between, and the importance of, objectivity and professional integrity, which underpin the statutory auditors' audit opinion on financial statements. The Principles also highlighted the threats that could affect independence, namely self-interest, self-review, advocacy, familiarity or trust, and intimidation.

To mitigate these risks, it was considered that a series of safeguards was needed combining prohibitions, restrictions, disclosures and other related policies. These safeguards were grouped into three main categories:

– audited entities' safeguards—referring to the governance of the appointment process for auditors and the nature of the disclosures that had to be made concerning relationships between the audit firm and the entity being audited;

– quality assurance—referring to the need for an audit firm to have adequate internal governance procedures in place to ensure that the audit process was effectively monitored and that quality would be maintained;

– statutory auditors' safeguards—these are of particular interest with respect to the current study. The Principles required that the majority of the voting rights in an audit firm be held by those permitted to undertake statutory audits within the EU (ie, qualified auditors). Furthermore, an audit firm should ensure that its legal statutes contain provisions such that a non-auditor could never gain control of the firm. In addition, an audit firm had to establish a set of internal safeguards, such as a system for internal risk assessment of independence threats and formal procedures in order to ensure that partners, managers and employees meet independence standards.

As far as independence issues are concerned, the Eighth Directive essentially reaffirms these 2002 Principles. With respect to the ownership of audit firms, Article 3.4b of the Directive requires the relevant authorities of Member States to approve only those firms that satisfy the following criteria:

> A majority of the voting rights in an entity must be held by audit firms which are approved in any Member State or by natural persons who satisfy at least the conditions imposed…

In addition, according to Article 3.4c of the Directive:

> A majority—up to a maximum of 75%—of the members of the administrative or management body of the entity must be audit firms which are approved in any member state or natural person who satisfy at least the conditions imposed.

Furthermore, it was recognised that the existence of outside owners in an audit firm might give rise to potential conflicts of interest that could compromise the independence of the firm. Therefore, Article 24 of the Directive requires that:

> Member States shall ensure that the owners or shareholders of an audit firm as well as the members of the administrative, management and supervisory bodies of such a firm, or of an affiliated firm, do not intervene in the execution of a statutory audit in any way which jeopardises the independence and objectivity of the statutory auditor who carries out the statutory audit on behalf of the audit firm.

[14] Commission of the European Communities (2002), 'Statutory Auditors' Independence in the EU: A Set of Fundamental Principles', May 16th.

The purpose of the present study is essentially to analyse, at both the EU and Member State level, the effect of these ownership rules on auditor independence, on the one hand, and on competition and choice, on the other. To some degree, there is a trade-off between these two policy objectives. For example, strict ownership rules to ensure independence might have some negative impact on competition and entry into the audit market, by limiting audit firms' access to capital. This trade-off is explored in detail in the study.

1.2.5 Recent policy reports relating to ownership rules in Europe and the USA

As noted above, the Market Participants Group was established in 2006 to provide advice to the FRC on how the risks associated with the current structure of the UK audit market might be mitigated. In April 2007, the Group issued an interim report proposing a series of recommendations designed to increase choice in the audit market while maintaining quality and independence.[15] The overall objectives of the proposals are to:

- increase the choice of auditor for public interest entities;
- reduce the risk of a firm leaving the market without good reason;
- reduce uncertainty and disruption costs in the event of a firm leaving the market.

Overall, the 15 recommendations appear to be aimed at increasing the transparency of audit firms' internal structures and financial results, while also placing more emphasis on the role of the FRC as a promoter of the benefits of greater choice in the market. The Group also recommends that the existing Combined Code on Corporate Governance in the UK be applied to audit firms, with suitable amendments, in order to ensure greater scrutiny of governance procedures.

The recommendations are as follows.

1) The FRC should promote a wider understanding of the possible effects of changing auditor ownership rules on choice, independence and quality. The Group appears to reject the criticism that any relaxation of the rules would lead to increased market power for the Big Four, as improved access to capital would enable them to consolidate their position still further.

2) Audit firms should disclose more information on the income they receive from audit work.

3) Any policy on auditor liability should seek to promote greater choice, although no specific recommendation was made regarding a preferred scheme for limiting liability.

4) In order to raise the profile of mid-tier firms, regulators should encourage them to take a more active role in standard-setting bodies and committees.

5) The FRC should promote greater understanding of audit quality and increased transparency of individual firms' capabilities. Reference was made to Article 40 of the revised Eighth Directive, which requires firms to publish transparency reports on their structure, governance and systems for ensuring quality. In undertaking this role, the FRC would, of course, need to ensure that it was not seen as actively endorsing or promoting any specific audit firm.

6) Incoming auditors should have improved access to information currently held by the existing auditor that is relevant to the audit.

[15] FRC (2007), 'Choice in the UK Audit Market: Interim Report of the Market Participants Group', April, www.frc.org.uk.

7) The FRC should provide independent guidance for audit committees and other market participants on considerations relevant to the use of firms from more than one network. Again, the FRC would need to ensure that it was not seen as favouring any one firm over another.

8) The FRC should amend the Smith guidance (on the role of audit committees) so that audit committees must give more information to shareholders on the auditor selection decision.[16]

9) Company boards should be required to disclose any contractual obligations placed on them (for instance, by advisers) to appoint certain types of audit firm.

10) Shareholders and audit committees should be encouraged to become more engaged in the process of auditor appointments and re-appointments. One possibility would be to require a vote on audit company reports.

11) When new ethical standards are developed, they should also take account of their impact on choice as well as on quality and independence.

12) The FRC should review the independence sections of the Smith guidance to ensure that they are appropriate.

13) Regulators should ensure that their response to possible breaches of rules is proportionate. This links in with the recommendations of the Commission on the Regulation of U.S. Capital Markets, which were aimed at reducing the adverse effects on reputation of an indictment of an audit firm prior to a decision being taken on the severity of any breaches of the rules.

14) All audit firms that audit public interest entities should comply with the Combined Code, with appropriate adaptations, or explanations for any deviations. At present, audit firms do not have to comply as they are not listed companies and, hence, not subject to the listing requirements of the UK Financial Services Authority (FSA).

15) Companies should include the risk of auditor withdrawal in their risk evaluation and planning.

Much of this report focuses on improvements in transparency as a means of promoting a demand-side-driven response to the problems in the audit market. In addition, the FRC seems to be given a greater role in promoting the benefits of increased choice. This would appear to represent a more proactive approach from a regulator than has been seen anywhere in the past.

Although the prospect of changing ownership rules is raised, the Group considers that this needs further research to determine its impact.

The link between ownership rules and competition has also been made recently in a report published in March 2007 by the Commission on the Regulation of U.S. Capital Markets in the 21st Century.[17] The Commission was established in February 2006 by the US Chamber of Commerce to analyse the reasons for the recent decline in the share of global capital markets activity accounted for by US capital markets. Its activity focuses on the legal and regulatory framework within which US capital markets operate, and its members include investment bankers, auditors, investment managers and lawyers drawn from a range of capital market firms.

[16] FRC (2003), 'Audit Committees Combined Code Guidance: A report and proposed guidance by an FRC-appointed group chaired by Sir Robert Smith', January.

[17] Commission on the Regulation of U.S. Capital Markets in the 21st Century (2007), 'Report and Recommendations'.

One section of the report is devoted to the challenges facing public company auditing. It highlights the importance of independent audits for the effective functioning of capital markets, but emphasises some of the challenges that auditors currently face:

- audit firms cannot be expected to provide near-absolute assurance that financial statements are correct;
- there are key issues surrounding materiality and reasonable assurance;
- there is considerable confusion, in the profession, with regard to auditor responsibilities;
- the failure of a major auditor would cause a serious crisis in the profession;
- the failure of mid-tier firms to break into the audit market for large clients is essentially due to a lack of capacity, in addition to the liability risk arising from auditing a Fortune 1000 business;
- the two most likely causes of auditor collapse are criminal indictment and catastrophic litigation;
- any firm under indictment will rapidly lose clients, which, in turn, will increase the probability of collapse;
- catastrophic litigation was seen as representing the greatest threat:
- there has been an increase in the size of class action lawsuits in which some auditors are named defendants;
- there is anecdotal evidence that private damages against auditors under state law are increasing;
- the possible impact of these factors is heightened by problems that auditors encounter in obtaining insurance.

The report by the Commission on the Regulation of U.S. Capital Markets in the 21st Century went on to say that, underpinning all of this was the fact that auditors cannot borrow against assets to mitigate the impact of claims against them, nor can they use bankruptcy as a protection due to the loss of reputation that would ensue from this.

Therefore, its recommendations seem to be based on the premise that measures need to be taken, first, to reduce the probability that a major audit firm will collapse, and, second, to mitigate the impact of such a collapse if one were to occur. With this in mind, it concluded that:

- there was a need to focus criminal indictments on responsible partners rather than the entire firm;

- a national charter for large audit firms should be established. This would be limited to firms that derive more than half of their income from public company audits and are represented in more than half of the states in the USA. It would represent a signal of the firm's quality and independence;

- audit issues should be placed on the G8's agenda;

- companies should be encouraged to evaluate a broader range of potential auditors, and regulators should encourage mid-tier firms to expand their scope;

- the use of alternative dispute resolution procedures should be encouraged in an attempt to reduce the incidence of class action lawsuits.

Although potential conflicts of interest and their implications for independence are recognised, the authors argue that precedent shows that these conflicts can be mitigated. They cite the example of member firms of the New York Stock Exchange (NYSE) which, until 1953, were required to be formed as partnerships. In 1953 they were allowed to incorporate and in 1970 the Exchange permitted public ownership of member firms.

The Commission on the Regulation of U.S. Capital Markets in the 21st Century expects that the criteria for obtaining a charter would result in only around 10–15 firms being eligible. By having such a charter, it believes that firms would be able to circumvent the independence rules requiring majority ownership by qualified auditors, which are imposed at state level in the USA. This would enable the holders of the charter to recapitalise by raising funds externally, possibly through equity issues, in order to increase the likelihood that they could withstand potentially damaging class action lawsuits. In addition, the Commission believes that being able to circumvent ownership rules would encourage the emergence of a new large audit firm, either by other parties creating such a firm from scratch, or by investing in an existing mid-tier firm. The report does not offer any evidence to support this view, and, although it mentions that a private equity firm might undertake such an investment, it does not assess the likelihood of this actually occurring.

In short, the Commission on the Regulation of U.S. Capital Markets in the 21st Century seemed most concerned with ensuring that the collapse of a large auditor is less likely to occur by improving their access to capital and reducing the risk of class action lawsuits emerging, while also making some, albeit limited, moves to encourage new entrants into the market for large company audits.

1.3 Structure of this report

The content and purpose of each section are summarised below.

Section 2 The analytical framework is set out, together with the main workstreams used to investigate the role of ownership and management restrictions in determining the structure of the market for larger audits.

Section 3 The approaches taken by legislators worldwide to issues concerning ownership and corporate governance are examined in this section, in so far as they relate to the structure of the audit market and the quality and independence of the audit. The findings from the study of ownership and governance rules in EU Member States are then presented, together with some comparisons between legislative regimes in Europe. A more detailed overview by individual Member State is presented in the separate Annex.

Section 4 This section begins with an assessment of the notion of auditors' independence, as discussed in academic literature and various policy initiatives. This is followed by a consideration of how the concept is viewed by auditors themselves, by audited entities and by the investment community in Europe.

Section 5 The typical ownership and management structures of audit firms across Europe are described, followed by an assessment of the drivers that have given rise to these structures, as well as the implications of any changes that have occurred. The nature of relationships between member audit firms forming an international network and the roles of international umbrella organisations are then considered.

Section 6 The section begins with an overview of the typical sources and uses of funds for audit firms across Europe. It then discusses methodologies for determining the impact of ownership structures on access to capital, before considering the potential impact of ownership and control restrictions on these structures and, hence, on access to, and the cost of, capital.

Section 7 The competitive environment in the audit market in Europe is examined in this section, together with the factors that affect the scope for the emergence of new entrants into the market and the potential for existing market participants to expand. The importance of ownership rules and access to capital as barriers to entry and expansion is examined relative to other factors that have driven the current high concentration in European audit markets.

Section 8 The final section brings together the above analysis to set out Oxera's main conclusions, and to formulate a series of policy options and topics for further debate relating to the ownership and management control rules on audit firms.

2 Analytical framework

2.1 Overview of the framework

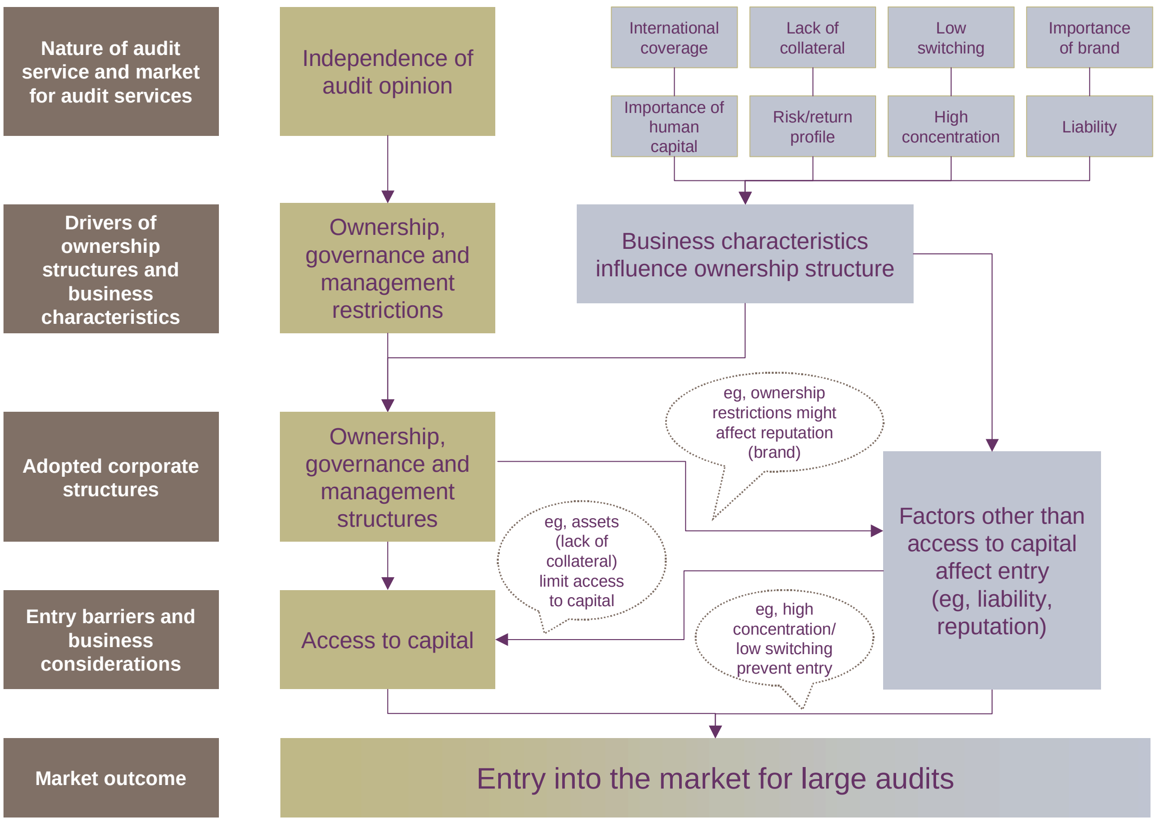
This section describes the analytical framework used in this study to investigate the role of ownership and management restrictions for the observed outcome in the audit market—ie, high concentration and limited entry—as well as to delineate and assess policy options that could be implemented to facilitate competition in the context of existing regulations concerning ownership and management structures.

The methodological approach adopted here is based on an examination of the causal links and relationships between the following key components of the framework:

– the nature of the audit service, market for audit services, and ownership, governance and management restrictions;
– ownership, management and governance restrictions, and ownership, governance and management structures adopted by audit firms;
– ownership and governance structures and the ability of audit firms to access capital;
– access to capital by audit firms and competitive dynamics in the market of large audits.

A stylised illustration of the analytical framework is shown in Figure 2.1.

Figure 2.1 Stylised illustration of the analytical framework



Source: Oxera.

2.2 Detailed components of the framework

2.2.1 The nature of the audit service and drivers of ownership and management structures

The nature of the audit service and characteristics of the audit market in the EU Member States represent a starting point for the analysis. Factors such as the existing market structure and the nature of the competitive process between auditors are likely to have an impact on the possibility of expansion. In this respect, the impact of ownership and management restrictions needs to be separated from the impact of other factors.

Ownership and management structures adopted by the audit firms represent another component of the analytical framework. Several issues need to be investigated in relation to ownership and management structures, including the following:

– to what extent might ownership and management structures adopted by audit firms affect concentration in the audit market and what are the barriers to entry (including, potentially, access to capital) that ownership and management structures might create?

– the impact of ownership and management structures on entry barriers needs to be separated from the impact of other factors. Other factors might include some of the characteristics of the audit market (eg, limited availability of liquid assets for the collateral for debt financing), the liability risk involved when undertaking large audits, as well as the current market structure (eg, low switching between auditors);

– the drivers for typical ownership structures need to be examined in order to understand the role and impact of ownership rules as a potential policy mechanism.

2.2.2 Auditor independence and regulatory restrictions

Economic theory suggests that the primary motive for regulatory intervention is the mitigation of market failures. It is therefore important to examine whether the potential lack of auditor independence might represent a market failure, and whether, in the absence of restrictions, the market outcome is likely to be characterised by an insufficient degree of auditor independence in the first place. Section 4 reports the results of Oxera's assessment of the role of regulatory restrictions in ensuring auditor independence.

Audit firms adopt a variety of ownership and management structures, for both commercial and legal/regulatory reasons. Section 5 discusses typical structures observed in the EU Member States. As discussed below, ownership and management structures might have an impact on access to capital and hence entry into the audit market. In this respect, it is important to understand the relationship between the regulatory restrictions and the choice of structures of audit firms, in order to:

– determine whether regulatory restrictions might have an impact on access to capital by affecting the ownership and management structures of audit firms;
– examine the potential impact of relaxing these restrictions.

Audit firms might adopt particular ownership and management structures for several different reasons. Regulatory restrictions represent one such driver and often differ by country. For the legal analysis of such restrictions across the Member States, Oxera was assisted by TELFA, a network of law firms across Europe.

To understand the role of regulatory restrictions, different potential drivers of ownership structures need to be assessed. For example, it is likely that the choice of structure would be affected by the nature of the audit business.

It is important to examine the drivers behind the management structures adopted by audit firms, in order to:

– delineate the role of regulatory restrictions for management structures adopted by audit firms;
– understand the extent to which ownership restrictions affect audit firms' behaviour, including strategic expansion and via what channels;
– assess the impact of the relaxation of management restrictions on auditor independence.

Section 5.1 examines the typical management structures adopted by the audit firms, and the potential drivers of these structures are then reviewed in section 5.4.

2.2.3 Ownership and management structures of audit firms, access to capital and barriers to entry

Given the objectives of this study, this analytical framework focuses on the relationship between the ownership and management structures of audit firms, the audit firms' ability to raise capital, and entry barriers.

Limited access to capital might represent a potential entry barrier. For example, the inability to raise funds to finance expansion might jeopardise entry due to the necessary investments. The ownership and management structures adopted by audit firms might affect access to capital. For example, it might be argued that the partnership structures limit access to capital because they prevent access to public capital markets.

In this respect, it is important to consider:

– what form of capital is required for business expansion and hence entry into other business areas?
– whether the amount of capital available might represent a binding constraint?
– whether access to capital by audit firms is indeed limited?
– to what extent access to capital is limited because of the predominant ownership and management structures.

2.2.4 Ownership and management structures and other entry barriers

Ownership and management structures might affect access to capital and thus potentially create entry barriers. At the same time, the adopted ownership and management structures might create alternative entry barriers (eg, limiting brand development and/or brand acquisition). For example, if a company with a strong brand could own a mid-tier audit firm, this might facilitate market expansion by the given firm.

2.2.5 Alternative factors affecting access to capital as entry barriers

Ownership and management structures might not be the only factor affecting access to capital. For example, the potential costs of liability claims might have an impact on the required rate of return and potential investors' willingness to commit capital. Therefore, such factors need to be considered to the extent that they represent a binding constraint on access to capital even in the absence of ownership restrictions.

It is possible that the high concentration and limited entry observed in the market for large audits result from factors not directly related to access to capital and/or audit firms' ownership and management structures. Some of the major potential entry barriers examined in Oxera (2006) were:

– the quality and expertise of staff;

– low switching rates;
– the long-term nature of the audit product;
– differences among firms in their international outreach;
– brand and reputation;
– level of global coordination;
– the relationships between the firm (ie, audit partner) and the company's finance director and audit committee.

Therefore, the potential impact of a change in ownership restrictions on entry and market dynamics (via access to capital as well as other factors) might need to be considered in light of other factors affecting entry. In particular, removing ownership restrictions might have a limited impact on market entry if other major challenges need to be overcome in order for mid-tier audit firms to enter the market for large audit services.

2.3 Description of study workstreams

The workstreams undertaken by Oxera in the course of this study are described below. Figure 2.2 at the end of this overview shows how the workstreams link to each of the sections of this report.

Workstream 1
Analysis of research on corporate structures

The initial input into the analysis of different corporate structures is a review of empirical cases and studies that analyse the drivers of different corporate forms, and the implications of these different forms for access to capital.

For this element of the research, Oxera engaged in discussions with the leading academics in this area. Oxera's Director, Professor Colin Mayer, Dean of the Saïd Business School, Oxford University, and Dr Steven Tadelis, Associate Professor at the University of California, provided valuable input on several key issues. This ensures that the analysis of drivers of corporate structures, and the role of human capital, presented in the remainder of this report, has been developed according to the latest academic thinking in this area.

The analysis of the relationship between human capital and adopted corporate structures is presented in section 5. The results of this workstream regarding the implications of significant aspects of particular corporate forms for access to capital are incorporated into section 6.

Workstream 2
Financial modelling: investment appraisal of the entry decision

Based on the results of workstream 1, a series of models of investment decisions (investment appraisal) has been developed to assess investments that potential providers of capital to audit firms would need to make. (These providers might include, for example, partners, creditors, or preferred minority shareholders.) Section 7 presents the results of the investment modelling.

As described below, the models have been applied to analyse different aspects of the decision to enter the market for audit of financial statements of public interest entities and larger unlisted entities, as well as to understand the dynamics of the potential entry barriers. The conclusions from the interview programme have been used to calibrate and validate the results from the investment models.

Workstream 3
Analysis of legislation, regulation and management structures of audit firms across EU Member States, and the implications for competition

The ownership structures adopted by audit firms in the EU Member States are ascertained through examination of the legislation and regulation applying to audit firms in 18 Member States. The results of this analysis, presented in sections 3 and 4, include the following elements:

- a description of the relevant legislation applicable to audit firms (section 3);
- a description of the leading structures adopted within each Member State (sections 3 and 4);
- detailed reports on the adopted structures across the EU (Annex);
- economic analysis of the identified legal structures (section 5).

The results of workstream 3 were mapped onto workstreams 1 and 2 to determine whether ownership structures actually adopted within the EU Member States result in increased cost of capital and/or capital rationing for smaller audit firms, and whether this has implications for competition. The results of this analysis are reported in sections 6 and 7.

Workstream 4
Primary research of the audit market: the interview programme across Europe

Oxera has undertaken a programme of structured interviews with key representatives from audit firms, investors and other organisations from across several Member States. With respect to the audit firms, many small and mid-tier audit firms as well as representatives of the each of the Big Four were interviewed. A number of large European investors were interviewed for their views as third parties to an audit, as well as potential investors in audit firms. Other organisations related to the audit profession were interviewed in various Member States, as well as European-wide organisations. These included the Institut für Wirtschaftsprüfer, IDW (Germany); the FRC (UK); the Institut des Reviseurs d'Entreprises, IRE (Belgium); and the European Federation of Accountants. In addition, interviews were held with several academics who specialise in the areas covered in the report.

A full list of the interviews can be found in section A3.1.

The interview programme has been structured to cover a wide range of issues, including:

- what the drivers of the adopted corporate structures are, in light of the current regulatory environment;
- how audit firms raise capital and any potential challenges to raising capital;
- the market positioning of the audit firms and trends in the respective markets;
- feasibility of entry into the market for larger audits;
- perceptions about the importance, and drivers, of auditor independence.

The objective of this analysis is to ascertain whether lack of access to capital is perceived as a significant barrier for firms to expand into the market for auditing larger companies than they currently audit. Furthermore, the interview programme has provided additional evidence about the perceptions, and drivers, of independence.

The interview programme has been crucial in developing the economic analysis in the other workstreams, particularly in sections 4, 5 and 6, and further detail on its structure is provided in section A3.1.

Workstream 5
Evaluation of entry and competitive dynamics

Investment opportunities in the audit market are further assessed through several approaches.

– A conceptual analysis of whether differences in the *economic* characteristics of different ownership structures might result in different levels of access to capital by audit firms. The results of this analysis are reported in section 6.

– Economic analysis of potential market segmentation between the larger and the smaller listed companies (section 7).

– Assessment of the main barriers to entry and expansion into the market for audits of large listed companies (section 7).

– Analysis of the relationship between the current ownership rules and market concentration in each Member State (section 7). Due to the lack of sufficient data, it has not been possible to develop a statistical model that relates differences in market dynamics to differences in ownership rules across Member States.

– Modelling of potential investments in the audit firms made by external parties (section 7).

Workstream 6
Economic analysis of auditors' independence and survey among EU companies and investors

Oxera has addressed the issue of independence in two steps.

– As a first step, secondary sources were analysed, including justifications for regulation and leading commentaries on the issue of auditor independence. In particular, the question of potential links between the notion of independence and regulated corporate structures was investigated. Moreover, comparison was made with selected other industries where independence is of relevance. The results of this analysis are reported in section 4.

– As a second step, Oxera conducted a series of interviews of audit firms in order to gain an understanding of the relationship between voting rights, ownership rules, management composition and the opening of the market for the provision of audit services. The conclusions from the interviews are discussed in section 5.

– As a third step, Oxera conducted a survey of consumers of audit—both companies and investors. The survey was designed to elicit views from these two groups about the importance of ownership structures of audit firms and levels of auditors' independence, in order to determine whether there is a perceived trade-off between the two, and whether any misaligned incentives might exist between the participants in the audit process. The results of the survey are reported in section 4.

The survey covered audited entities and their investors across 25 EU Member States.[18] In some cases, sufficiently comprehensive conclusions can be achieved with a small number of survey respondents, particularly when there is little variation in the unique features of the market across Member States. For this study, however, derivation of robust conclusions

[18] Since the commencement of the study, the EU has been expanded to 27 Member States.

requires that the sample comprise a large number of audited companies and their investors, particularly as there appears to be significant diversity within the audit market across Member States.

With this in mind, a sample was identified comprising the top 20 audited listed entities in each Member State, as measured by market capitalisation, resulting in a total potential sample size of 500.[19] By confining the sample to large listed companies, it was hoped to cover a high number of entities that operate in several Member States, in order to take advantage of their knowledge of different legal frameworks, market and corporate structures. In each case, an introductory email was sent to the office of the chairman or chief executive, with a link to the on-line version of the survey. The respondents' anonymity was maintained, as the survey only required them to provide a unique identification number rather than their company name. It was felt that this would help to increase the response rate.

In addition, a separate group of 31 leading asset managers across Europe was identified and a similar introductory email sent to senior representatives of these organisations containing a link to a separate and distinct version of the survey. Due to the relatively small number of major investing institutions in Europe, it was not possible to divide the sample equally between companies and investors.

Following this initial contact, a further email was sent to the respondents two weeks later and printed versions of the survey were posted to those who requested them. The asset managers who participated in the survey can be found in Table A1.1.

Workstream 7
Ownership and control structures: identification of options and impact assessment (part I)

Part 1 of the final workstream was undertaken in order to establish:

– the limits of options available under the Eighth Directive using legal and economic analysis. The results of this are analysed in section 3;

– the acceptability to audit *clients* of different types of ownership structure (particularly outside the ownership structures currently present in the major audit markets). This is provided by the survey of audit clients—both direct (companies), and indirect (investors in companies). The results of the survey are examined in section 4;

– whether there are willing providers of investment capital to audit firms under different ownership and control structures. Insight into this critical issue is provided by the investment modelling discussed under workstream 5, as well as the analysis reported in section 6.

Overall, workstream 7 consolidates the outputs from the previous workstreams and presents a selection of options concerning voting rights, ownership rules and management composition that could be seen as most advantageous in encouraging entry by smaller audit firms into the market for audit of larger unlisted entities. The results of this workstream are presented in section 8.

[19] It has not been able to obtain accurate contact details for all the companies, so the final sample size was 471.

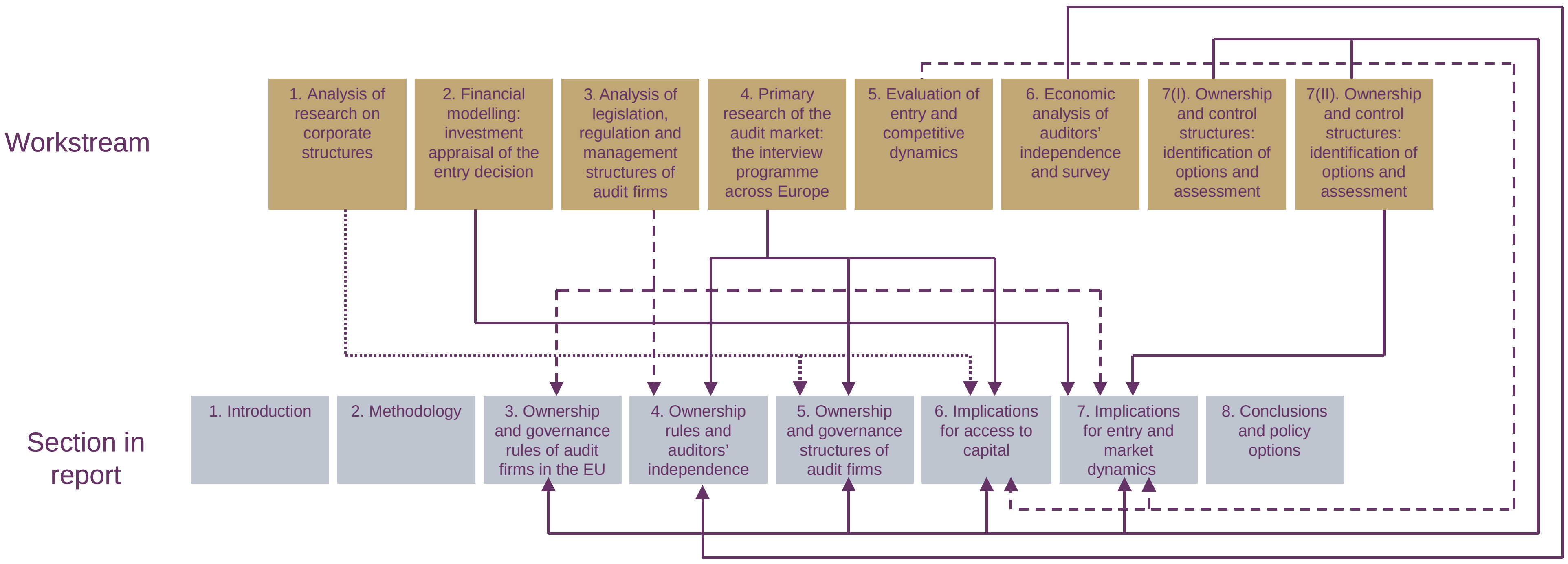
Workstream 7

Ownership and control structures: identification of options and impact assessment (part II)

Part II of the final workstream was undertaken to identify whether there is any reduction in the barriers to entry other than those related to access to capital (or, more correctly, a reduction in the cost of capital). This analysis is based on theoretical considerations and literature reviews, and considers the likely effect of options that have been identified in relation to ownership and control (see section 6.4).

Workstream 7 consolidates the outputs from the previous workstreams, and is summarised in section 8.

Figure 2.2 Link between workstreams and structure of the report



Source: Oxera.

3 Ownership and corporate governance rules of audit firms in the EU

3.1 Introduction to rules and regulations

3.1.1 Overall introduction

The audit market is characterised by a significant degree of regulation, reflecting both its complexity and specific economic features. Broadly speaking, the supply of audit services is subject to rules and regulations that seek to:

– limit the types of ownership and control structures that are permissible for suppliers of audit services;
– ensure that the suppliers of audit services remain independent from outside influences which might impinge on the quality and independence of the audit being produced;
– ensure that internal conflicts of interest within the audit firm, which might also impinge on the quality and independence of the audit, are mitigated;
– subject the suppliers of audit services to certain restrictions on the supply of non-audit services to their audit clients;
– subject the suppliers of audit services to restrictions on obtaining services from their clients;
– apply quality regulation (in terms of training and competency requirements) to those who can supply those audit services that are required to be purchased by audit clients;
– require certain types of legal entity to purchase certain types of audit services—in particular, companies with publicly traded equity have to purchase audits from recognised auditors in order to maintain their access to public equity.

In addition, auditors are subject to ongoing oversight and monitoring, either by independent monitoring organisations set up by governments, or directly by government departments or agencies.

The analysis presented in this section of the rules and regulations imposed on audit firms shows that a variety of legal forms are permitted in most Member States and that firms have taken advantage of this. However, it appears that most audit firms across Europe adopt some variation of the limited company structure. This exception is the UK, where the large firms are set up as limited liability partnerships (see section 5.2.1, which details the legal form of audit firms in several Member State countries).

Restrictions on outside ownership and on the composition of the management board are prevalent across all Member States following the original Eighth Directive of 1984, and, in some countries, restrictions predate even this. Some countries have adopted particularly strict requirements in the past, designed to prevent any outside ownership (even a minority interest) and presence on the management board of non-qualified persons. For the most part, these additional restrictions seem to be related to historical concerns about the potential impact of outside ownership or involvement in decision-making on independence and potential conflicts of interest.

The monitoring of auditors is evolving and an increasing number of countries are establishing independent oversight bodies, although some differences exist in the requirements for the composition of these bodies, and in some Member States, oversight is still conducted by professional associations or financial services regulators.

For the purposes of this study, it is necessary to concentrate on those aspects of the legislative framework that deal with the ownership and control of the suppliers of audit services, particularly in so far as they relate to the structure of the audit market and the quality and independence of the audit.

Before assessing the impact of these rules and regulations in the remainder of this report, it is necessary to determine the nature of the legislative framework that audit firms face across Europe, with a view to highlighting where there are significant differences between countries which, in turn, may go some way to explaining differences in the structure of audit markets between countries. This section therefore first describes the origins of the current rules, and then presents the results of the country-by-country assessment undertaken by Oxera in conjunction with the TELFA network.

Early ownership rules at the national level: the case of Germany

The origins of auditing in Germany go back to the 19th century when banks formed trust companies to manage and monitor their portfolios of assets in Germany and overseas. Over time, the auditing function of these companies attained greater significance until, following the German banking crisis in 1931, audits of financial statements were made compulsory and the profession of auditor (Wirtschaftsprüfer) was created. In addition to providing audit services, these firms provided more general consultancy services for their clients.

Even at this early stage in the profession's development, there appears to have been concern about potential conflicts of interest emerging as a result of the ownership structures of these audit and trust companies. Some of these were still owned by the banks that had created them. In addition, a number of government trust companies had been established to undertake audits of state-owned enterprises.[20]

Most audit firms were not established as partnerships. As the banks that created these firms wanted to avoid potentially high liability exposure, most of the firms were set up as limited liability companies. Therefore, when the Law Regulating the Profession of Auditors (Wirtschaftsprüferordnung) came into force in 1961, most audit firms were already established as limited liability companies. No attempt was made to prohibit this legal form and audit firms have continued to make use of it to the present day. Most mid-tier firms are still structured as private limited liability companies (Gesellschaften mit beschränkter Haftung, GmbH), while larger firms tend to take the form of public limited companies (Aktiengesellschaften, AG).

The Law of 1961 also restricted non-professional ownership (ie, ownership by outsiders) of audit firms. As this applied to new owners of audit firms only, existing outside owners were allowed to retain their stakes in companies. However, many banks had already begun to sell their equity stakes to the directors of audit firms due to the concerns over independence noted previously. At the same time, restrictions were placed on outside involvement in the management boards of the firms due to the same concerns about potential conflicts of interest.

Although these concerns over threats to independence and potential conflicts of interest appear to have had a significant influence on the development of legislation in Germany, there appear to be no actual instances of a particular audit firm's independence being questioned, in public, as a result of pressure from outside owners or management board members.

During the 1970s firms continued to amend their ownership structures, possibly in the expectation that rules could be tightened still further in the future. Existing outside owners,

[20] Quick, R. (2005), 'The formation and early development of German audit firms', *Accounting, Business and Financial History*, **15**:3, 317–43, November.

principally banks, continued to transfer their shares to the directors of the audit firms. An example of such a transfer in that period relates to the audit firm, Süddeutsche Treuhandgesellschaft AG, which had previously been owned by three German banks (Bayerische Hypotheken-und Wechselbank, the Bayerische Vereinsbank and the Bankhaus Merck, Finck & Co). These organisations sold their shares to the directors and managers of the audit firm, as well as to another Düsseldorf-based audit firm, Dr Wollert–Dr Elmendorff KG.

The regulatory trend to restrict outside ownership of audit firms was reinforced by the Accounting Directives Law (Bilanzrichtlinien-Gesetz) of 1985, which implemented the European Commission's Eighth Directive.

It is clear, therefore, that the impetus to remove non-professional owners from audit firms in Germany was driven by fundamental concerns over their impact on independence, and that the sale of shares by the outside organisations that had originally established audit firms resulted from both regulatory developments and market pressure.

3.1.2 Statutory auditors' independence in the EU: a set of fundamental principles

As stated in the Introduction, within the European Community, the concept of auditor independence was encapsulated in a set of Fundamental Principles issued in 2002.[21] These emphasised the link between, and the importance of, objectivity and professional integrity, which underpins the statutory auditors' audit opinion on financial statements. The Principles also highlighted the threats that could affect independence, namely self-interest, self-review, advocacy, familiarity or trust, and intimidation.

The Principles established a working definition of independence based on objectivity and integrity:

> The ultimate goal of the Statutory Audit is to express an objective audit opinion. The main means by which the Statutory Auditor demonstrates that he can express such an opinion is by demonstrating that he performs the audit process in an objective manner. To achieve this he must act with fairness, intellectual honesty, integrity and without any conflict of interest which might compromise his independence.[22]

However, it was recognised that objectivity and integrity are difficult to measure and therefore difficult to verify. In addition, it was concluded that independence should not be perceived as an absolute standard that all auditors should be expected to attain, as it was felt that complete independence was not an achievable goal.

Instead, it was recommended that any monitoring of independence should take account of the specific circumstances of individual auditors, with a view to identifying any particular relationships or interests which might be perceived as reducing an auditor's independence. The test to be applied by those monitoring the auditor was whether such interests would:

> cause a reasonable and informed third party, knowing all these circumstances, to conclude that the Statutory Auditor is independent, ie, is capable of exercising objective and impartial judgement on all issues encompassed within the statutory audit engagement.[23]

The Principles acknowledged that, in order to ensure that this assessment of an auditor's independence is appropriate, it needs to take account of the specific threats to independence that exist and to determine their significance.

[21] Commission of the European Communities (2002), 'Statutory Auditors' Independence in the EU: A Set of Fundamental Principles', May 16th.
[22] Ibid., Annex 1.
[23] Ibid., Annex 1.

The potential risks to independence faced by an auditor were grouped into several broad categories:

- self-interest, whereby independence could be affected by financial or other relevant relationships between the auditor and client;
- self-review, whereby the auditor's internal self-review procedures with respect to a particular audit were compromised in some way;
- advocacy, whereby the auditor's independence could be affected by their acting on behalf of the client in litigation proceedings or undertaking transactions in shares or securities of the client;
- familiarity or trust, whereby the auditor is unduly influenced by having a close, long-term relationship with the client, which, in turn, may have affected the auditor's objectivity;
- intimidation, whereby the auditor is subject to threats from third parties.

To mitigate these risks, it was argued that a series of safeguards was required combining prohibitions, restrictions, disclosures and other related policies. These safeguards were grouped into three main categories:

- audited entities' safeguards—referring to the governance of the appointment process for auditors and the nature of the disclosures that had to be made concerning relationships between the audit firm and the entity being audited;

- quality assurance—referring to the need for an audit firm to have adequate internal governance procedures in place to ensure that the audit process was effectively monitored and that quality would be maintained;

- statutory auditors' safeguards—these are of particular interest with respect to the current study. The Principles required that the majority of the voting rights in an audit firm be held by those permitted to undertake statutory audits within the EU (ie, qualified auditors). Furthermore, an audit firm should ensure that its legal statutes contain provisions such that a non-auditor could never gain control of the firm. In addition, an audit firm had to establish a set of internal safeguards, such as a system for internal risk assessment of independence threats and formal procedures in order to ensure that partners, managers and employees meet independence standards.

With respect to the ownership rules, it was recognised that, even in the form suggested, conflicts of interest could emerge if a single non-auditor were able to control 49% of the voting rights. Therefore, it was suggested that restrictions should be considered on the size of individual blocks owned by non-auditors.

Finally, it was recommended that, if a non-auditor owner did emerge, the relationship between themselves, the auditor and the audited entity should be subject to the general requirements referred to in the principles concerning the existence of financial or business links between them.

3.1.3 Directive 2006/43/EC on Statutory Audits of Annual and Consolidated Accounts

This Directive, commonly known as the Eighth Company Law Directive (Directive 2006/43/EC), came into force in June 2006, replacing the existing legislation introduced in 1984. It builds on the previous set of principles and establishes an amended set of criteria designed to ensure the quality of the final audit and the independence of the audit process.

The Directive contains a number of provisions intended to enhance confidence in the audit profession across the EU. It clarifies the duties of statutory auditors and provides for their independence and ethical standards; introduces a requirement for external quality assurance; and provides for public oversight of the audit profession. In addition, it aims to ensure greater cooperation between public oversight bodies in Member States with those in third countries.

With respect to the ownership of audit firms, Article 3.4b of the Directive requires the relevant authorities of Member States to approve only those firms that satisfy the following criterion:

> A majority of the voting rights in an entity must be held by audit firms which are approved in any Member State or by natural persons who satisfy at least the conditions imposed

In addition, Article 3.4b requires that:

> A majority—up to a maximum of 75%—of the members of the administrative or management body of the entity must be audit firms which are approved in any Member State or natural person who satisfy at least the conditions imposed

As far as independence issues are concerned, Article 22 of the Directive reaffirms the 2002 Principles discussed above with respect to the need to ensure that there is no direct or indirect financial, business or other relationship between the auditor, the audit firm or the network and the audited entity, such that:

> An objective, reasonable and informed third party would conclude that the statutory auditor's or audit firm's independence is compromised. (Article 22.2)

In addition, however, it was recognised that the existence of outside owners of an audit firm might give rise to potential conflicts of interest that could compromise the independence of the firm. Therefore, Article 24 of the Directive requires that:

> Member States shall ensure that the owners or shareholders of an audit firm as well as the members of the administrative, management and supervisory bodies of such a firm, or of an affiliated firm, do not intervene in the execution of a statutory audit in any way which jeopardises the independence and objectivity of the statutory auditor who carries out the statutory audit on behalf of the audit firm.

A further measure to enhance independence is contained in Article 42, which requires the key audit partner responsible for the audit of an individual client to be rotated within a maximum period of seven years.

In order to ensure comprehensive oversight of the audit profession across the EU, the Directive confirms the need for Member States to make sure that they have effective systems in place for a public body to undertake this function. Although Member States have flexibility in determining their precise structure of public oversight, the Directive does establish a set of high-level principles that must be adhered to when setting up such a body. These include providing the body with sufficient powers to enable it to conduct investigations and take appropriate action in the event of the discovery of wrongdoing. The body must be adequately funded and its work must be transparent. In addition, arrangements need to be put in place to ensure that there are appropriate means of cooperation and coordination between the oversight bodies of individual Member States, as well as between those within the EU and those in third countries.

3.1.4 Independence and ownership rules in the international context

In addition to the European Commission, a number of other jurisdictions and agencies have adopted standards, based on some of the notions of independence discussed in section 4, to ensure auditor independence through a combination of legislation and requirements set by relevant professional bodies.

As noted in the Introduction, in the USA the Sarbanes-Oxley Act, introduced in 2002 soon after the dissolution of Arthur Andersen, makes it unlawful for audit firms to provide any non-audit service to a client (Section 201), including the following 'prohibited activities':

– bookkeeping or other services related to the accounting records or financial statements of the audit client;

– design and implementation of financial information systems;
– appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
– actuarial services;
– internal audit outsourcing services;
– management functions;
– human resources;
– broker/dealer, investment adviser or investment banking services;
– legal services and expert services unrelated to the audit;
– any other service that is not permitted by regulation.

While some exemptions from the above are possible, overall the Sarbanes-Oxley Act is aimed at preventing conflicts of interest between audit and non-audit services. In addition, Section 203 of the Act makes it mandatory for the lead audit partner and the reviewing partner to be rotated every five years.

In order to implement the Sarbanes-Oxley Act, the Securities and Exchange Commission (SEC) adopted a series of rules in 2003,[24] based on four fundamental independence principles—namely, whether the relationship between the auditor and the client:

– creates a mutual or conflicting interest between the auditor and the audit client;
– places the auditor in the position of auditing their own work;
– results in the auditor acting as an employee of the audit client or part of its management;
– places the auditor in a position of being an advocate for the audit client.

These principles have some similarity to the independence risks contained in the Commission's own principles on auditor independence, discussed in section 3.1.1. The rules also reaffirmed the importance of both actual and perceived independence, by stating that they were:

> Designed to ensure that auditors are qualified and independent of their audit clients both in fact and appearance.[25]

In addition to requiring the SEC to establish rules implementing its provisions, the Act vested in the PCAOB the authority to establish standards relating to ethics and independence in public company auditing. Having been given this authority, the PCAOB adopted, as its interim, transitional, independence standards, the American Institute of Certified Public Accountants (AICPA) interpretations and guidance. The notion of independence embedded in these standards is referred to in section 4 of this report. The standard released by the PCAOB requires that auditors:

> Not only be independent in fact; [but also] avoid situations that may lead outsiders to doubt their independence.[26]

The standard goes on to state that:

> Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence.[27]

Again, reference is made to both actual and perceived independence. It is worth noting that both the SEC rules and the PCAOB standards refer only to the nature of the relationship between auditor and client, and make no mention, in this context, of the issue of potential conflicts of interest arising from outside ownership of the audit firm.

[24] SEC (2003), 'Strengthening the Commission's Requirements Regarding Auditor Independence', SEC release no.33-8183.
[25] Ibid., Preliminary Note 1.
[26] PCAOB (2003), 'Statement on Auditing Standard no.1, Codification of Auditing Standards and Procedures', S.220, para 03.
[27] Ibid.

In the UK the FRC, via its subsidiary, the Auditing Practices Board (APB), has issued a set of Ethical Standards for auditors, with Standard 1 relating to integrity, objectivity and independence having been re-issued in December 2004. These standards were reviewed during the first half of 2007.

Standard 1 defines independence as:

> Freedom from situations and relationships which make it probable that a reasonable and informed third party would conclude that objectivity either is impaired or could be impaired…independence relates to the circumstances surrounding the audit, including the financial, employment, business and personal relationships between the auditors and their client.[28]

Again, reference is made to the perception of independence as being of paramount importance. Standard 1 also notes that independence is related to—and, indeed, underpins—objectivity. However, whereas objectivity refers to the particular characteristics of the individual auditor, independence is concerned with the more general issues inherent in the relationship between auditor and client.

Standard 1 requires auditors to determine the risk to objectivity and independence using the same criteria and guidelines as set out in the Commission's Fundamental Principles of 2002. Having taken steps to identify the potential threats, the auditor is required to put procedures in place which will either eliminate the threat completely, such as removing an individual auditor from the engagement team, or reduce the threat to what is termed an 'acceptable' level. Such a level is defined as one in which there would be no perception, by a third party, of a loss of independence. One example given of an action that could bring about such a reduction is having the audit work reviewed by another partner or another audit firm.

Elsewhere, internationally, some countries (eg, Australia) have adopted principles and standards that mirror the guidance established in the International Federation of Accountants (IFAC) Code of Ethics for Professional Accountants, published in June 2005. It is worth noting that the Code refers to independence *of mind*, which it defines as:

> The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgement, allowing an individual to act with integrity, and exercise objectivity and professional scepticism.[29]

In addition, it refers to independence *in appearance*, which it defines as:

> The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional scepticism had been compromised.[30]

The Code emphasises that it is impossible to be free from all economic, financial and other relationships, and, therefore, the significance of any relationships must be evaluated in terms of what is perceived to be unacceptable or inappropriate. As with other regimes' standards and principles, the Code requires auditors to evaluate the risks to independence and to ensure that appropriate safeguards are put in place to mitigate them.

There are a number of similarities between the approaches to ensuring independence across the different regimes considered. It is also notable that the US approach appears to be based on a comprehensive set of detailed rules underpinned by a small number of guiding

[28] APB (2004), 'APB Ethical Standard 1, Integrity, Objectivity and Independence', p. 6.

[29] IFAC (2005), 'Code of Ethics for Professional Accountants', p. 34.

[30] IFAC (2005), op. cit., p. 34.

principles, whereas the approach adopted by the UK and IFAC places more emphasis on higher-level principles with fewer rules.

3.2 Summary of the country reports

3.2.1 Approach to the assessment by Member State

In order to identify differences in individual legislative regimes within the EU, it was necessary for the purpose of the present report to develop a questionnaire, using a standard template, which could be sent to representative law firms in a number of EU Member States. To facilitate responses to this questionnaire, use was made of TELFA, which has member firms in 18 EU Member States.

The purpose of the review of the relevant legislation was to provide both an indication as to the rationale for the rules in each country, as well as being able to compare the legislation between different Member States. This piece of analysis is a historical review and was carried out in March 2007. It should be noted that many of the Member States had not transposed the Eighth Directive into national legislation, and those that had done so may not have implemented the legislation at the time of writing this report. Any assessment of legislation contains an element of interpretation. Therefore this review can be seen as a subjective interpretation of the audit legislation at a single point in time, rather than an up-to-date description of currently evolving guidelines, and thus the analysis may be perceived as one of several possible interpretations of the audit legislation.

Oxera developed a template for TELFA to identify the key legislative requirements in a number of broad areas and across a range of countries, as follows (see Appendix 1):

– requirements for companies to obtain audited accounts;
– auditors' duties and obligations;
– corporate governance and ownership rules of audit firms;
– auditor oversight.

One legislative area that has not been covered in the research is that of rules relating to auditor liability. A review of these rules was undertaken in the London Economics study referred to in section 1.2.2, and the Commission's consultation on liability referred to in the same section contains an overview of the rules.

The main parts of legislation that form the focus of the assessment undertaken for this present study are described below.

Requirements for companies to obtain audited accounts

It is necessary to confirm, for each Member State, that there exists both a statutory definition of audit as well as a statutory requirement for organisations to have audited accounts. If there were no such definitions or requirements for audit, it would be difficult to determine the nature and characteristics of the market for audit services. Variations in the definitions and requirements between countries could result in the emergence of both different market structures and different organisational structures for audit firms.

Auditors' duties and obligations

Even if a statutory definition of audit does exist, there could still be scope for auditors to exercise discretion in the way in which they undertake the audit, unless there are legal obligations or duties that define the nature of the output that auditors provide to their clients.

In addition, the purchaser of the audit product (the company and, more specifically, the management of the company) is not the only consumer of this product. Other consumers include existing and potential shareholders, debt holders (and potential fixed-income investors), taxation officials and the public more generally. The particular requirements of these different groups may conflict with each other. If any one group were able to exert undue pressure on the auditor, this could result in an audit product that was unsuitable for others. Therefore, it may be necessary to impose legal obligations and duties on auditors to ensure that the product can be relevant for a wide variety of user groups.

However, to ensure that these obligations to both the purchasers of the audit product and consumers are met, it may also be necessary to provide for sanctions that can be imposed on the auditor if they breach the requirement. Such sanctions could, for instance, take the form of actions for damages brought by consumers, or disciplinary procedures imposed by a trade association or oversight body.

Again, it is useful to identify any differences that may arise between countries with respect to both the duties and obligations and sanctions that may be imposed, as these could also have a bearing on market structures.

One of the main requirements for consumers of the audit product is that the audit is perceived to be independent. Consumers of the audit product need to be certain that the audit has been produced without the client being able to unduly influence its contents. If this were not to be the case, consumers would have to incur costs to verify the accuracy of the information provided. Therefore, it may be necessary for the duties and obligations placed on auditors to include a requirement for them to be independent of their clients. However, as there is no universally agreed definition of what is meant by independence, and, indeed, no clearly defined consensus on what factors ensure independence, it may be that different countries will adopt different requirements, and these need to be identified.

It may also be the case that independence could be ensured by means other than statutory obligations (pressure from shareholders, for instance, to force the removal of auditors who are not perceived to be demonstrating independence). Therefore, it is important to determine and assess the relative importance of both legislation and market-led solutions between various countries, and to identify any situations where one type of solution is preferred to another.

Corporate governance and ownership rules of audit firms

This is a key section in the questionnaire, as information gained from this provides the underpinning for the proposition that there may be a link between ownership and market structure.

There are a number of different aspects to the regulations and rules relating to the ownership and management of audit firms. They can relate to:

– professional standards for those wishing to conduct audits;
– restrictions on the type of organisation that can carry out audits;
– restrictions on the type of organisation that is allowed to hold an ownership stake (of any size) in an audit firm;
– restrictions on the type of organisation that is allowed to hold a controlling ownership stake in an audit firm;
– restrictions on the composition of the management board of an audit firm.

In light of these restrictions and requirements, the structure of the audit market in a particular country may exhibit certain characteristics relating to the ownership, control and management of firms. These characteristics need to be determined and differences between countries identified. The corporate forms adopted by audit firms may also be related to their size, and, again, such instances are important to the present report and need to be identified and analysed.

The possible relationship between ownership and independence is of particular interest. Legislation relating to the ownership, control and management of audit firms may have been developed with the intention of protecting or enhancing their independence, although this may not have been referred to explicitly at the time the legislation was formulated. It is therefore necessary to identify when and in which countries such rules and regulations are put in place with this explicit intention in mind.

Auditor oversight

The Eighth Directive specifically refers to the need for Member States to ensure that an effective system of public oversight for audit firms is in place. This is often in addition to self-regulation or supervision by the auditors' professional associations. Effective monitoring of auditors, together with enforceable sanctions in the event of a breach of rules, may also be used to ensure that auditor independence is maintained or enhanced. However, the oversight of the audit profession appears to vary between countries and it is useful to identify these differences and their impact in order to determine the likelihood that such bodies do, in fact, effectively ensure auditor independence.

The main areas of interest that assist in determining the effectiveness of the oversight body are:

– how the directors of the oversight body are appointed;
– whether the oversight body has the authority to set rules or standards for the audit process;
– whether it has the authority to determine who is allowed to conduct statutory audits;
– whether it has the power to impose sanctions for breaches of rules or standards.

3.2.2 Summary table of the country reports

Table 3.1 below provides a summary of the information covering the key legislative requirements in 18 Member States. This information was compiled for the purpose of this study by members of the TELFA network and is one possible interpretation of the legislation. The information was subsequently reviewed by relevant government departments or audit market regulators in the Member States. The information is not intended to be an exhaustive, or a current comprehensive legal overview; rather, it has been included as part of the study to gain a general historical indication of the legislation that applies in each Member State. In addition, many Member States were still in the process of implementing the Eighth Directive into national legislation at the time of writing, so the rules and regulations summarised here may be subject to change.

Table 3.1 Summary of ownership and corporate governance rules in the EU

Country	Auditors' duties and obligations		Corporate governance and ownership rules				Auditor oversight	
	Obligations and duties to client and third parties	**Enforceability of obligations and duties**	**Minimum professional standards; rules, obligations and bylaws**	**Ownership and control rules**	**Management board rules**	**Nature and incidence of corporate forms adopted by audit firms**	**Regulation and existence of oversight body**	**Rules, standards, approval and sanctions**
Austria	Various obligations in the Wirtschftstreuhandberufsgesetz.	The auditor is liable for breaches, intended or through negligence, of contractual duties and statutory rules. In addition, there are disciplinary measures, prohibitory action, a Criminal Code and an Unfair Competition Claim.	Audits may be carried out by tax advisers, chartered accountants and auditors. However, those requiring a formal auditor's report may be carried out by chartered accountants and auditors only. There are separate examinations for tax advisers and for chartered accountants and auditors.	Only tax advisers, chartered accountants and auditors may be owners of audit firms. For stock corporations, fiduciary shareholders are prohibited. The majority of capital shares and voting rights must be held by tax advisers, chartered accountants and auditors.	Management board members must be tax advisers, chartered accountants and auditors.	Partnership, limited liability partnership, limited liability company, stock corporation. The Big Four are organised as limited liability companies. There are three stock corporations, 1,823 limited liability companies, 444 partnerships, and 7,695 single natural persons.	The Kammer der Wirtschaftstreuhänder (KWT) is a state-supervised organisation established under public law. All tax advisers, chartered accountants and auditors must be a member of the KWT.	The KWT can set rules and standards. As all auditors must be members of the KWT, and audits can only be carried out by auditors, the KWT has indirect influence over who can carry out audits. The Audit Quality Control Oversight Board is responsible for public oversight, but has no involvement in setting standards.

Country	Auditors' duties and obligations		Corporate governance and ownership rules				Auditor oversight	
	Obligations and duties to client and third parties	**Enforceability of obligations and duties**	**Minimum professional standards; rules, obligations and bylaws**	**Ownership and control rules**	**Management board rules**	**Nature and incidence of corporate forms adopted by audit firms**	**Regulation and existence of oversight body**	**Rules, standards, approval and sanctions**
Belgium	Various accounting standards of the Instituut der Bedrijfsrevisoren must be followed. These include specific rules on independence and the prohibition of certain activities.	The auditor is liable to their client for breaching their contractual agreement, and joint and severally liable towards companies and third parties with respect to the Belgian Companies Code or articles of association. Summons can be issued under national law requiring the auditor to complete their contractual obligations. Company auditors can also be criminally prosecuted for certain acts.	Requirements include academic qualifications, passing an entrance test for the traineeship, completion of the traineeship (three years), passing a professional competence examination, and taking an oath. Audit firms may be both partnerships and companies.	All partners must be members of the Instituut der Bedrijfsrevisoren. In addition, the majority of voting rights must be held by members of the Instituut der Bedrijfsrevisoren.	All business managers and directors of an audit firm must be members of the Instituut der Bedrijfsrevisoren.	Unlimited partnerships, private limited liability companies, and cooperative companies. The Big Four are limited liability cooperative companies. Larger auditors favour the limited liability cooperative corporate form, whereas smaller auditors prefer the limited liability private corporate form. There are 425 private limited liability companies, and 42 cooperative companies.	The Instituut der Bedrijfsrevisoren is a public law, professional organisation. Its responsibilities include oversight of training, and providing a professional association that codifies competence, independence and supervision. There are various oversight bodies involved, such as the Advisory and Control Committee on the Independence of the External Auditor (ACCOM), and the High Council for Economic Professions (HREB-CSPE).	Independent from the Instituut der Bedrijfsrevisoren is the Disciplinary Committee, which imposes sanctions for the breach of professional ethical standards. The Instituut der Bedrijfsrevisoren has developed a set of rules that is binding on company auditors, however they adopt these standards only after consulting with the HREB-CSPE.

Country	Auditors' duties and obligations		Corporate governance and ownership rules				Auditor oversight	
	Obligations and duties to client and third parties	**Enforceability of obligations and duties**	**Minimum professional standards; rules, obligations and bylaws**	**Ownership and control rules**	**Management board rules**	**Nature and incidence of corporate forms adopted by audit firms**	**Regulation and existence of oversight body**	**Rules, standards, approval and sanctions**
Cyprus	The Companies Act and the manual of the Institute of Certified Public Accountants of Cyprus (ICPAC) stipulate various obligations of the audit firm, including quality control procedures, take-up of professional indemnity insurance cover, and having a professional licence	Auditors are liable for damages to shareholders, but post-Caparo (for further details, see Cyprus section in the Annex) they do not appear to be liable towards third parties. Violation of parts of the Companies Act is a criminal offence. ICPAC can also take disciplinary action	There are academic requirements and auditors must be a member of an established body of auditors	75% of a partnership or limited partnership must be held by qualified company auditors; 75% of shareholders of limited liability companies must be qualified company auditors. Only qualified persons may control audit firms.	For partnerships, 75% of partners have to be qualified accountants. For limited liability companies, 75% of directors must be qualified auditors.	Limited liability companies and partnerships (general and limited).	ICPAC is an organisation for professional accountants which trains, instructs and informs its members on auditors' professional activities.	ICPAC has established a code of conduct that promotes professional ethics. ICPAC is able to employ a range of sanctions for breaches of rules and standards.

Country	Auditors’ duties and obligations		Corporate governance and ownership rules				Auditor oversight	
	Obligations and duties to client and third parties	**Enforceability of obligations and duties**	**Minimum professional standards; rules, obligations and bylaws**	**Ownership and control rules**	**Management board rules**	**Nature and incidence of corporate forms adopted by audit firms**	**Regulation and existence of oversight body**	**Rules, standards, approval and sanctions**
Czech Republic	Various obligations based on IFAC’s ‘Code of ethics for professional accountants’ and the Act on Auditors. Auditors must provide an audit report. They must hold professional liability insurance covering all reasonably anticipated damages. There is no provision in law for limited liability through any contractual undertaking.	‘Objective liability’ is borne by auditors with respect to their client. It is not clear whether third parties have direct recourse. Investigating authorities may interrogate auditors only in relation to serious criminal charges. The contract between auditor and client raises the possibility of civil action. Sanctions can also be imposed by the oversight board.	The auditors’ exam tests theoretical knowledge and the ability to apply this knowledge in practice.	The majority of voting rights must be owned by auditors entitled to provide audit services (for joint stock companies, shares must be registered shares)	The majority of the statutory and supervisory bodies of audit firms must be auditors entitled to provide audit services	Joint stock companies, limited liability companies, limited partnerships, and general partnerships. There are 321 limited liability companies, 12 joint stock companies, three limited partnerships, and three general partnerships.	The Auditors Chamber is a self-governing professional organisation and a legal entity.	The Auditors Chamber can issue professional regulations and audit guidelines as well as oversee the proper delivery of audit services. It can impose a range of sanctions on auditors and audit firms, The Supervisory Commission, a body of the Auditors Chamber, monitors the performance of audit firms.

Country	Auditors' duties and obligations		Corporate governance and ownership rules				Auditor oversight	
	Obligations and duties to client and third parties	**Enforceability of obligations and duties**	**Minimum professional standards; rules, obligations and bylaws**	**Ownership and control rules**	**Management board rules**	**Nature and incidence of corporate forms adopted by audit firms**	**Regulation and existence of oversight body**	**Rules, standards, approval and sanctions**
Denmark	Various obligations and duties for auditors set out predominantly in the CRA Act, as well as IFAC's Code of Ethics. Auditor independence and circumstances in which it could be compromised are detailed.	Auditors are liable and can be sued for damages for malpractice and negligence for both clients and third parties; and they have contractual obligations to their clients. There are various bodies that can impose sanctions	Three years' practical experience, professional exam for either certified or registered auditors, and liability insurance are required. All auditors must be appointed by the Danish Commerce and Companies Agency (DCCA). Over a period of three years, an audit firm must have no more than 20% of fees from the same client.	Auditors and audit firms, persons who have their main occupation in an audit firm, persons who have obtained shares as part of a stock option plan for employees and certain foreign professionals are allowed to be shareholders of an audit firm. The majority of voting rights must be held by auditors or audit firms.	The majority of the management board must be auditors (either registered or certified).	Individual enterprises, partnerships, public limited companies, private limited companies, and limited partnership companies. The largest 10 audit firms are public limited companies. 40% private limited companies, 15% public limited companies and 45% other.	The Supervisory Authority on Auditing, appointed by the DCCA, conducts quality inspections of auditors and audit firms.	The DDCA is responsible for adopting standards and legislation on auditing. The Supervisory Authority on Auditing can only refer cases to the Disciplinary Board. Ultimately the DCCA has responsibility for the quality assurance and disciplinary systems.

Country	Auditors' duties and obligations		Corporate governance and ownership rules				Auditor oversight	
	Obligations and duties to client and third parties	**Enforceability of obligations and duties**	**Minimum professional standards; rules, obligations and bylaws**	**Ownership and control rules**	**Management board rules**	**Nature and incidence of corporate forms adopted by audit firms**	**Regulation and existence of oversight body**	**Rules, standards, approval and sanctions**
France	Auditors have a range of duties and obligations to both their client and third parties, in verifying and certifying the reliability, sincerity and truthfulness of the accounts. In addition, there are duties to inform the client of any changes, irregularities or mis-statements to the accounts. There are also duties to keep shareholders and the Financial Market Authority informed.	Auditors are liable for any consequences resulting from any wrongdoing or negligence during the audit engagement. Auditors can be sued for damages, and held criminally liable for a range of offences.	Statutory auditors must be registered on a list and sworn in. To be sworn in, several conditions must be met with regard to nationality, education and integrity.	Any individual or legal entity can hold a maximum of 25% of the capital of the professional corporation. 75% of the capital and shareholdings must be held by statutory auditors.	75% of the management body (as well as the administrative and supervisory bodies) must be statutory auditors.	Non-trading partnerships, joint stock corporations, simplified joint stock companies, and limited liability companies.	The High Council for Statutory Auditors (Le Haut conseil du commissariat aux comptes, H3C) is the public oversight body that oversees the profession, maintains professional ethics, acts as an appeals court for disciplinary matters, and defines and oversees controls on statutory auditors. The National Company of Statutory Auditors (La Compagnie nationale des commissaires aux comptes, CNCC) oversees the profession and protects the reputation of its members with regard to public bodies	The CNCC can draft rules of professional practice that require approval by the Justice Minister. The minister consults H3C before approving the draft rules. Both the Regional Disciplinary Chamber and the H3C as an appeal court can impose a range of sanctions for a breach of law, regulation, professional norm, ethics code, or for serious negligence.

Country	Auditors' duties and obligations		Corporate governance and ownership rules				Auditor oversight	
	Obligations and duties to client and third parties	**Enforceability of obligations and duties**	**Minimum professional standards; rules, obligations and bylaws**	**Ownership and control rules**	**Management board rules**	**Nature and incidence of corporate forms adopted by audit firms**	**Regulation and existence of oversight body**	**Rules, standards, approval and sanctions**
Germany	The Public Accounts Act stipulates a range of obligations and duties for an auditor to both clients and third parties. There is a distinction between the statutory legal obligations, contractual obligations, and professional conduct rules for auditors.	Auditors can be sued for damages and sanctions can be imposed on them by the oversight body and/or a professional court. Auditors have contractual obligations to their clients.	The Chamber of Public Accountants (Wirtschafts-prüferkammer WPK) appoints auditors following a professional examination, with requirements for educational and practical experience as well.	Auditors or audit firms must hold the majority of voting rights. Tax consultants, lawyers and selected other persons may be owners provided that 50% of such persons are employed by the firm.	The majority of members of the management board must be auditors.	Stock corporations, associations limited by shares, limited liability companies, general commercial partnerships, limited partnerships, and professional partnerships. The larger audit firms have adopted the public limited corporate form, whereas medium-sized and smaller audit firms have adopted the private limited liability corporate form. 85.08% limited liability companies, 6.41% professional partnerships, 5.81% stock corporations.	The WPK is a state-supervised organisation which oversees the auditing profession. Membership is mandatory for all auditors and audit firms. Its main duties include disciplinary action, approval and registration of auditors, coordinating the external quality assurance system, and professional exam and representing the audit profession. The Auditor Oversight Commission (APAK) is responsible for public oversight of the WPK in relation to all areas concerning statutory audits.	Rules and standards are stipulated in the Berufssatzung, a statutory body of professional conduct rules, issued by the WPK.

Country	Auditors' duties and obligations		Corporate governance and ownership rules				Auditor oversight	
	Obligations and duties to client and third parties	**Enforceability of obligations and duties**	**Minimum professional standards; rules, obligations and bylaws**	**Ownership and control rules**	**Management board rules**	**Nature and incidence of corporate forms adopted by audit firms**	**Regulation and existence of oversight body**	**Rules, standards, approval and sanctions**
Greece	A Presidential Decree and professional code of conduct of the CPA body obligates a range of duties with respect to clients and third parties—including confidentiality, holding professional liability insurance, independence. There are also contractual and statutory obligations for auditors.	Auditors can be sued for damages as well as having sanctions and fines imposed by the Disciplinary Council. There are also certain infringements that can lead to penal sanctions.	All auditors must be registered with the Financial Chamber of Greece. CPAs must also be registered with the CPA body. There are also various requirements relating to education, and practical training, among others	Only CPAs and audit firms registered with the CPA body can be shareholders or partners in an audit firm. CPAs may only participate in one audit firm.	All members of the management board must be CPA-registered with the CPA body. For share companies (SAs), all directors must be CPAs, whereas all administrators of limited companies, partnerships and joint ventures must be CPAs.	There are no restrictions on the legal form of audit firms, except for sole practitioners. It appears that the larger audit firms are SAs, whereas smaller and medium-sized firms are limited companies. 78.26% SAs, 17.39% limited companies, 4.35% common partnerships.	In 2003 the Committee of Accounting Standards and Audits (CASA) was established.	CASA can set conduct rules for the audit profession. The supervisory board of the CPA body can also issue regulations and general instructions. The CPA body indirectly approves auditors through its register and professional exams. The Disciplinary Council of CASA can impose a variety of sanctions from a warning to permanent deregistration from the Register of the CPA body.

Country	Auditors' duties and obligations		Corporate governance and ownership rules				Auditor oversight	
	Obligations and duties to client and third parties	**Enforceability of obligations and duties**	**Minimum professional standards; rules, obligations and bylaws**	**Ownership and control rules**	**Management board rules**	**Nature and incidence of corporate forms adopted by audit firms**	**Regulation and existence of oversight body**	**Rules, standards, approval and sanctions**
Hungary	Professional legal obligations are found in the Chamber Act, Statutes of the Chamber of Hungarian Auditors' Code of Ethics, and the Companies Act. These do not differentiate between duties to clients and third parties.	Auditors have a contractual obligation to their clients, as well as statutory legal obligations, and may be sued for damages. In addition, auditors may have sanctions imposed by the Ethics Committee. Furthermore clients can force auditors to fulfil their contractual duties by civil suit.	All auditors must be appointed by the Chamber. They must have the necessary educational and practical experience, and sit a professional exam.	The majority of registered capital must be owned by members of the Chamber or by audit firms registered in the country of the owner. The majority of voting rights must be held by members of the Chamber or by audit companies registered in the country of the owner.	The majority of the management board must be members of the Chamber.	There are no restrictions, but certain requirements must be met. Most audit firms are limited liability companies irrespective of size, although some smaller audit firms have adopted the limited and general partnership form.	The Chamber of Hungarian Auditors, a public body with powers of self-government, oversees the audit profession. All auditors and audit firms must be members of the Chamber.	The Chamber can issue professional conduct rules stipulated in the Statutes. The Chamber Act also requires the Chamber to develop, supplement and modify national methodological regulations for auditing, which are published.

Country	Auditors’ duties and obligations		Corporate governance and ownership rules				Auditor oversight	
	Obligations and duties to client and third parties	**Enforceability of obligations and duties**	**Minimum professional standards; rules, obligations and bylaws**	**Ownership and control rules**	**Management board rules**	**Nature and incidence of corporate forms adopted by audit firms**	**Regulation and existence of oversight body**	**Rules, standards, approval and sanctions**
Italy	Auditors have to ensure and guarantee that the audit is undertaken correctly. The Code of Ethics issued by CONSOB, the securities market regulator, has various requirements relating to professional independence, integrity, objectivity, professional competence and due care, confidentiality, and relations between auditors.	The Italian Civil Code stipulates that auditors must fulfil their duties with professionalism and diligence required by the appointment. Both auditors and audit firm employees are joint and severally liable for damages caused by negligence or illegal acts. There are also sanctions which can be applied.	There are minimum requirements for admission to the Register of Auditors and Special Register of Audit Firms, relating to education and vocational training, and qualifying exam.	The majority of voting rights must be held by individuals registered with the relevant register.	The majority of partners or the majority of the interests in limited partnerships must be held by individuals registered with the relevant register.	Audit firms can take both the form of partnership and company. The corporate forms listed are informal partnership, general partnership, limited partnership, joint stock companies, limited partnership by shares, and limited liability company.	CONSOB is responsible for the public oversight of audit firms.	In consultation with the Bar of Chartered Accountants, CONSOB sets rules and standards. Audit firms must be registered with the Register of Auditors and Special Register of Audit Firms. There is a range of sanctions for breaches of professional rules by the auditor.
Luxembourg	Audit is conducted in accordance with Practice Guidelines issued by the oversight body, the Institut des Réviseurs d’entreprises (IRE). Professional duties are to know one’s customer, implement suitable internal control systems, and cooperate with competent authorities.	Infringements of professional duties are punishable by fines. Although, auditor liability is in general unlimited, it is usual for audit firms and clients to limit the extent of liability by contractual agreement. In addition the board of discipline can impose a variety of penalties.	Professional standards set by the oversight body include a requirement to undertake a 4-year university degree with specified subjects, obtain 3 years’ work experience at a recognised audit firm, and undertake a professional exam to be qualified as a réviseur d’entreprises.	The majority of limited partners’ registered capital interest must be held by auditors or audit firms. The majority of voting rights must be held by auditors or audit firms.	n/a	There are no restrictions on the legal form, but certain requirements must be met. Audit firms are usually organised as companies but with restricted purposes. The most popular forms are limited liability companies although two of the largest four are organised as stock companies	There is no single public oversight board; rather, the following bodies are responsible for oversight: the Ministry of Justice, Financial Supervisory Authority (Commission de Surveillance du Secteur Financier, and Commissariat aux Assurances) and the Disciplinary Council and Quality Control Commission.	The IRE has powers to set rules and standards and the Disciplinary Council can impose a variety of sanctions on auditors.

Country	Auditors' duties and obligations		Corporate governance and ownership rules				Auditor oversight	
	Obligations and duties to client and third parties	**Enforceability of obligations and duties**	**Minimum professional standards; rules, obligations and bylaws**	**Ownership and control rules**	**Management board rules**	**Nature and incidence of corporate forms adopted by audit firms**	**Regulation and existence of oversight body**	**Rules, standards, approval and sanctions**
Netherlands	The Wet toezicht accountantsorganisaties (Wta) sets out a range of duties for auditors and obligations to protect the interests of clients as well as third parties, including the government. Duties refer to independence, competence, objectivity and integrity of auditors among others.	Obligations and duties are enforceable by general actions for damages pursuant to the Dutch Civil Code. All breaches of contracts require the debtor (auditor) to compensate the damages of the claimant (client). Third parties can also make a claim against an auditor.	Only auditors registered in the Auditor Register and those employed or affiliated to an audit firm with an Authority for Financial Markets (AFM) Wta licence may perform statutory audits. There are various education and practical experience requirements in order to be registered.	There are no rules on ownership of audit firms, however the majority of voting rights must be held by qualified auditors.	The management board comprises policy-makers and contributory policy-makers. A majority of policy-makers must be competent members.	There are no restrictions on corporate form. Smaller audit firms tend to be partnerships, whereas larger firms tend to be limited liability companies or public limited companies	Audit firms that perform statutory audits come under the supervision of the AFM. Supervision is also carried out by two professional bodies that represent certified public accountants and accountant-administration consultants.	The AFM does not have the authority to set rules or standards. Rules and standards are set by professional bodies taking account of relevant legislation.

Country	Auditors' duties and obligations		Corporate governance and ownership rules				Auditor oversight	
	Obligations and duties to client and third parties	**Enforceability of obligations and duties**	**Minimum professional standards; rules, obligations and bylaws**	**Ownership and control rules**	**Management board rules**	**Nature and incidence of corporate forms adopted by audit firms**	**Regulation and existence of oversight body**	**Rules, standards, approval and sanctions**
Poland	Auditors have a range of duties and obligations to both clients and third parties, including compliance with the Code of Ethics and requirements to be independent.	The civil code sets out obligations that auditors must meet. There are independence requirements, as well as all firms being required to take out third-party liability insurance, among others. In addition, disciplinary proceedings can be brought against auditors by the professional organisation of auditors.	All auditors must be listed on the National Council of Statutory Auditors' register having taken an oath. To this end, there are several requirements including education, practical experience and examinations.	Partnerships can only be owned by auditors, however for limited liability and joint stock companies the majority of shareholders must be auditors. The majority of voting rights of the supervisory bodies (if applicable) must be held by partners or shareholders who are auditors.	The majority of members of management board must be auditors.	Sole traders, civil partnerships, registered partnerships, professional partnerships, limited partnerships exclusively owned by auditors, and legal entities that meet certain requirements. The most popular form of entity for an audit firm is a limited liability company or similar. It is rare to find partnerships.	Auditors are supervised by the National Chamber of Statutory Auditors. Members of this body are representatives of the profession. It is accountable to the Minister of Public Finance.	The Chamber has the authority to set professional and ethical standards for auditors. There are bodies of the Chamber which can conduct disciplinary proceedings against auditors.

Country	Auditors' duties and obligations		Corporate governance and ownership rules				Auditor oversight	
	Obligations and duties to client and third parties	**Enforceability of obligations and duties**	**Minimum professional standards; rules, obligations and bylaws**	**Ownership and control rules**	**Management board rules**	**Nature and incidence of corporate forms adopted by audit firms**	**Regulation and existence of oversight body**	**Rules, standards, approval and sanctions**
Portugal	There is a range of statutory obligations relating to the need to perform duties with due care and competence and to comply with ethical requirements. The auditor performs their work by way of a service contract. No specific obligations are placed on auditors with regard to third parties.	Auditors are subject to disciplinary, civil and criminal liability. Any violation of a professional duty to clients or others may result in an action for damages. In addition, the Securities Market Commission (Comissão do Mercado dos Valores Mobiliários, CMVM) may impose fines or bar statutory auditors from auditing.	All auditors must be listed in the Ordem. They must have a relevant university degree, sit a professional exam, and undertake a period of relevant work experience.	75% of the voting rights of an audit firm must belong to statutory auditors.	75% of members of the management board must be statutory auditors.	Audit firms are civil companies endowed with legal personality and can adopt any legal type defined in the Companies Code. Most small/medium-sized firms take the form of professional partnerships. A few larger audit firms are joint stock corporations.	Oversight is carries out by both the Auditors' Professional Institute (Ordem dos Revisores Oficiais de Contas, OROC) and the CMVM, the latter's jurisdiction is limited to auditors who provide audit services to listed companies.	The Ordem has the right to set rules and technical procedures and to make recommendations to the government about the regulation of the profession. All governing and other corporate bodies of the Ordem are elected at a general meeting composed of only statutory auditors.

Country	Auditors' duties and obligations		Corporate governance and ownership rules				Auditor oversight	
	Obligations and duties to client and third parties	**Enforceability of obligations and duties**	**Minimum professional standards; rules, obligations and bylaws**	**Ownership and control rules**	**Management board rules**	**Nature and incidence of corporate forms adopted by audit firms**	**Regulation and existence of oversight body**	**Rules, standards, approval and sanctions**
Republic of Ireland	Auditors must provide an audit report on the company's financial accounts with professional integrity.	Auditors can be sued for negligence. However 'duty of care' towards investors may arise in limited circumstances only. There is a list of indictable offences that the auditor must report to the authorities; failing this, they may themselves be charged with an indictable offence.	Qualification requirements for the appointment of auditors are set out in the Companies Act 1990. In addition, each recognised accountancy body ensures that the standards relating to training, qualifications and repute are not less than those specified in the applicable articles of the Eighth Directive. Auditors must be a member of a recognised body of accountants and must hold a practising certificate from that body. In addition, auditors must be registered with the Registrar of Companies. Auditors may also receive a Ministerial Authorisation allowing them to continue as auditors.	There are no legal rules, but partners of audit firms usually have an accounting qualification, although these can vary widely. The internal rules of the recognised accountancy bodies determine the partners of an audit firm.	There are no legal rules. The internal rules of the recognised accountancy bodies determine this. Under the Institute of Chartered Accountants in Ireland, the majority of voting rights must be held by qualified individuals, registered individuals or a combination of both.	Audit firms must be sole practitioners or partnerships.	The Irish Auditing and Accounting Supervisory Authority (IAASA) is a state body that operates through a public company in its function as the public oversight body.	The IAASA may require changes to and approve the constitution and bylaws of accountancy bodies. It can examine, under oath, members of accountancy bodies, request books or documents in an investigation, and apply other sanctions. Only members or member firms of the Chamber may carry out audits. There is a range of sanctions for ethical and disciplinary offences committed by the auditor.

Country	Auditors' duties and obligations		Corporate governance and ownership rules				Auditor oversight	
	Obligations and duties to client and third parties	**Enforceability of obligations and duties**	**Minimum professional standards; rules, obligations and bylaws**	**Ownership and control rules**	**Management board rules**	**Nature and incidence of corporate forms adopted by audit firms**	**Regulation and existence of oversight body**	**Rules, standards, approval and sanctions**
Spain	A range of statutory obligations relating to independence, confidentiality, custody, information requirements and the issuing of the interim report. No clear distinction is made between duties to the client and those to third parties.	Auditors are directly and severally liable, without limit, to audited companies or to third parties for damages and loss caused by breaches of their obligations, contract with their client, and of the civil code.	Auditors must be registered on the Official Register of Auditors and must provide a bond to guarantee their responsibilities. To be registered, auditors must have obtained any university degree and must have completed a range of additional courses recognised by the Accounting and Auditing Institute. In addition 3 years' practical training must be undertaken together with a final professional proficiency examination.	A majority of the share capital and voting rights in an audit firm must be held by practising auditors—ie, those listed on the Official Register of Auditors.	A majority of the company administrators and directors of an audit firm must be practising auditors	First-grade services cooperatives, civil law societies, general partnerships, limited partnerships, partnerships limited by shares, joint stock companies or public limited liability corporations, limited liability corporations. Most audit firms (six of the seven largest) are organised as limited liability corporations	The Accounting and Auditing Institute (ICAC), established in 1988, is responsible for the oversight of the auditing profession. It reports to the Ministry of Economy who appoints the Chairman and members of the Auditing and Accounting Committees.	ICAC is responsible for requiring professional rules and standards to be prepared.

Country	Auditors' duties and obligations		Corporate governance and ownership rules				Auditor oversight	
	Obligations and duties to client and third parties	**Enforceability of obligations and duties**	**Minimum professional standards; rules, obligations and bylaws**	**Ownership and control rules**	**Management board rules**	**Nature and incidence of corporate forms adopted by audit firms**	**Regulation and existence of oversight body**	**Rules, standards, approval and sanctions**
Sweden	Auditors are subject to a range of duties and obligations to both clients and third parties, as set out in the Auditors Act, relating to independence and professional standards, among others.	Auditors may be held liable in the event of breaches of their obligations under the Audit Act, the Companies Act and the Tort Liability Act. In addition, the Supervisory Board of Public Accountants can enforce disciplinary measures.	Auditors must, among other requirements, have obtained a first degree in a relevant subject area and then have passed the examination of professional competence. In addition, they should have received at least five years of practical training, including three years under the supervision of an authorised public accountant.	At least 75% of the shares with voting rights of an audit firm must be held by auditors.	At least 75% of the board members and at least 75% of the deputy board members and the managing director must be auditors.	Sole traders, non-registered partnerships with another auditor, partnership, and limited companies. There are 98 public accounting firms registered at present (mostly larger firms), of which 93% are limited companies and 7% limited liability partnerships.	The Supervisory Board of Public Accountants is responsible for auditor oversight. It was established in 1995 and reports to the Ministry of Justice.	The Supervisory Board sets rules and standards directly or indirectly through decisions on disciplinary matters. The Board also approves authorisation and registration of public accountants.

Country	Auditors' duties and obligations		Corporate governance and ownership rules				Auditor oversight	
	Obligations and duties to client and third parties	**Enforceability of obligations and duties**	**Minimum professional standards; rules, obligations and bylaws**	**Ownership and control rules**	**Management board rules**	**Nature and incidence of corporate forms adopted by audit firms**	**Regulation and existence of oversight body**	**Rules, standards, approval and sanctions**
United Kingdom	Auditors must carry out investigations sufficient to enable them to form an opinion on whether proper accounting records have been kept by the entity being audited. Auditors must also consider whether the directors' report is consistent with the annual accounts. There is no general duty of care to third parties (post-Caparo).	The Companies Act 2006 obliges auditors to have a duty to perform their work with due skill and care. Where auditors are negligent in the performance of their work, claims may be made against the auditors. The Accountancy Investigation and Discipline Board (AIDB) may bring disciplinary charges against auditors.	The APB has issued an Ethical Standard concerning integrity, objectivity and independence.	The majority of voting rights must be held by qualified individuals or registered auditors. In partnerships, the majority of partners must be qualified individuals or registered auditors. In body corporates, the majority of shareholders' voting rights must be held by qualified individuals or registered auditors.	The majority of the management board, committee or other body must be qualified individuals or registered auditors.	Audit firms or individuals can be either body corporates or partnerships. The large majority of audit firms in the UK are limited liability partnerships.	The FRC is the sole independent regulator of the accounting and auditing profession and is made up of six different bodies.	The APB (part of the FRC) sets standards and guidelines. The various Recognised Supervisory Bodies, under active oversight by the Public Oversight Board (part of FRC), approve statutory auditors. Sanctions can be imposed by the AIDB (part of the FRC).

Source: Information taken from the Annex and summarised by Oxera. For further details, see the Annex.

3.3 Main conclusions from the assessment of the current ownership rules in Europe

Ownership and composition of the management board

The survey of rules and regulations across Member States reveals considerable uniformity with respect to the specific rules on ownership and composition of the management board in terms of minimum requirements. All countries require a majority of voting rights in audit firms to be held by qualified auditors, as required by the European Commission's Eighth Directive from 1984. However, some Member States have interpreted this more strictly than others by requiring 75% or more of the owners of audit firms to be qualified auditors. Such countries include Cyprus, France, Greece, Portugal and Sweden, with Greece not allowing any outside ownership at all.

Such rules were introduced in response to concerns over the independence of firms that had previously been established and, subsequently, owned by organisations such as banks and cooperatives. In the case of France, where the requirement is for 75% of the voting rights to be controlled by auditors, the rules on independence date back even earlier, to Ordonnance no. 45-2138 of September 1945.

Likewise, the requirement for a majority of members of an audit firm's management board to be suitably qualified persons was also adopted by all Member States following the 1984 Directive. Again, certain countries have adopted a far stricter regime. Such countries include Austria, Belgium, Cyprus, France, Greece, Portugal and Sweden. Greece requires all of the members of the management board to be qualified persons and they are joined in this respect by Austria and Belgium.

Legal form

With regard to the legal form that audit firms are allowed to take, it appears as though all countries, with the exception of Ireland, allow firms to adopt any one of a wide variety of corporate forms, including public and private limited companies, as well as various forms of partnerships (with both unlimited liability for all partners as well as limited liability for some and unlimited liability for others). As noted, Ireland is an exception to this, in that it requires audit firms to take the form of either a sole trader or an unlimited liability partnership. At present audit firms are not permitted to adopt the structure of a limited liability company or a partnership with limited liability for any of the partners. In recent years a number of countries, including the UK and Germany, have introduced a new corporate form—the 'limited liability partnership' (LLP), in which all the partners of the firm have limited liability. Further analysis of the legal forms that can be adopted by audit firms and the implications of this are provided in section 5 below.

Professional qualification requirements for auditors

Professional qualification requirements for auditors remain strict across all Member States. All countries appear to require a first degree (sometimes in a recognised subject or at a specific type of institution) followed by a further professional qualification and, generally, between three and five years of practical experience. It is clear, therefore, that anyone considering auditing as a career must be prepared to undertake a lengthy period of education and training before they can commence work as a qualified auditor. This implies a significant investment in human capital, both on the part of the individual and the firm employing them, before the former can achieve a relatively high income and the latter can achieve an appropriate rate of return in the form of fee income being generated. The issue of investment in human capital and its implications is considered in greater depth in section 6 below.

Auditor oversight

The structure of auditor oversight in Europe is evolving, with many Member States establishing independent public oversight bodies such as the FRC in the UK (originally established in 1990, but granted independent status and additional responsibilities in 2004) and the Auditor Oversight Commission (Abschlussprüferaufsichtskommission, APAK) in Germany, which was also established in 2004. In France, the high council for statutory auditors (Le Haut conseil du commissariat aux comptes, H3C) was set up in 2003. In Spain the Accounting and Auditing Institute (ICAC) was established by Royal Decree in 1988. These public oversight bodies are in addition to the self-regulation or supervision that is carried out by the auditors' professional associations, and it is important to note that the oversight boards are independent.

There remains, however, some variation in the rules governing the composition of these oversight bodies. In France, the council is made up of a combination of law officers, representatives from government departments, academics as well as statutory auditors. In Germany, the Commission comprises former government officials, business leaders and academics. There is an additional requirement in Germany that, in order to ensure independence, members of the Commission cannot have been members of the professional association of auditors in the five years prior to their appointment. In addition, in Italy and the Netherlands, oversight is undertaken by financial market regulators—the Commissione Nazionale per le Societa e la Borsa (CONSOB) in the former and the Authority for the Financial Markets (AFM) in the latter. In Belgium, public oversight is carried out by the Advisory and Control Committee on the Independence of the External Auditor (ACCOM) and the High Council for Economic Professions (HREB-CSPE).

In general it is clear that publicly available information on the legal forms adopted by auditors, their ownership structures and internal governance is difficult to obtain. This makes it difficult for both investors and corporate clients of audit firms to gain an accurate appreciation of how audit firms are structured in practice. This has been recognised both by the European Commission and by the FRC in the UK. Article 40 of the amended Eighth Directive requires audit firms to produce a transparency report describing their legal form, ownership, network structures and internal governance procedures; its aim is to improve the information that is made available.

The ownership rules in Europe, described in this section, are the subject matter of the present study—in particular, as concerns their effect on audit market concentration. This is dealt with in subsequent sections of this report. Section 4 first presents a further assessment of the ownership rules in terms of their effect on, and importance to, auditor independence.

4 Ownership rules and auditors' independence

4.1 Notion of auditors' independence—theoretical and empirical perspectives

Capital markets are characterised by asymmetric information between, among others, investors and the companies in which they are investing. The existence of this market failure impinges on the efficiency of capital markets. If reliable information about the financial performance of companies is made available to both current and potential investors, the inherent asymmetric information problem can be mitigated. In order for this information to be considered reliable, and for the asymmetric information problem to be mitigated, it must be verified. In the absence of the auditor, each individual investor would have to undertake their own verification and incur the associated costs. Likewise, companies would have to incur significant costs if this exchange of information had to be undertaken with each individual investor. Finally, the mere existence of the audit can act as a signalling mechanism to the markets that the information that is being provided by the company is reliable.

The existence of the auditor ensures that economies of scale can be achieved in this verification and monitoring process. However, the cost benefits of this will be lost if the investor cannot be certain that the auditor's verification of the financial performance is being undertaken in an objective and impartial manner—in other words, the verification must be seen to be independent of any undue influence from the management of the company whose performance is under scrutiny.

It has long been acknowledged that the independence of the auditor is, therefore, critical for the efficient functioning of capital markets. The Council of the American Institute of Certified Public Accountants (AICPA), in a statement adopted in 1947, expressed the view that:

> Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession's strength and stature.[31]

It has also been recognised that auditors can face conflicts of interest that might affect their ability to maintain independence. Early recognition of this came in the USA when the Federal Trade Commission issued regulations in 1933 that prevented auditors from serving as officers or directors in companies they were auditing and from having direct or indirect interests in client firms. There was concern that having such relationships with clients might subconsciously affect the auditor's objectivity. This occurred only one year after the AICPA had rejected such prohibitions, as it did not consider them necessary—the implication being that conflicts of interest that might harm integrity, honesty and objectivity were not considered significant.

Despite this long tradition of legislation being used in various forms to maintain the independence of auditors, the theoretical underpinnings for such legislative developments have not been conclusive. The academic literature has struggled to develop a consistent theory of independence. To do so requires, first, a clear and agreed definition of the subject. Second, the economic (or other) incentives that encourage independence need to be identified, together with the conflicts of interest, so that these conflicts may be mitigated.

[31] Moore, D.A., Tetlock, P.E., Tanlu, L. and Bazerman, M.H. (2006), 'Conflicts of Interest and the Case of Auditor Independence: Moral Seduction and Strategic Issue Cycling', *Academy of Management Review*, **31**:1. p. 10.

If these key incentives and conflicts of interest can be identified and their relative importance determined, it becomes easier to ascertain what interventions may be necessary, on the part of legislators or regulators, to ensure that independence is maintained.

Theoretical studies of independence have tended to be affected by two important factors:

– it has proved difficult to define independence precisely;
– independence is not observable, so studies have tended to focus on proxies for independence, and, more specifically, on perceptions of independence.

In recent years, increasing attention has been focused among policy-makers on the impact of the provision of non-audit services to audit clients and the potential conflicts of interest that may emerge as a result (see, also, section 1.2 above). However, the existing literature on independence seems to provide little insight into this issue. The literature is also somewhat inconclusive in its analysis of the other factors that may influence independence.

As discussed below, studies that have attempted to identify the causal factors of independence tend to be based on three different approaches: formal models that identify economic incentives and their effects on independent behaviour; behavioural studies that concentrate more on the importance of the culture of the audit firm; and broader-based models which combine economic, behavioural, regulatory and contextual approaches, and which, again, focus on ethical considerations and culture.

In addition, a number of attempts have been made over the years to undertake empirical research to test some of the theoretical models that have been developed. The main avenue of research has been to use attitudinal or experimental approaches to determine how different variables determine perceptions of independence—the reason being that it is impossible to observe actual independence and it is, therefore, necessary to use perceptions of independence instead.

4.1.1 Definitions of independence

The academic literature and, indeed, initiatives from policy-makers tend to be affected by the fact that there is no single definition of auditor independence. However, it is possible to identify some representative definitions that highlight some of the main concepts that are considered relevant:

– DeAngelo (1981): ‘the conditional probability of reporting a discovered breach’;[32]
– Knapp (1985): ‘the ability to resist client pressure’;[33]
– AICPA (1992): ‘an attitude/state of mind’;[34]
– AICPA (1997): ‘an absence of interests that create an unacceptable risk of bias’;[35]
– Independent Standards Board (2000): ‘freedom from those pressures and other factors that compromise, or can reasonably be expected to compromise, an auditor’s ability to make unbiased audit decisions’;[36]

DeAngelo’s definition is the one that appears to be used most often in the economic literature. The underlying assumption in this approach is that the auditor undertakes some form of cost–benefit analysis to determine whether an error in the financial statements will be

[32] DeAngelo, L.E. (1981), ‘Auditor Independence, “Low Balling”, and Disclosure Regulation’, *Journal of Accounting and Economics*, **3**, August, 113–27.

[33] Knapp, M.C. (1985), ‘Audit Conflict: An Empirical Study of the Perceived Ability of Auditors to Resist Management Pressure’, *The Accounting Review*, **60**:2, April, 202–11.

[34] AICPA (1992), ‘Professional Standards’, American Institute of Certified Public Accountants, New York, NY.

[35] AICPA (1997), ‘Serving the Public Interest: A New Conceptual Framework for Auditor Independence’, American Institute of Certified Public Accountants, New York, NY.

[36] ISB (2000), ‘Statement of Independence Concepts: A Conceptual Framework for Auditor Independence’, Exposure draft ED 00-2, Independent Standards Board.

reported. The costs of not reporting include the auditor's loss of reputation if the error subsequently comes to light, together with any litigation cost that may arise. The benefits include current and future audit fees from that particular client. This definition does not purport to identify the particular drivers that may influence the auditor's reporting decision. It also makes the implicit assumption that the only independence that matters is that from the client, whereas an auditor may face other sources of conflicts of interest.

Having examined the literature, it becomes clear that two characteristics of an auditor are considered fundamental to independence: objectivity and integrity. In addition, both academics and policy-makers often make the distinction between independence *of mind (or fact)* and independence *of appearance.* As the former is generally unobservable, it is the perception of independence that is most commonly examined. Moore et al. (2006) concluded that maintaining the appearance of independence became more important for policy-makers in the years leading up to the Enron collapse. They cited the SEC, which in 2000 released a standard governing auditor independence, stating that:

> An auditor is not independent if a reasonable investor, with knowledge of all relevant facts and circumstances, would conclude that the auditor is not capable of exercising objective and impartial judgment.[37]

The authors then go on to conclude that, although the Sarbanes-Oxley Act of 2002 is widely seen as an example of legislators' attempts to address the issue of independence of mind, by concentrating on actual conflicts of interest faced by auditors, it does not in fact go far enough in this respect. They argue that, although the Act prohibited audit firms from undertaking some non-audit services, it still allowed them to undertake tax consultancy work. In addition, although the Act required rotation of the audit partner, it did not require rotation of the audit firm. Finally, the authors also argued that the Act did not address the very common occurrence of individual auditors moving from their firms to their clients, which, they argue, has also given rise to potential conflicts of interest.

Ramsay (2001)[38] quoted the Panel on Audit Effectiveness[39] as stating that:

> Audit improves the reliability of financial statements, makes them more credible and increases shareholders' confidence in them. Auditors constitute the principal external check of the integrity of financial statements.

Again, there is an emphasis on perceived independence. However, according to Ramsay, independence of mind can never be shown, and thus there is no demonstrable way of showing that an auditor possesses it.

Kleinman, Palmon and Anandarajan (1998) stated that auditor independence allows the auditor to act impartially and provide an unbiased report, thus attesting to the credibility of corporate financial statements. This aids investors to allocate their capital in a way that best fits their preferences.[40]

Finally, although independence is often perceived as a discrete concept in the literature (ie, the auditor can be either independent or not independent), it may be better to think of it in terms of a matter of degree (ie, the auditor can be more or less independent). An example of the notion of relative independence was developed by Bartlett (1993).[41]

[37] Moore et al. (2006), op. cit., p. 14.

[38] Ramsay Report (2001), 'Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform', October, Commonwealth of Australia, www.treasury.gov.au.

[39] Set up in 1998 by the SEC in the USA to report on the state of the audit market. Its report was issued in 2000.

[40] Kleinman, G., Palmon, D. and Anandarajan, A. (1998), 'Auditor Independence: A Synthesis of Theory and Empirical Research', *Research in Accounting Regulation*, **12**, 3–42.

[41] Bartlett, R.W. (1993), 'A Scale of Perceived Independence: New Evidence on an Old Concept', *Accounting, Auditing & Accountability Journal*, **6**:2, 52–67.

In summary, the definitions of independence go some way towards enhancing the overall understanding of the concept of independence, but still exhibit deficiencies, in that they make little specific reference to the particular conflicts of interest that auditors face. In addition, there is an implicit assumption that independence is an issue only between the auditor and the client, and, therefore, the auditor's independence from other stakeholders is not being considered.

4.1.2 Other European perspectives on independence

In addition to the Anglo-Saxon perspective on independence, there are various insights from other European countries. For the purposes of this study, the alternative perspectives will be confined to France and Germany as it is in these two countries where the most substantial debate over the question of auditor independence, in both academia and among market participants, appears to have taken place. Elsewhere, in Europe, it has not been possible to find similar examples of in-depth discussion or assessment of auditor independence among the academic or practitioner communities. This section of the study therefore reviews the literature available in order to explain any differences in perspectives on independence between those Member States for which information appears to be available.

In France there has been a legal distinction between the accountancy and auditing professions. The Ordre des Experts-Comptables (OEC) represents chartered accountants and is under the authority of the Ministry of Finance, whereas the Compagnie Nationale des Commissaires aux Comptes (CNCC) represents statutory auditors and is under the authority of the Ministry of Justice.

> Because the CNCC is supervised by the Justice Minister of the French government, the disciplinary system of the commissaries aux comptes has both legal and administrative aspects.[42]

Stevenson (2002)[43] stated that the French auditor (Commissaire de sociétés) was first recognised by 'la loi du 24 juillet 1867' amid the Industrial Revolution. The role, scope and name of the auditor have developed through time as a result of different legislation. Independence of the auditor was reinforced by the Decree-Act of August 8th 1935,[44] and, in 1966, the statutory auditor (Commissaire aux comptes) was made the only recognised individual eligible to carry out statutory audits following the 'Loi sur les Sociétés Commerciales'. It should also be noted that most statutory auditors are also chartered accountants and members of the OEC. Unlike in the UK, where the statutory auditor must be reappointed annually by shareholders,[45] in France the 2003 law of financial security provides that the statutory auditor is appointed for a six-year term.[46] The Professional Ethics Code for Statutory Auditors 2005 (adopted on the basis on the aforementioned 2003 law) reinforces independence and lists the activities that are incompatible with an audit engagement.[47] Furthermore the Professional Ethics Code contains strict independence rules in relation to non-audit services provided by the network.[48] According to Stevenson (2002), independence is the most important factor, taking precedence over audit quality, competence, confidentiality and other factors.[49]

[42] Baker, C., Mikol, A. and Quick, R. (2001), 'Regulation of the statutory auditor in the European Union: a comparative survey of the United Kingdom, France and Germany', *The European Accounting Review*, **10**:4, p. 774.

[43] Stevenson, J. (2002), 'Auditor independence: A comparative descriptive study of the UK, France and Italy', *International Journal of Auditing*, **6**, 155–82.

[44] Citation of Solus's 1938 study of the reform of company law, in Stevenson (2002), op. cit., p. 163.

[45] This is contained in the Companies Act2006, Part 16, Chapter 2, S.489(1).

[46] Art. L. 822-14.

[47] Décret n° 2005-1412 du 16 novembre 2005 portant approbation du code de déontologie de la profession de commissaire aux comptes, Art. 10 'Situations interdites'.

[48] Ibid. See Art. 24 and 29.

[49] Stevenson (2002), op. cit., p. 167.

An important difference is a requirement for two (joint) auditors for a statutory audit in France (and until recently in Denmark).[50] Piot (2007) stated that:

> The joint-auditing requirement permits the legislator to enhance quality at two levels. First, the practice of joint-auditing can ensure that an audit is conducted with due diligence because of the existence of a cross review and reciprocal monitoring procedure between two co-auditors. Second the presence of two auditors is perceived to protect independence, specifically the objectivity of professional judgment, by diluting the effect of potential managerial pressure.[51]

Independence of the statutory auditor is clearly an important issue in France, and in April 2007, nine French audit firms set up 'l'Association de développement des activités de commissariat aux comptes dans les Entités d'Intérêt Public' (ADACEIP). In conjunction with the French Association for Quality Assurance (AFAQ), ADACEIP launched the AFAQ premium statutory audit certificate. This aims to guarantee a higher quality of service during the audit process by affirming the values of independence and auditor competency.

The notion of independence in Germany has already been referred to in section 3. The audit market in Germany is notable for the fact that auditing was initially seen as a subsidiary function of trust companies set up by commercial banks in order to monitor the performance of their investment portfolios.[52] Even after the audit functions of these firms were established as separate entities, they continued to be owned by banks for many years, as well as maintaining some of their non-audit functions such as tax consultancy and other advisory work. Although some owners began to dispose of their equity stakes as early as the late 1930s and early 1940s, it was only much later, in the 1970s and 1980s, that many of the non-auditor equity holdings were finally disposed of and transferred to partners and directors of the audit firms themselves.

As discussed in section 3, the motivation for this arose from the perception that auditor independence could be compromised and conflicts of interest might arise as a result of permitting non-auditors to hold equity holdings in audit firms. As a result of this perception, the German rules on ownership and composition of management boards, discussed more fully in section 3, have been made stricter, with the requirement being that the majority of the equity be owned by auditors, audit firms or qualified persons and, similarly, the majority of the management board should be comprised of auditors and qualified persons. However, even though the ownership structures of German audit firms have changed, they still continue to provide a variety of non-audit services to clients—in particular, tax consultancy. It is worth noting that most German auditors are also qualified as tax consultants (Steuerberater).

4.1.3 Economic models of independence

An early example of the models in this category is DeAngelo (1981),[53] who based her analysis on the notion that the auditor's decision to remain independent might be impaired if they realised that, by losing the contract to audit a company, they would be forgoing the future economic rents that would accrue from repeatedly auditing the same client. This rent results from the acquisition of client-specific knowledge. In turn, this knowledge results in audit costs falling over time, as a result of the benefits of learning effects, while audit fees

[50] Act No. 448 of June 7th 2001 (updated by Act No.647 of June 15th 2006) states that: 'Notwithstanding subsection (2), the requirement that there must be two auditors in state-owned public limited companies and listed limited liability companies … shall remain in force for financial years beginning on or before 31 December 2004.'

[51] Piot, C. (2007), 'Auditor concentration in a joint-auditing environment: the French market 1997–2003', *Managerial Auditing Journal*, **22**:2, 161–76. However, Piot also acknowledges that the interdependencies created by a joint-auditing environment might have a detrimental impact on independence: 'In practice, when two audit firms operate jointly over a large number of clients, their familiarity with each other will result in cross-review procedures becoming routinized which in turn affect their respective levels of scrutiny and objectivity' (p. 162)

[52] Quick (2005), op. cit., p. 319.

[53] DeAngelo (1981), op. cit.

rise. This rent serves to create a state of dependence between the auditor and the client, but this dependence will be apparent in both directions if both auditor and client share the cost savings that emerge.

However, potential reputation loss from perceived non-independence is seen as undermining this relationship, as it will reduce the size of the auditor's client portfolio. Over time, the decision to remain independent results from the auditor being able to compare the gains and losses arising from a loss of independence. The auditor will face incentives to ensure that future economic rents from the client are maintained, possibly at the expense of independence. The relative strength of these incentives relies on several factors, such as the significance of the audit client in the auditor's portfolio and the risk of being caught if a less than rigorous audit has been undertaken.

Antle (1984)[54] built on the work of DeAngelo to develop a single-period principal–agent model, which assumes that both the auditor and the management of the client are effort-averse and utility-maximising. The management, which might have a performance-based compensation contract, has incentives to misrepresent the financial condition of the company. The reason for this lies in the assumption of effort aversion. Under such an assumption, the manager will not impart sufficient effort to maximise shareholder wealth. However, such a perceived lack of effort may result in the owner dismissing the manager or reducing their compensation. Thus, an effort-averse manager has an incentive to misrepresent the financial condition of the company to the owner.

The owner is clearly aware of the potential for this misrepresentation and will attempt to mitigate it through costly contracting, in an endeavour to reduce the manager's compensation, in view of the expected losses as a result of shirking or costly monitoring of the manager's behaviour.

The crucial issue is the extent to which the auditor cooperates with the manager in pursuit of the auditor's self-interests. The auditor is also assumed to be effort-averse and utility-maximising. Therefore, there is an incentive for the manager to offer side payments to the auditor in exchange for the auditor's non-effort. However, the observability of auditor–client relationships, assumed in Antle's model, serves as a major constraint on this behaviour. In the analysis, Antle examines varying levels of this constraint, and concludes that the presence of a strong reputational loss would maintain the auditor's independence.

The major development in this model, compared with that of DeAngelo, was the introduction of the owner and the consequent changes to incentives. However, the model's single-period setting does not allow for learning on the part of any of the agents.

4.1.4 Behavioural models

The economic models presented have to make a number of simplifying assumptions concerning human behaviour as it relates to the complex relationship between auditor, client and the owner of, or investor in, the client. More recent attempts have been made to build on the interactions of psychology and economics that might provide a better insight into both the behaviour of the auditor and the nature of the auditor–client relationship. This strand of research focuses on moral psychology, ethical reasoning and independence.

This research examines the auditor's personal attributes in the decision-making process relating to the audit, rather than any exogenous factors, and hence focuses on ethical reasoning and judgement formation. Moizer (1997) identified two types of ethical reasoning: 'consequentialism' and 'deontology'.[55] The former concerns actions that are judged in terms

[54] Antle, R (1984), 'Auditor Independence', *Journal of Accounting Research*, **22**:1, Spring, 1–20.64.

[55] Moizer, P. (1997), 'Independence', chapter 3 in M. Sherer and S. Turley (eds.), *Current Issues in Auditing*, Paul Chapman Publishing.

of their consequences (to self and others) and the latter concerns actions that are deemed morally obligatory. The argument concludes that the auditor who follows the latter type of reasoning will always behave in an honest and independent manner. However, the auditor who follows the former type of reasoning may be less willing to report irregularities in financial statements if it is believed that this would be to the detriment of either themselves or others.

4.1.5 Broader-based studies

Johnstone, Sutton and Warfield (2001) developed a framework for assessing the factors that potentially increased independence risk and those that might mitigate such risk. The factors include both incentives and the particular issues that emerge when judgement-based decisions are made. With respect to incentives, they argue that potential increases in independence risk may arise from:[56]

– direct investments;
– contingent fees;
– potential employment;
– financial dependence;
– interpersonal relationships;
– auditing work of self or firm.

In addition to these incentives, the authors argue that judgement-based decision-making must also be present before independence risk affects audit quality. Examples of such judgement-based decision-making include difficult accounting issues, audit-conduct decisions, or issues surrounding materiality.

The authors also identify several factors that may mitigate the threats to independence, such as:

– corporate governance mechanisms;
– regulatory oversight;
– audit firm policies;
– audit firm culture;
– individual auditor characteristics.

Beattie et al. (1999)[57] uses a case study approach to assess the nature of a number of actual auditor–client relationships. From this, they identify factors that determine the nature of the relationship between the auditor and its client, including the level of integrity of the audit partner, the company type and its situation, the effectiveness of corporate governance, the clarity of accounting rules on a particular issue, and the quality control exercised by the audit firm.

From this analysis, they characterise audit partners along a continuum, ranging from those they term 'crusaders', who exhibit high levels of professionalism and personal integrity and are prepared to escalate issues, through to those they describe as 'trusters', who show moderate levels of professional integrity and are less willing to criticise or question the client, thereby increasing the likelihood that rules may, unwittingly, be followed less than rigorously.

The result of these and other similar studies is that there are a number of factors that determine the nature of the relationship between auditor and client, and, hence, the degree of independence enjoyed by the audit firm. These include the regulatory framework as well as the governance of the audit firm and the personal characteristics of the audit partner.

[56] Johnstone, K., Sutton, M. and Warfield, T. (2001), 'Antecedents and Consequences of Independence Risk: Framework for Analysis', *Accounting Horizons*, **15**:1, 1–18.
[57] Beattie, V., Brandt, R. and Fearnley, S. (1999), 'Perceptions of Auditor Independence: UK evidence', *Journal of International Accounting, Auditing & Taxation*, **8**:1, 67–107.

4.1.6 Perception research

The theoretical studies referred to previously assist in providing some understanding of the meaning of independence and the nature of the relationship between the stakeholders involved in the audit process that may affect the degree of independence achieved in the audit relationship. However, these models are still lacking in their ability to determine the relative importance of the actual factors that affect independence. To undertake this sort of analysis, it is necessary to attach some measure of quantification to the factors involved in determining actual audit relationships.

Actual independence is very difficult to observe. However, perceptions of independence are important in their own right, and several studies have examined this.

In an early example of this type of analysis, Hartley and Ross (1972)[58] surveyed auditors, users and preparers of financial statements. They also separated the issue of auditor competency from auditor independence. The key variable in their analysis is the degree of provision of non-audit services. They examined the perception that the lack of independence, when providing non-audit services, stems from the belief that auditors are not competent to perform it, and that it is incompatible with the image of a qualified auditor. Only 6% of respondents to their survey ranked non-audit services provision as the greatest threat to independence, whereas flexible accounting rules and economic dependence ranked much more highly.

Much of the subsequent work in this area came out of the research undertaken by Shockley (1981),[59] who used an experimental task method and surveyed the Big Eight partners (at the time there were eight major audit firms), non-Big Eight partners, commercial loan officers (creditors) and financial analysts (investors). The research examined the perceived effects of competition, non-audit services, audit firm size and tenure on independence. With regard to audit firm size, it was argued that larger firms were less likely to be dependent on a given client, as fees were likely to be a smaller proportion of total income. In addition, there were certain characteristics inherent in small audit firms that increased the possibility of impairment, such as close relationships with the client.

The results suggest that higher levels of competition increased the risk of independence being impaired; that auditors who provided non-audit services to audit clients were more likely to lose independence than those who did not; and, finally, that smaller firms were more likely to lose independence than larger firms. The hypothesis that an increased length of tenure would reduce independence was found not to be significant. Noteworthy is the fact that smaller auditors placed larger weights on competition than Big Eight auditors, indicating that competition issues were of greater significance for smaller firms. The scope of this study precluded the identification of the causes of the view that smaller auditors were less dependent than larger ones.

Reckers and Stagliano (1981)[60] surveyed the degree of confidence that auditors remained independent based on varying levels of provision of non-audit services—acquisition search, pension/actuarial services, system design, tax planning and tax preparation were chosen due to their alleged role in causing loss of independence. Less knowledgeable, less experienced groups (proxied by MBA students, rather than financial analysts) seemed to have less confidence in auditor independence. Financial analysts who responded to this survey expressed a very high degree of confidence that auditors could remain independent while providing non-audit services alongside auditing.

[58] Hartley, R.V. and Ross, T.L. (1972), ‘MAS and Audit Independence: An Image Problem’, *Journal of Accountancy*, November, 42–51.

[59] Shockley, R.A. (1981), ‘Perceptions of Auditors’ Independence: An Empirical Analysis’, *The Accounting Review*, **56**:4, October, 785–800.

[60] Reckers, P.M.J. and Stagliano, A.J. (1981), ‘Non-Audit Services and Perceived Independence: Some New Evidence’, *Auditing: A Journal of Practice & Theory*, **1**:1, Summer, 23–37.

Knapp (1985)[61] investigated the impact of four factors on loan officers' perceptions of independence—in particular, the perceived ability of auditors to resist client pressure in the event of disputes with the client. The subjects responded to 16 randomly ordered cases and were asked to record their perceived likelihood that the client's management would obtain its preferred resolution to the dispute. The results seemed to show that greater subjectivity in technical standards decreased the audit firm's perceived ability to withstand pressure exerted by the client. The results also appeared to support the hypothesis that the healthier a client's financial position, the greater the perceived ability to obtain its preferred outcome from an audit conflict—possibly as a result of an audit firm being willing to compromise its position in order to retain the account of a successful company.

Schleifer and Shockley (1990)[62] examined users' and auditors' reactions to a range of policies designed to enhance auditor independence. From the viewpoint of the auditors, there was general support for assuring that auditing work is independent. However, there was disagreement between the survey respondents over whether the provision of non-audit services needed to be restricted.

Bartlett (1993)[63] surveyed loan officers and auditors on how independent they believed the auditor was in ten different situations. The situation where only audit services were provided was used as a benchmark. On average, both groups perceived less than complete independence. The results showed that auditors reported a higher degree of independence in the situations presented, which could indicate that financial statement users are less sure about auditor independence, or that auditors are more confident in their ability to remain independent, or both.

Hussey (1999)[64] surveyed UK finance directors about auditor independence and the 'familiarity threat'. The survey examined the underlying causes of the familiarity threat including, in particular, the method for the appointment of auditors and the criteria for their selection, the duration of auditor appointment, and the frequency of contact between auditors and finance directors. The majority of finance directors did not believe that auditors should be prevented from taking on non-audit work for the client. With respect to the appointment process, it was found that the more influential the finance director was in this process, the more likely the familiarity threat would occur. This survey showed that the executives of public companies retained substantial influence in the selection of the auditor and recommended the curbing of director influence at the selection and appointment stages.

Beattie, et al. (1998 and 1999)[65] surveyed, by questionnaire, UK audit partners, finance directors and financial journalists regarding economic and regulatory factors that could impair or enhance auditor independence. A high level of non-audit service provision (>100% audit fees) was perceived as a serious threat among audit users, although there was no desire for the prohibition of the provision of non-audit services. The other threat identified by the study was economic dependence. Of note was the fact that this was perceived as being most threatening at the micro level—ie, when the individual partner's income depended on the retention of a specific audit client.

The results of this strand of the literature reveal that a number of factors are perceived as affecting auditor independence, as reflected by the type of disclosure made, the degree of adjustment to financial statements, and the type of report issued. The factors include the

[61] Knapp, M.C. (1985), 'Audit Conflict: An Empirical Study of the Perceived Ability of Auditors to Resist Management Pressure', *The Accounting Review*, **60**:2, April, 202–11.

[62] Schleifer, L.L.F. and Shockley, R.A. (1990), 'Policies to Promote Auditor Independence: More Evidence on the Perception Gap', *Journal of Applied Business Research*, **7**:2, 10–17.

[63] Bartlett, R.W. (1993), op. cit.

[64] Hussey, R. (1999), 'The Familiarity Threat and Auditor Independence', *Corporate Governance*, **7**:2, April, 190–7.

[65] Beattie, V., Fearnley, S. and Brandt, R. (1998), 'Auditor Independence and the Expectations Gap: Some Evidence of Changing User Perceptions', *Journal of Financial Regulation and Compliance*, **6**:2, 159–70; and (1999), 'Perceptions of Auditor Independence: U.K. Evidence', *Journal of International Accounting, Auditing & Taxation*, **8**:1, 67–107.

provision of non-audit services; the financial health of, and revenues generated, by a client; and the length of the auditor–client relationship. However, the studies also showed that there was a lack of agreement between the different agents involved in the process over what the most important factors were.

4.1.7 Summary

It is clear from the literature that the concept of independence is difficult to define. Most analysis and certainly many of the policy decisions related to independence have concentrated on the objectivity and integrity of the audit firm in the audit process. However, for the purpose of the present study, such definitions fail to address some important questions, such as who, within the audit firm, is most important when determining the degree of objectivity and integrity for the firm as a whole, and whether the auditor is to be independent of the client only.

In addition to these definitional issues, the research is also somewhat deficient when identifying and assessing the relative importance of the main factors that may influence independence. Studies that focus on perceptions of independent behaviour may not be able to identify, fully, the motivations and incentives for this.

When research has succeeded in identifying the factors that may affect independence, such as the provision of non-audit services and the closeness of the relationship between audit partner and client, there does not appear to be sufficient consensus among the agents involved in the audit process to enable a conclusion to be drawn on the relative importance of these factors. Therefore, it appears that research offers only limited guidance to the policy-maker.

From the perspective of this project, it is interesting to note that there have been few attempts in the literature to look, specifically, at the relationship between the ownership of the audit firm and its independence, and to consider the importance of this factor relative to other determinants. Therefore, in order to undertake the analysis for the present study, it has been necessary to consider the broader academic literature which attempts to identify the impact of different forms of ownership on corporate behaviour, and to hypothesise that the economic effects of different ownership forms will be similar for audit firms as for other corporate entities, while taking account of any characteristics peculiar to audit firms. This analysis is undertaken further in section 5. In sections 4.2 and 4.3 below, notions of independence from comparator industries are examined further. First, auditors' perceptions of independence are considered and the findings from the survey are then presented.

4.2 Case studies: ownership and independence in comparator industries

This section considers a number of other services industries where the notion of independence is essential to the credibility and usefulness of the type of service provided. These are:

- law firms;
- credit rating agencies (CRAs);
- investment banks.

Some of the issues and policy debates that have arisen in these industries provide useful insight for the auditing profession. This section examines how the issue of independence has been dealt with through rules on ownership and governance, and how current ownership structures shape the incentives faced by different parties. Each of these industries constitutes a subject matter in its own right, and a substantial amount of research and policy documents have been produced on each—this section therefore does not seek to be comprehensive in reviewing those industries, but rather aims to highlight the features that are of most relevance to the audit industry.

4.2.1 Case study on independence in the legal profession

The legal profession is examined in order to provide further insight into the issue of choice of ownership form. For the legal profession, independence and the need for it are commonly understood; and its necessity is often assumed as a given by the consumer of legal services and other third parties. Over the past few years there has been debate as to whether law firms could adopt other forms of alternative ownership structures than those currently allowed, and whether this would affect their independence from outside influence (although this is still an issue, even under current structures). This section examines whether there are any laws or governance rules that require independence, as well as any safeguards that are in place to ensure this, as well as looking at what the current ownership structures are. It also provides an analysis of the incentives that the owners face.

Ownership and management structures and the incentives of law firms

There is a perception that law firms and the legal profession in general need to be independent to ensure fairness and equality in the judicial process. To this end, the most common form of legal firm structure is the lawyer-owned and managed partnership.[66] There are often detailed rules that stipulate independence requirements—for example, the 'Code of Conduct for European Lawyers' issued by the Council of Bars and Law Societies of Europe (CCBE),[67] which states that:

> 2.1. Independence
>
> 2.1.1. The many duties to which a lawyer is subject require his absolute independence, free from all other influence, especially such as may arise from his personal interests or external pressure. Such independence is as necessary to trust in the process of justice as the impartiality of the judge. A lawyer must therefore avoid any impairment of his independence and be careful not to compromise his professional standards in order to please his client, the court or third parties.
>
> 2.1.2. This independence is necessary in non-contentious matters as well as in litigation. Advice given by a lawyer to his client has no value if it is given only to ingratiate himself, to serve his personal interests or in response to outside pressure.[68]

These principles are not prescriptive, however, and independence is often referred to with respect to the government, although potential 'external pressure' is actually much broader. This section focuses on the loss of independence and external pressures due to management and ownership issues, and relates them directly to the audit market.

The question of whether non-lawyer owners and managers of law firms, themselves, will be a threat to independence needs further examination. In July 2003, the Department for Constitutional Affairs in the UK[69] launched a wide-ranging independent review of the regulation of the legal services market, aimed at promoting competition and innovation and improving services for the customer. From this review came the Clementi report.[70] Clementi's terms of reference included consideration of what regulatory framework would best promote competition, innovation and the public and consumer interest in an efficient, effective and independent legal sector, and the recommendation of a framework which would be independent in representing the public and consumer interest, and would be comprehensive,

[66] An exception to this is the example of a legal firm in Australia, which in May 2007 became the first law firm to be listed on a stock exchange. Australia's Slater & Gordon raised almost €22m in its share offering. With the capital it has raised, it is said to be planning to buy other (personal injury) law firms in order to consolidate on a national level. Institutional investors purchased around two-thirds of the shares offered in the flotation. In relation to safeguarding independence, the corporate governance statement issued by Slater & Gordon states that: 'if there is an inconsistency or conflict between the duties to the court, to clients and to shareholders then that conflict or inconsistency shall be resolved as follows: 1. The duty to the Court will prevail over all duties; and 2. The duty to the client will prevail over the duty to shareholders' (www.slatergordon.com.au).

[67] CCBE (2006), 'Code of Conduct for European Lawyers', last amended by the CCBE on May 19th 2006.

[68] ibid, p. 8.

[69] In a reorganisation in May 2007, the Department for Constitutional Affairs was brought into the Ministry of Justice.

[70] Clementi, D. (2004), 'Review of the regulatory framework for legal services in England and Wales', Final report, December. Sir David Clementi has been Deputy Governor at the Bank of England and the Chairman of Prudential plc.

accountable, consistent, flexible, transparent, and no more restrictive or burdensome than is clearly justified.

In addition, the Danish Ministry of Justice commissioned a report which examined, among other issues, whether rules regarding ownership could be modified. Copenhagen Economics presented its report in January 2006.[71]

The restrictions contained within the rules of the main legal professional bodies prohibited:

– the formation of partnerships between barristers and between barristers and other professionals (both lawyers and non-lawyers);
– solicitors entering a partnership with members of other professions (both lawyer and non-lawyer); and
– solicitors in the employment of businesses or organisations not owned by solicitors (eg, banks or insurance companies) from providing services to third parties, with a few exceptions.

It is interesting to note that Clementi referred to the accountancy profession as a precedent for the percentage of outside ownership permitted:

> With regard to percentage ownership there is a precedent within the accountancy profession. Under EU 8th Company Law Directive outside owners may not own in excess of 49 per cent of the capital of an audit practice. The Bar Council has proposed that outside ownership should be restricted to no more than 30 per cent of the capital. Both of these limits are restrictions on the aggregate level of shareholding to be held by outsiders.[72]

For reasons discussed further below, the Clementi report proposed two alternative business structures:

– legal disciplinary practices (LDPs)—a legal firm could only provide legal services, although it could be owned by its managers (not necessarily lawyers—ie, HR professionals, accountants) or by owners who are not managers;
– multi-disciplinary practices (MDPs)—a legal firm could offer legal as well as other services, and could be owned by its managers as well as non-managers.

Non-lawyers as managers and owners of legal firms

Within the scenario whereby non-lawyers are allowed to be managers and owners, there is a concern that non-lawyers would not be subject to the same high level of ethical standards, which are formalised by membership of a professional association. Clementi proposed the creation of a 'Head of Legal Practice'. This person must be a lawyer and would oversee the legal business in accordance with the regulatory rules. In addition, a 'Head of Finance and Administration' (HOFA) would be created. This person would not necessarily have to be a lawyer.

The Bar Council was opposed, in principle, to non-lawyers becoming managers.[73] However, other respondents to the Clementi report believed that some liberalisation was necessary, as it would enhance the services of a law practice.[74] In order to mitigate the potentially conflicting incentives between lawyers and non-lawyers, non-lawyer managers would be obliged to sign a Code of Practice agreed with the regulator of the LDP. Clementi does stipulate, however, that the majority of the management group must be lawyers, as this is a more certain way of ensuring that the fundamental attributes of the profession are maintained.

[71] Copenhagen Economics (2006), 'The Legal Profession: Competition and Liberalisation', January.
[72] Clementi (2004), op. cit., p. 122, para. 56.
[73] Ibid, p. 113, para. 30.
[74] Ibid.

External ownership of legal firms

The Clementi report referred to inappropriate owners of legal firms, if ownership were opened up, and that there should be a ‘fit to own’ test, based on the following criteria:

- honesty, integrity and reputation;
- competence and capability;
- financial soundness.

The Solicitor Sole Practitioners Group argued that non-lawyers would not be subject to the same professional regulation and might therefore pursue commercial optimisation at the expense of ethical duties. Clementi argued that this might not be the case if the following safeguards are implemented:

- the Head of Legal Practice must be a lawyer;
- the Head of Finance and Administration must be competent in their areas;
- both the Head of Legal Practice and Head of Finance and Administration are nominated and subject to a competence test;
- lawyers represent a majority in the management group;
- non-lawyers adhere to a Code of Practice to be agreed with the regulator;
- outside owners have no adverse interest in the legal outcome of a client and have no right to interfere in any case, or have access to information.

In relating the example of legal firms to the audit industry, MDPs can be seen as professional services firms. These firms are multi-disciplinary in that they offer a variety of services that are not exclusively audit services. LDPs, however, can be seen as the equivalent of firms that offer audit services only.

Following the review, the Department for Constitutional Affairs in the UK commissioned a number of academics to analyse some of Clementi’s recommendations. In one such analysis, Grout (2005) examined the potential risks of outside ownership and regulatory response. In particular, he mapped out the incentives that the agents in this structure face.[75] Grout stated that regulation should target underlying incentives rather than business structures.

- **Partnership**: in this scenario there is a return on human capital (lawyer-specific) and a return to the partnership (business-specific). Although the partnership return will usually be higher than the human capital return, in the case of sole traders and smaller partnerships the human capital return will be a very significant component. In the case of inappropriate behaviour, where the most severe penalty is to disbar the lawyer, the effects of punishment will clearly be more severe for the lawyer than for non-lawyers. This forms the rationale for imposing restrictions on the composition of non-lawyer management. Grout acknowledged the appropriateness of a rule on management composition. However, the minimum requirement for 51% of management to be lawyers appeared to him to be somewhat arbitrary for an initial restriction.

- **Shareholding owners of large LDPs/MDPs**: if the aggregate value of shares is large, this can create an incentive to monitor and thus constrain the lawyers’ behaviour, especially if the broader corporate reputation is at risk. If customers identify this effect and the effect itself is strong, customers may be willing to pay more for their legal services.

  Grout argues that the incentives contradict the view that lawyer owners are better than external owners. If ownership is concentrated in the hands of outside owners, the human capital return will be greater than the business return for an individual lawyer. As regulatory action has a greater impact on a lawyer manager, due to the human capital

[75] Grout (2005), ‘The Clementi Report: Potential Risks of External Ownership and Regulatory Responses’, July.

element, any equity value saved by protecting a major client goes to the outside owner, not the lawyer. Specifically, the lawyer will not be so inclined to take risks because their gain-to-loss ratio is not favourable (the risk-to-reward ratio increases).

In contrast, if the lawyer owns a large share of the business, they still bear the risk of losing human capital, but capture a large share of the equity value saved by protecting the client. Thus, in this view, the problem is not one of non-lawyer to lawyer ownership, but rather of concentrated ownership.

The Clementi report recommends limiting the composition of management teams (with the majority being lawyers) and ring-fencing legal teams within new ownership structures.[76]

– **Financial structure**: for equity owners the downside risks are capped at the value of their shareholdings. Thus, they often choose to take riskier strategies resulting in the problem of 'moral hazard'. The higher the debt to equity ratio in a firm, the more attractive riskier strategies become to owners. However, debt owners will have opposite incentives, but are external to the organisation and are not in a position to monitor the behaviour. Grout suggests that the focus of regulation in highly concentrated LDPs and MDPs should be on financial structure rather than management.

In its response to a super-complaint made by the consumer body, *Which?,* in relation to the Scottish legal profession, the Office of Fair Trading (OFT) in the UK stated that:

> 5.16 The prohibition on external ownership and on MDPs prevents lawyers from taking advantage of the efficiencies that these organisational forms provide, the benefits of which can be passed on, directly or indirectly, to consumers. The OFT recognises that particular safeguards would be necessary in order for law firms owned by non-lawyers to operate properly, if the prohibition were to be lifted. The OFT believes that the need for such safeguards does not outweigh the benefits that could be achieved for consumers in Scotland by lifting the current blanket ban, and that these restrictions should be removed.[77]

Case study on independence in the legal profession: main implications

In the case of legal firms, there has been extensive debate on the structure of ownership rules. Much of the thinking and policy options can be directly transposed across to the audit market. Incentives can be examined at two levels: the management level and the ownership level.

– At the *management* level, the question is whether to let non-lawyers become part of the management team and, in the case of a partnership, an owner (there is no external ownership in this example). The benefit of non-lawyer management (and partners) is seen to bring expertise (and extra capital) to the legal firm. However, non-lawyers are not subject to the same code of conduct or responsibilities as lawyers, and this could threaten the reputation and objectivity of the firm, of which one aspect is independence.

– At the *ownership* level, the question of internal ownership must be addressed first. If non-lawyers, such as the IT, marketing or finance director, become owners of a legal firm, will this erode the independence of the firm? As noted above, Clementi proposed creating a Head of Finance and Administration who must sign a code of practice agreed with the regulator. Others have put forward the counterargument that, as ownership is increasingly located outside the legal firm, the regulatory bite on the lawyers in the firm

[76] Copenhagen Economics states that 'ownership requirements should only be modified with great care and preserve the independence of the lawyers'. Copenhagen Economics (2006), op. cit., p. 15.
[77] OFT (2007), 'Restrictions on business structures and direct access in the Scottish legal profession', July.

has a stronger effect, such that they are actually less inclined to take non-independent actions.

Noteworthy is the fact that the review of the regulation of the legal services market was driven by the aim to promote competition and innovation, and to improve services for the customer, which is similar to the rationale for the studies on the auditing profession.

4.2.2 Case study on credit rating agencies

Credit rating agencies (CRAs) play a critical role in the world's financial markets as providers of information and pricing signals. By rating a large proportion of debt issued around the world, CRAs provide important information to investors and governments on the probability of default of individual debt issues. The global scale of credit rating agency activities and the sheer amount of money at stake—in 2006, the amount of debt issued globally was valued at US$6.9 trillion[78]—mean that it is a significant public policy concern to ensure the credibility and independence of CRAs. The Committee of European Securities Regulators (CESR) stated in a recent consultation paper that:

> both real and perceived independence, objectivity and quality of credit ratings is important, as the mere perception of lack of independence, objectivity and quality of credit ratings can undermine confidence in them.[79]

Importantly, CRAs are privately owned companies. The CRA industry is highly concentrated (even more so than the audit industry), with three main CRAs globally: Moody's, Standard & Poor's (S&P), and Fitch Ratings.

What do credit rating agencies do?

CRAs occupy a strategically important position, primarily as a nexus between issuers and investors. Their primary role is to 'digest' information on bond issuers, analyse issuers' financial positions, and formulate an 'opinion' about the probability of an issuer defaulting on a particular bond issue. Investors and lenders frequently place significant reliance on those credit ratings. In this respect, the CRAs can be seen as playing a complementary role to that of auditors.

The information used by a CRA typically depends on the arrangements between the agency and the issuer. For 'unsolicited' credit ratings—those that agencies produce without being paid or requested to do so—the information used is typically restricted to that which is publicly available. For 'solicited' credit ratings, significantly more information may be provided by the issuer. The issuer pays the CRA to produce the credit rating, and shares private information on a confidential basis. In that respect, too, a credit rating is very similar to an audit, in that it is commissioned by the company for the benefit of its capital providers, as well as other potential investors.

As an activity, rating debt instruments is not a precise science, given that there is always necessarily an 'opinion component' in any rating. In addition, it is a common expectation that, at some point, a CRA will make a mistake—in a process with significant human input, regardless of how well safeguarded it is, it is difficult to avoid any errors. Regulators are mainly concerned with the extent to which such mistakes occur systematically and repetitively as a result of structural problems—ie, market failures or limited innovation as a result of a lack of competition. The controversial cases of Parmalat, Enron and Worldcom in the last five years have highlighted the CRAs' apparent inability to recognise the risks of failure in those companies. In these cases, despite their access to private information, CRAs

[78] Source: Thomson Financial standard league tables.

[79] CESR (2004), 'Consultation Paper—CESR's technical advice to the European Commission on possible measures concerning credit rating agencies', November, p. 20.

appear to have continued to produce investment-grade ratings until shortly before the event of default.

Credit ratings are available to investors to be used as inputs into their investment decisions. In this respect, they can be seen as public information. By adding information to the market (in particular, because they can incorporate private information into credit ratings), the presence of CRAs can be viewed as an efficient outcome, preventing the duplication of a significant amount of research effort among investors. In other words, as with auditing, the presence of CRAs means that investors and lenders do not need to assess the creditworthiness of issuers by themselves.

Independence and possible conflicts of interest

The issue of CRAs' independence is important since, in each case, they issue an opinion, where the value of that opinion is critically linked to the independent assessment of the situation of a given issuer. Potentially biased ratings would send wrong pricing signals and therefore create significant inefficiencies in the marketplace.

The CRAs therefore need to be independent of the company they are rating. The wide range of users of their services underlines the importance of these ratings. In controversial cases such as those of Parmalat and Enron noted above, it is not clear whether any type of bias might have played a role. It is generally difficult to judge the performance of CRAs, particularly as the event being predicted—default on bonds—is intrinsically rare. Even after the event, it may be difficult to distinguish between inaccurate credit ratings caused by conflict of interest and those resulting from other factors. Galil (2003), using long-term data, suggested that publicly available data may not have been efficiently incorporated into credit ratings.[80]

Potential conflicts of interest that could affect CRAs' independence and the objectivity of their assessment could arise in the following two ways:

– similarly to auditors in the case of audit opinions, CRAs do not receive payments from the direct users of their rating reports (investors), but rather from the firms that issue debt and want it to be rated (just like audit entities, which pay the audit fee);

– similarly to auditors, CRAs may offer ancillary services to issuers, such as risk management advice.

These potential conflicts of interest may be offset, at least to some extent, by other factors. For example, the income from an individual issuer constitutes a small proportion of a CRA's total revenues, and is therefore unlikely to affect an agency's considerations significantly. Furthermore, if a CRA's opinion is found to have been compromised from the independence perspective, the potential credibility loss (and therefore value loss) of a CRA would be significant, potentially threatening its entire raison d'être. A similar mechanism works in auditing, where audit firms themselves have to carefully guard their reputation. In addition, the potential for conflict of interest has been recognised by the CRAs themselves. For example, S&P has procedures in place to ensure that no individual is able to link a credit rating opinion to fees.[81]

Evidence on the actual effects of a conflict of interest in the case of CRAs is limited. A recent study showed that solicited credit ratings are more favourable than unsolicited credit ratings, which provides some indication of a potential bias.[82] If this is the case, the CRAs could be

[80] Galil, K. (2003), 'The quality of corporate credit rating: an empirical investigation', working paper, Centre for Financial Studies.
[81] Fuchita, Y. and Litan R. (eds.) (2006), *Financial Gatekeepers—can they protect investors?*, Brookings Institution Press, p. 69.
[82] Poon, W. (2003), 'Are unsolicited credit ratings biased downward?', *Journal of Banking and Finance*, **27**:4.

seen as inducing issuers to commission credit ratings by compromising independence. However, issuers who actually seek credit ratings may do so because they have better private information than those who do not. If so, the result that solicited credit ratings are more favourable than unsolicited credit ratings reflects this self-selection effect, and, consequently, the different information sets available to the agencies.[83]

Legislation and governance rules

A statement of principles by the International Organization of Securities Commissions (IOSCO) (2003) indicates that:[84]

> CRA ratings decisions should be independent and free from political or economic pressures and from conflicts of interest arising due to the CRA's ownership structure, business or financial activities, or the financial interests of the CRA's employees. CRAs should, as far as possible, avoid activities, procedures or relationships that may compromise or appear to compromise the independence and objectivity of the credit rating operations.

Therefore, CRAs and their employees need to stay independent in order that their ratings remain objective. The above provision in the statement of principles makes independence of CRAs an explicit requirement. Furthermore, following the publication of this statement in 2003, various commentators and the CRAs themselves accepted that it would be useful to have a more detailed code with guidance on how the principles could be implemented in practice. This resulted in the 'Code of conduct fundamentals for credit rating agencies'. Section 2, entitled 'CRA independence and avoidance of conflicts of interest', states that:

> The CRA should separate, operationally and legally, its credit rating business and CRA analysts from any other businesses of the CRA, including consulting businesses, that may present a conflict of interest. The CRA should ensure that ancillary business operations which do not necessarily present conflicts of interest with the CRA's rating business have in place procedures and mechanisms designed to minimize the likelihood that conflicts of interest will arise.

In the same way that ownership rules are imposed to prevent conflicts of interest, this code states that the credit rating business must be separated operationally and legally from the CRA's other business activities.

Another stakeholder in the CRA industry, the Association of Corporate Treasurers (ACT)—representing the clients of ratings—has published a, non-binding, code, which states that:[85]

> CRAs should have an ownership structure that is not likely to create opportunities for conflicts of interest to arise.

Ownership structures

The ownership structure of the three main CRAs is shown in Table 4.1. An important difference with auditing is that CRAs are all owned by a combination of institutional investors and for-profit services companies. McGraw-Hill Companies, Inc. is a global information services provider operating in various sectors, including finance, business and education. The core activities of Moody's Corporation are in credit ratings, research and risk analysis covering debt instruments and securities in the global capital markets. Financière Marc de Lacharrière (Fimalac) provides financial services, including financial ratings and risk

[83] See Gan, Y. (2003), 'Why do firms pay for bond ratings when they can get them for free?', The Wharton School, University of Philadelphia.

[84] IOSCO (2003), 'IOSCO statement of principles regarding the activities of credit rating agencies', September 25th, p. 2.

[85] ACT (2005), 'Code of standard practices for participants in the credit rating process'. The ACT is an international body for finance professionals working in treasury, risk and corporate finance, and has the objective to promote study and best practice in finance and treasury management.

management. The Hearst Corporation is a diversified communications company operating in across several media.

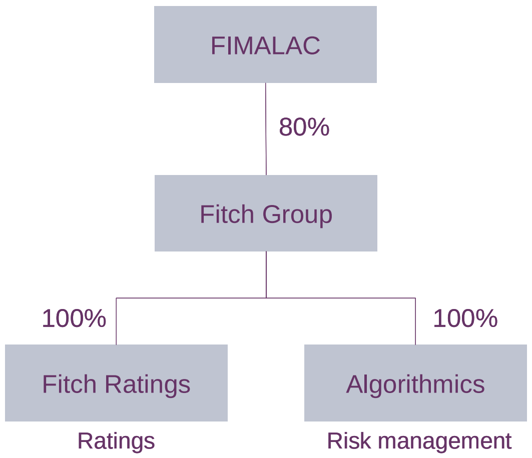
Table 4.1 Credit rating agencies and their shareholders

Credit rating agency	Parent company	Shareholders of parent company
Moody's Investor Service	Moody's Corporation	91.7% institutional and mutual fund holders
		6.25% individual ownership
		2.05% repurchased shares
S&P	McGraw-Hill	82.5% institutional and mutual fund holders
		5.9% individual ownership
		11.6% repurchased shares
Fitch Ratings	Fitch Group	80% Fimalac
		20% Hearst Corporation

Note: The parent companies wholly own the CRAs.
Source: Thomson Financial and Bloomberg at December 31st 2006.

Following IOSCO regulations, the CRAs are legally and operationally separate from any other business activities that might be performed by the same corporate group. Figure 4.1 illustrates Fitch Ratings' ownership structure, and shows how the ratings business is separated from its other business activities, in keeping with the code issued by IOSCO.

Figure 4.1 Simplified structure of Fitch Group



Source: www.fimalac.com.

Case study on credit rating agencies: main implications

The credit rating industry has recently been under review by various regulatory and public bodies. For example, IOSCO published high-level principles and guidelines in 2003 and 2004 respectively, which require the credit rating business to be legally and operationally separate from any other activities of the CRA. Furthermore, the European Commission has been reviewing the need for legislation with respect to rating agencies. The CESR published a report in December 2006 on the CRAs' level of compliance with the IOSCO code. The CRAs have incorporated these guidelines into their own code. One outstanding issue is whether 'rating assessment services' should be considered as ancillary services. With the exception of the above, CRAs have, according to the CESR report, separated the credit ratings business from other areas.

The attention currently being paid to CRAs is driven by their important role in the financial system, the potential scope for conflicts of interest, and their relatively high concentration in the market, all of which closely resemble the characteristics of the audit market. However, the empirical evidence to date of the actual effects of these considerations, as observed in practice, is limited.

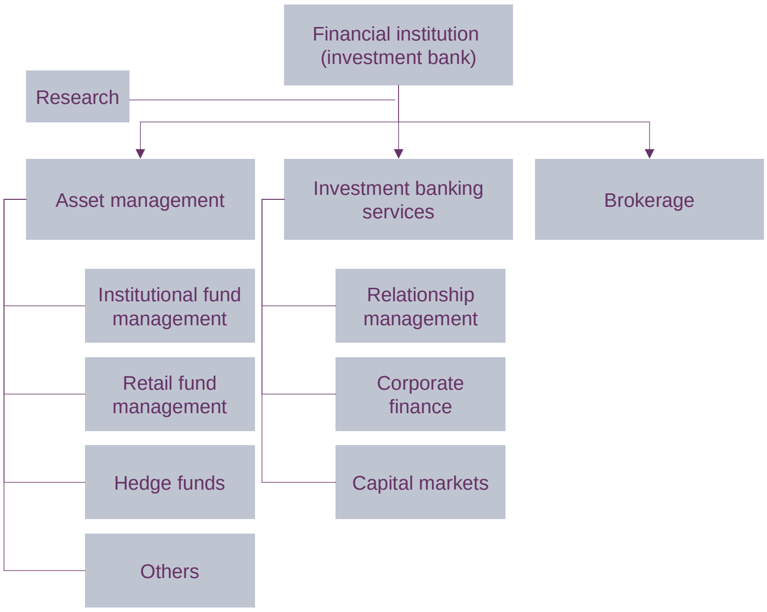
4.2.3 Case study on investment banking

Potential conflicts of interest in investment banks' activities
In general, the terms 'investment banking' can refer to:

– **the financial institution as a whole**—the services provided by the financial institution often include fund management, brokerage, and specific investment banking services;
– **the investment banking division within a financial institution**—the investment banking division usually covers activities such as corporate finance (mergers and acquisitions, M&As), capital markets (IPOs and subsequent offerings, etc), and relationship management;
– **the relationship managers within the investment banking division**—these managers act as financial advisers to large corporates. They are often called the investment bankers.

This case study focuses on the investment banking division within a financial institution.[86] A typical structure of an investment bank is illustrated in Figure 4.2.

Figure 4.2 Typical investment bank structure



Source: Oxera.

The core activities of an investment bank are in the areas of 'capital markets'—eg, initial public offerings (IPOs) and subsequent offerings—and 'corporate finance'—eg, mergers and acquisitions (M&As). The essence of these activities is that sellers and buyers are brought together. Investment bankers mainly play an advisory role, although they may sometimes also take risks themselves (eg, in the case of underwriting IPOs). Supporting activities often carried out by investment bankers include research and relationship management.

[86] The case study is based on a report by Forum Group (2003), 'Financial Analysts: Best practices in an integrated European financial market', Recommendations from the Forum Group to the European Commission services, September 4th. The market-focused Forum Group of experts was set up in 2002 by European Commission services to research and evaluate current regulatory and market practice issues, with a view to recommending optimal regulatory and best practice options within an integrated European capital market.

Investment banks' activities can be subject to potential conflicts of interest. One area where this has come to the fore is in the investment advice and research opinions that the banks' analysts provide to the investor community—such opinions are complementary to those provided by auditors and the CRAs, and are expected to be unbiased and independent. Following a policy debate in April 2003, ten major US investment banks agreed to a set of behavioural and structural reforms to avoid this type of conflict of interest, including the physical separation of research and other investment banking activities.[87]

More generally, in recent years, various regulators around the world have been scrutinising potential conflicts of interest arising in investment research. This regulatory scrutiny has highlighted a particular feature of investment research—namely, the conflict of interest arising when research and other investment banking activities form part of the same organisation.

Analysts producing investment research can broadly be categorised into independent research houses, buy-side analysts working for fund management firms, and sell-side analysts employed by investment banks. The first two groups seem to have little to gain from compromising the objectivity and quality of their research—the independents' competitiveness depends on it, and the fund managers' performance benefits directly from it. However, sell-side analysts may take account of their firms' other investment banking activities, such as M&As and underwriting. Positive research statements might help to create public interest in the issuance of new shares. In addition, creating strong demand might be important with regard to the underwriter's role in following the issued securities in the aftermarket. In practice, any explicit or implicit pressure from the investment banking arm could have an impact on the objectivity of the analysts' research.

Evidence on conflicts in practice

There is some evidence to support the claim that conflicts of interest have biased research. For example, according to the FSA, 80% of the recommendations made by investment bank analysts on FTSE 100 companies with which they also had an investment banking relationship were to 'buy', while this figure was only 45% for companies with which no relationship existed.[88] Two academic studies in the USA found similar results.

– Michaely and Womack (1999) assessed the potential conflict in relation to recommendations on IPOs.[89] They found that investment banks that acted as the lead underwriters of the issue achieved a significantly poorer performance in providing recommendations on the issuing firm. The two-year post-recommendation performance for non-underwriters was found to be higher by 50% compared with the recommendations issued by underwriters.

– Hong and Kubik (2003) examined the analysts' incentives with regard to compensation and career progression within investment banks.[90] Their findings suggest that equity analysts' career prospects are determined not only by the accuracy of their forecasts but also by the optimism shown in their recommendations. Analysts who had been more optimistic seem to have enjoyed better career progression. The authors also found that, for analysts covering shares underwritten by their employer, their job progression depended even less on accuracy, and more on optimistic recommendations.

[87] Sirri, E. (2004), 'Investment Banks, Scope, and Unavoidable Conflicts of Interest', *Federal Reserve Bank of Atlanta Economic Review*, **4**.

[88] FSA (2002), 'Investment Research: Conflicts and other issues', Discussion Paper 15, July.

[89] Michaely, R. and Womack, K. (1999), 'Conflict of interest and the credibility of underwriter analyst recommendations', *Review of Financial Studies*, **12**:4, 653–86.

[90] Hong, H. and Kubik, J. (2003), 'Analyzing the analysts: Career concerns and biased earnings forecasts', *Journal of Finance,* **58**:1, 313–51.

However, some studies point to a different conclusion. A working paper by Clarke et al. (2004) examines empirically whether analysts' behaviour differs according to their affiliation—ie, whether it is to an investment bank, a pure brokerage (no investment banking activity) or an independent research firm (no brokerage or investment banking activity).[91] The 'bias hypothesis' states that investment banks are more likely to produce biased research as they are under pressure to generate investment banking business; and the 'information bias' states that forecasts and recommendations from investment banks are relatively more informative than those from other financial institutions.

The results showed that, even after controlling for analyst-specific factors, investment banks are found to be less optimistic than analysts at other financial institutions, with the exception of large brokerages. Their forecasts were found to be more accurate than small investment banks and large independent research institutions, and not any less accurate than other financial institutions. Thus, the results are inconsistent with the bias hypothesis, but consistent with the information hypothesis. The reasons why investment bank analysts are more informative are as follows:

– (irrespective of the legality) if 'Chinese walls' are breached, investment bank analysts may have access to information not available to research institutes and brokerage firms, which in turn produces more informative forecasts;
– investment banks are likely to have more resources at their disposal; and
– investment banks are able to afford better compensation packages for their analysts and thus attract higher-quality staff, leading to higher-quality research for the given information.

Regulatory initiatives to deal with conflicts

The majority of recent regulatory initiatives have focused on insulating the analysts from the investment banking pressure. The settlement in the USA, noted above, led to a set of prescriptive rules governing various aspects of the analysts' relationship with other functions, including an obligatory physical separation between research and investment banking departments. In addition, the settlement required the investment banks to fund independent research as an alternative source of investment advice.

In contrast, several European policy proposals in this area have emphasised broad regulatory principles as opposed to detailed rules. The FSA regulations, for example, do not include forced separation between investment banking departments, but rather place the onus on banks' senior management to provide evidence that the potential conflicts are addressed appropriately. Neither the FSA nor the European Forum Group has deemed it necessary to compel the investment banks to fund independent research. Nevertheless, on both sides of the Atlantic, the conclusion seems to be that analysts have, in effect, been influenced by this conflict, and that some regulatory intervention is required to correct this influence.

Case study on investment banking: main implications

Similar to the audit market, clients of investment banking services may find it difficult to assess the quality of the investment bank ex ante, even though they are sophisticated customers. Reputation and experience are thus used as proxies for quality per se. The audit, like investment research, has a wider role to inform third parties such as shareholders and potential shareholders, but is paid for by the company that is being audited. Although the literature cited above shows mixed evidence for a bias or an absence of it, regulators around the world have been concerned with this issue and have implemented a number of measures. In part, these measures seek to create greater internal separation between

[91] Clarke, J., Khorana, A., Patel, A. and Rau, P.R. (2004), 'The good, the bad and the ugly? Differences in analyst behaviour at investment banks, brokerages and independent research firms', Purdue University working paper, September.

investment banks' research and other activities, and better information (health warnings) to investors as regards possible conflicts.

4.2.4 Case study: the Goldman Sachs example—the decision to go public

This section looks at the example of Goldman Sachs and the overall corporate form of investment banks in the USA.[92] In 1970, NYSE permitted investment banks to incorporate themselves as limited liability companies, although it is notable that, for market-making firms, 51% of the shareholdings were to be held by members.[93] In 1999, Goldman Sachs followed in the footsteps of other investment banks by becoming a joint stock company, although it was one of the last investment banks to do so. It provides a useful case study for ownership structures in auditing.

The reasons why Goldman Sachs went public are as follows.

– Prior to the relaxation of the rules stipulating corporate form, investment banks were partnerships. The economic reasoning for the partnership form stems from the importance of tacit human capital in investment banking. Partnerships with reputations for being trustworthy and unbiased could earn a high return for their partners, thus partners would mentor new associates in order to guarantee themselves a return on their stake. However, a free-rider problem may exist whereby a partner would gain completely the utility associated with avoiding their mentoring duties, whereas any loss would be shared among the partnership. Hence, this could constrain the size of the partnership and ultimately the amount of capital that could be invested into it. Over the few decades prior to the flotation, the investment banking profession had become more standardised and thus tacit human capital had not played such a significant role.

– Morrison & Wilhelm (2004) suggested that it was a technological shock that acted as a catalyst for Goldman Sachs to go public. The advent of computer technology that could now be substituted for human capital resulted in a trade-off between the two. The new technology was subject to increased minimum scale; thus, a larger partnership and hence more capital were needed in order to make the investment in this technology efficient. The alternative to this method of financing (when the rules were relaxed) was through a joint stock company, not constrained in size due to the free-rider problem, and this is the path Goldman Sachs took when it decided to float in June 1999, almost a decade or more after its peers.

Goldman Sachs had reportedly proposed and rejected the idea of going public six times before it actually happened. In 1986, when an IPO was first proposed, the rationale was the same as that used by Morgan Stanley which had floated earlier in the year—more capital was needed to be able to compete successfully in a fiercer globalised environment. The argument against the need for more capital was the concern that the elimination of the partnership structure would diminish the retention of human capital (in this scenario, human capital is at the partner level of the firm).

The evolution of its capital structure

Goldman Sachs had both general and limited partners, and in 1985 these two types of partner owned more than 80% of the firm. As time progressed, other equity holders were introduced; by 1993 the partners owned only 40%, and in 1994 this proportion was down to 28%. The partners retained full control of the voting rights, irrespective of the firm's ownership.

[92] A range of sources (referenced below) was used to prepare this case study. One important source was Nanda, A., Salter, M., Groysberg, B. and Matthews, S. (2006), 'The Goldman Sachs IPO', Harvard Business School case study.

[93] Morrison, A.D. and Wilhelm, W.J. (2004), 'The demise of investment-banking partnerships', working paper, July, p. 32.

In 1994, Goldman Sachs suffered large financial losses, which provoked the question of whether the private partnership structure with unlimited liability and inherently unstable capital was obsolete for a modern investment bank. In 1996, although partners voted against going public, the chairman at the time introduced structural changes that indicated which direction he was taking the bank. The withdrawal of partners' capital was made more restrictive; the corporation was made a general partner, and individual partners (including other equity holders) became limited partners.

By 1997 the view that an IPO was inevitable was emerging. Although Sumitomo Bank and Bernice Pauahi Bishops Estate were non-voting equity holders, there was a view that this separation of funding from voting could not be maintained indefinitely.

The view from inside

It is said that although there was no sharp split of the vote (which was private), there was more opposition from investment bankers than from traders (Nanda et al. 2006). The traders argued that the bank should take advantage of the recent high earnings, whereas opponents were concerned about the additional transparency required as a publicly listed company and its stock market positioning, given that a significant share of profits came from the volatile proprietary trading business.

Thus, in 1998 the partners finally voted overwhelmingly to go public, for three reasons:

– Goldman Sachs had already become more of a corporation than a partnership;
– the pressure from the concentration of ownership had grown; and
– additional 'partners in the wings' could no longer be excluded.

Case study: the Goldman Sachs example—main implications

Like many other industries where corporate reputation is important, investment banks have historically adopted the form of partnerships as means of best ensuring this. Today, this paradigm still occurs in law, audit and some other professional services. In contrast, the investment banks have moved away from partnership-like structures.

The investment bank industry, and the Goldman Sachs case study in particular, address issues of corporate structure in relation to independence and human capital and the rationale for going public—the need for capital. This is of direct relevance to the issue of ownership structures of audit firms, as explored further in section 5.

4.3 Ensuring auditors' independence—implications for audit firms

The issue that relates to the independence of the audit firms (ie, the corporate entity) may be better understood in relation to individual audits. The definitions of independence enshrined in legal requirements (see section 4.1 above) are directed primarily at the output (ie, the audit). Thus, the (main) objective of rules relating to independence is that the particular audit statement is, and is seen to be, independent. The professional requirements on auditors also tend to relate to the independence of mind, professional scepticism and similar characteristics that apply to the individual(s) carrying out the specific audit assignment. In addition, obligations arise through both professional requirements and regulatory oversight requirements to ensure that any audit is carried out by staff with the appropriate qualifications, including professional qualifications relating to audits (ie, those actually carrying out the audit and operationally responsible for it are required to be independent).

However, the audit firm is generally the entity that is responsible for the audit, and therefore takes ultimate responsibility for the independence of the audit statement. As described in section 4.1, there is little direct evidence or analysis on the causal links between ownership rules applied at the corporate level and independence as it is applied to the individual product (ie, the individual audit). At the theoretical level, the application of rules to the entity may, or may not, have an impact on the quality, in general, and the independence, in particular, of the specific output only to the extent that these rules mediate (in a positive way) the internal relationships within the firm between those with operational responsibility for the output and the internal management and power structure within the firm itself.

Where the firm is small, rules applying to its owners or managers may have quite similar impacts to rules that apply to individuals carrying out specific tasks, as they are likely to affect the same people. Requiring a small audit firm to be owned and/or managed by a majority of auditors is likely to have a similar impact as a rule requiring qualified auditors to be operationally responsible for carrying out the audit task. Thus, a rule restricting ownership or management to qualified auditors could act as a reasonable proxy for a rule(s) that applied to operational responsibility for the audit product.

However, in the presence of a stand-alone rule(s) requiring a qualified auditor to have operational responsibility for the individual audit task, the *additional* requirement for the firm to be owned and/or managed by qualified auditors will only deliver additional independence if it improves the relationship between the firm (as an entity) and the individual (employee or partner) carrying out the individual audit assignment.

In larger firms, the relationship between the owners or managers and the individual with operational responsibility for the audit is likely to be complex. Larger audit firms have characteristics similar to other larger corporate entities—with internal management and reward structures designed to allow a relatively small number of people to control the activities and output of a much larger group. The critical issue for the independence of audits is whether the ownership and/or management restrictions with respect to qualified auditors have a significant positive impact on the way in which these internal management systems affect the ability and motivations of those with operational responsibility for individual audit to produce independent audits.

4.3.1 Views of audit firms

The indications from the interviews undertaken by Oxera is that the mid-tier firms, in general, do not see the ownership or management requirements as the crucial factor delivering this increased motivation for independent audit. They all consider the requirement to deliver independent audits as critical to the success of the firm, regardless of the rules—indeed, they identify a requirement to have a strong reputation for independent audit as being a necessary condition for continued operation. This necessary requirement at the corporate level would apply whether or not the corporate entity was owned and/or managed by a majority of auditors.

The actual exercise of the ownership functions and the corporate management functions in larger firms may be somewhat removed from the operational responsibility for most, if not all, individual audits. In exercising their role in the ownership function or in the management function of the firm, the issues faced by these individuals are more related to the performance of the entity as a whole, and not the independence (or otherwise) of individual audits. If, as perceived by both firms and clients of firms, a reputation for independence is a necessary condition of continued operation, the strategic objective of maintaining that reputation will apply to owners or managers, irrespective of whether they are themselves qualified auditors.

Therefore, the critical dimensions that link ownership and management structures and independence in the larger audit firms are the motivations of those owners (or those who effectively exercise ownership functions) and managers with respect to the internal control functions and the subsequent motivations placed on the individual auditor(s) with operational responsibility for individual audits. The general emerging view from the interviews appears to be that the ownership restrictions do not, on their own, particularly help or hinder the conflicts that can arise between the interests of those exercising ownership or management functions and the overall interest of the firm to produce independent audits. (There is a general acknowledgement that there are some specific issues of ownership and conflict—see below—but that these can be addressed outside the rules restricting majority ownership and management to auditors.)

There is some support that having auditors (or ex-auditors) in a management role can be useful in ensuring that audit quality and independence are well managed. Experience of issues faced by those with operational responsibility for individual audits is seen as a valuable input into the overall management of the firm, but other skills and expertise would also be useful in this respect. Removing the majority requirements could change the management of firms, but this would not necessarily be for the worse.

The (few) smaller audit firms interviewed (ie, below mid-tier size, with few partners) were more likely to see the ownership restrictions as delivering benefits with respect to independence. For the reasons set out above, in small firms the ownership and management restrictions are more closely aligned with individual audits, and hence these restrictions may be more directly effective, although they may still be duplicative.

Notwithstanding these general conclusions, there are clearly circumstances when the ownership of audit firms by non-auditors could create specific conflicts which could lead to pressure to compromise audit quality or independence. An audit firm owned by an entity that also owned the audit client could have a commercial interest in compromising the quality or independence of the audit. However, such direct conflicts could be avoided by relatively simple, and much narrower, ownership restrictions (for example, a rule prohibiting a firm from auditing a company where there is a significant degree of common ownership).

In addition, if the ownership of the firm is widely spread, any particular (part-) owner with a specific interest in the audit client would find it difficult to exert such an influence on the firm. The potential negative consequences from the reputational damage would be likely to be significant, while the benefits to owners without the specific interest in the audit client would be minimal, if not non-existent. For cases where the potential conflict between owner and audit independence is related to the owners' interest in some other entity (eg, the audit client), it is the *concentration* of ownership that, at least partly, causes the problem. Only through concentration can the owner exert pressure on the operation of the firm with respect to a particular client.

4.4 Perceptions of auditors' independence—survey results of audited entities across Europe

As set out in section 2, a survey was undertaken among EU companies regarding their views on auditor independence. Copies of the survey template are included in Appendix 2.

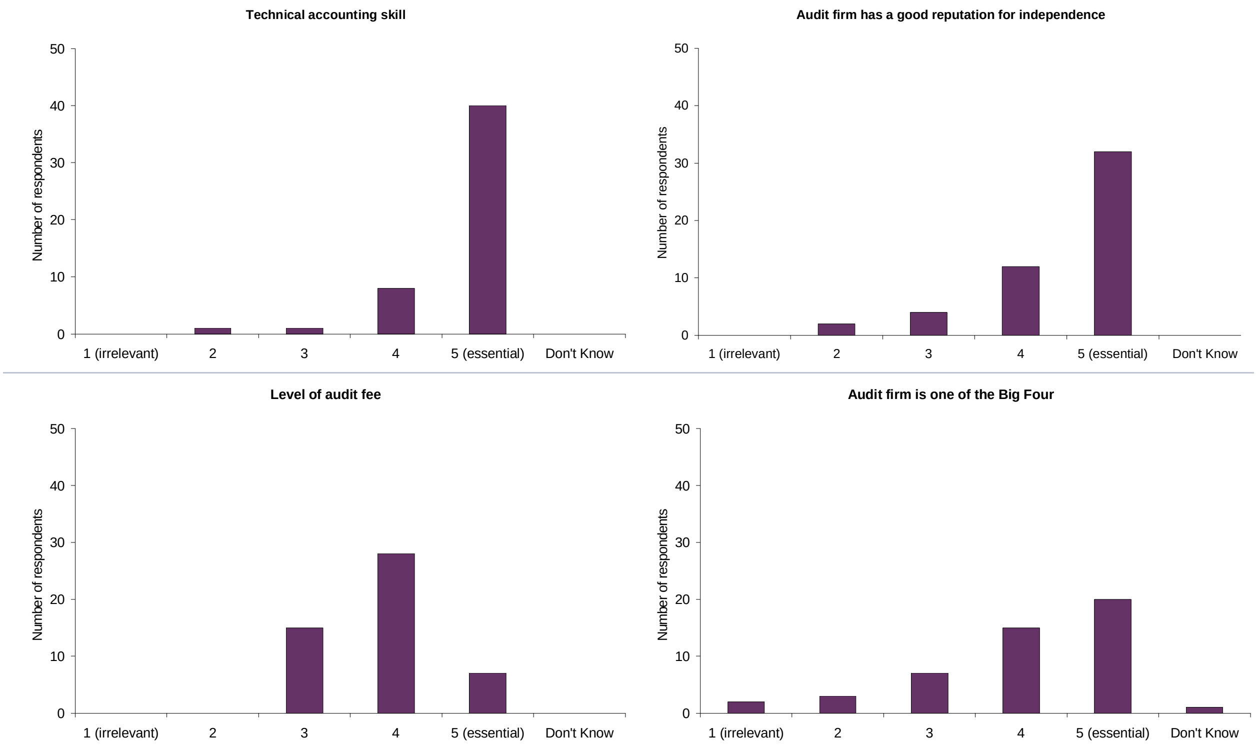
A total of 50 fully completed survey questionnaires were received from companies, representing a 10.6% response rate. Of these 50 responses, 22 of the EU 25 Member States are represented, and, of these, 11 responses come from the new Member States. The companies surveyed represented the largest listed companies in each country and come from a range of industries. The full results of the survey and its respondents are provided in sections A2.4 and A2.3 respectively.

4.4.1 Perception of auditor independence

Figure 4.3a shows that companies take a variety of factors into account when choosing an audit firm, and the results of this survey are broadly consistent with those of the London Economics (2006) and Oxera (2006) reports.

Figure 4.3a Factors that influence the choice of audit firm

On a scale of 1 to 5, where 5 is essential and 1 is irrelevant, how do you rate the following factors when choosing an audit firm to carry out the statutory audit of your company?

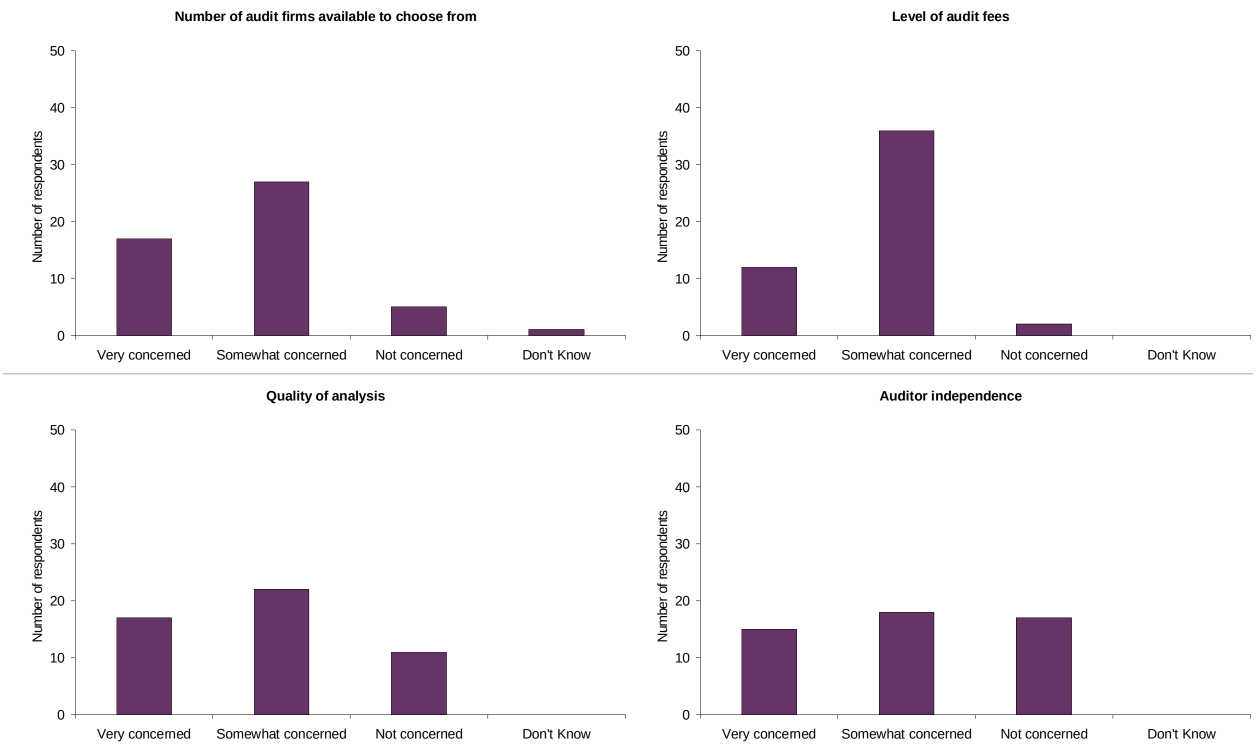


Source: Oxera survey.

The results in Figure 4.3b indicate that there is considerable concern about the degree of choice available in the audit market, and that this is combined with a concern about the level of fees—the two may, of course, be linked. There appears to be relatively less concern about the quality of audits and the independence of auditors. This may reflect the large number of policy initiatives, in recent years, which have been directed at these issues, and which may have alleviated many of the concerns that arose following the various accounting scandals in the USA and Europe.

Figure 4.3b Policy issues in the European audit market

Given the current state of the audit market in Europe and the development of new policy initiatives, how concerned are you about each of the following policy issues?

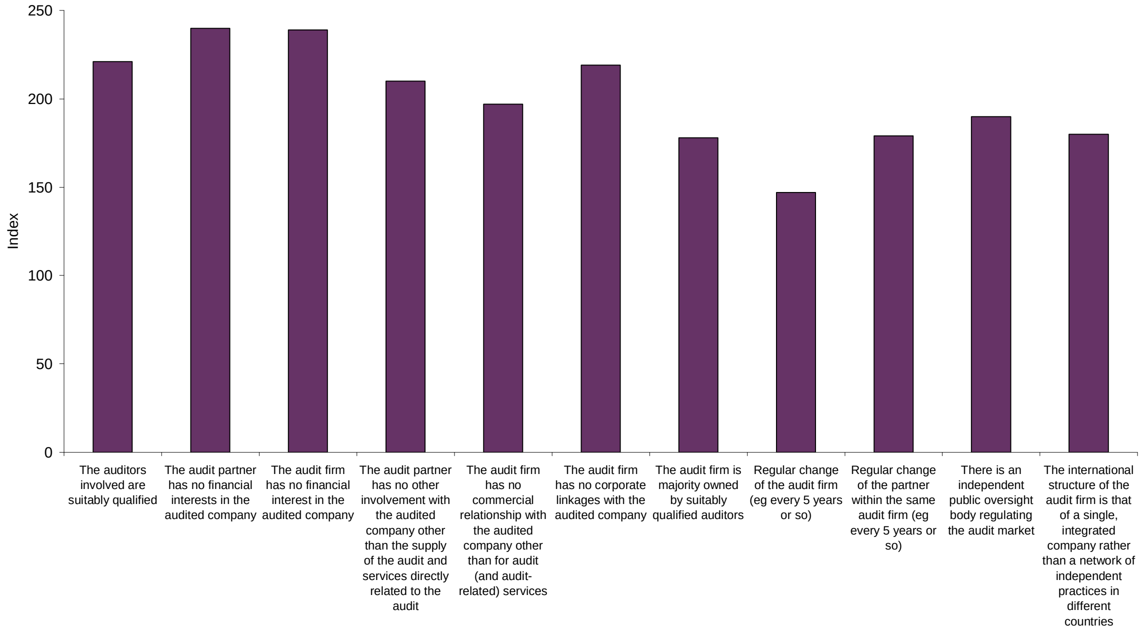


Source: Oxera survey.

The results from Figures 4.3c and 4.3d show that companies perceive the most important drivers of auditor independence as being focused on the audit firm and audit partner having no financial interests with the client, relative to other factors. At the same time, the audit firm having commercial and corporate linkages with the client as a whole appear to be less of a concern relative to having financial interests in the client.

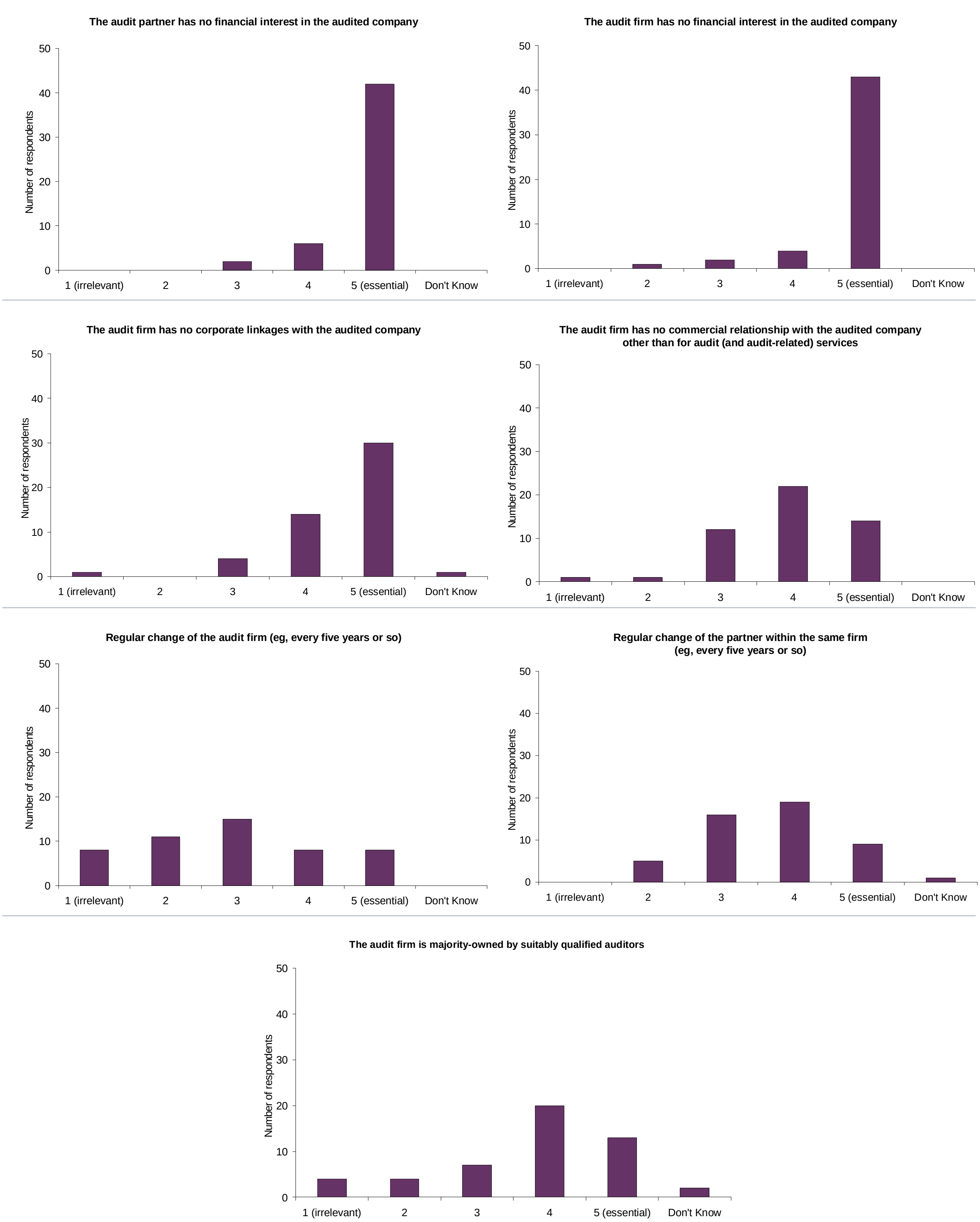
Figure 4.3c Factors that affect the independence of an audit

What is the relative importance of each of the following factors in ensuring that an audit is independent?



Note: An index of responses weighted by the different scores for each factor is presented.
Source: Oxera survey and calculations.

Figure 4.3d Factors that affect the independence of an audit



Source: Oxera survey.

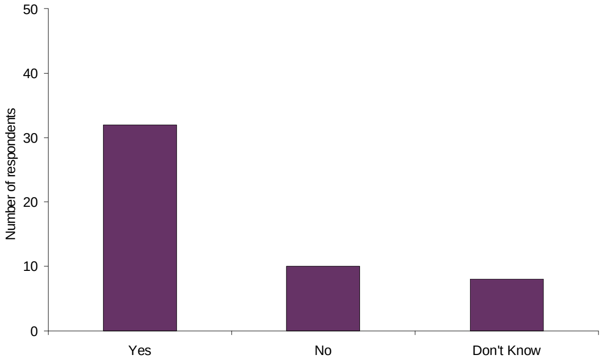
The results in Figure 4.3d also indicate that regular rotation of the audit firm or the audit partner is not considered to have the same impact on independence, and, when compared with the other factors, majority ownership of audit firms by auditors is also of less significance. Again, many of the policy initiatives in recent years have focused on removing potential conflicts of interest between the auditor and the client, and these results could be reflecting this emphasis.

4.4.2 Ownership rules

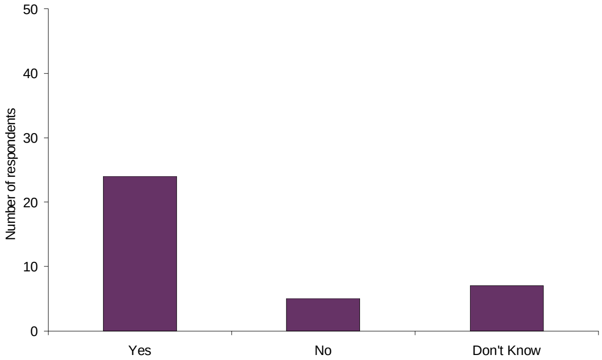
Figure 4.4a relates directly to the ownership rules and shows that 32 of a possible 50 company respondents are aware of such rules. The responses in Figure 4.4b also reveal that companies would be very unwilling to sacrifice quality of the audit and independence in return for increased choice in the market.

Figure 4.4a Awareness of ownership rules for audit firms

Are you aware of any rules that restrict the level of outside ownership of audit firms in your country?



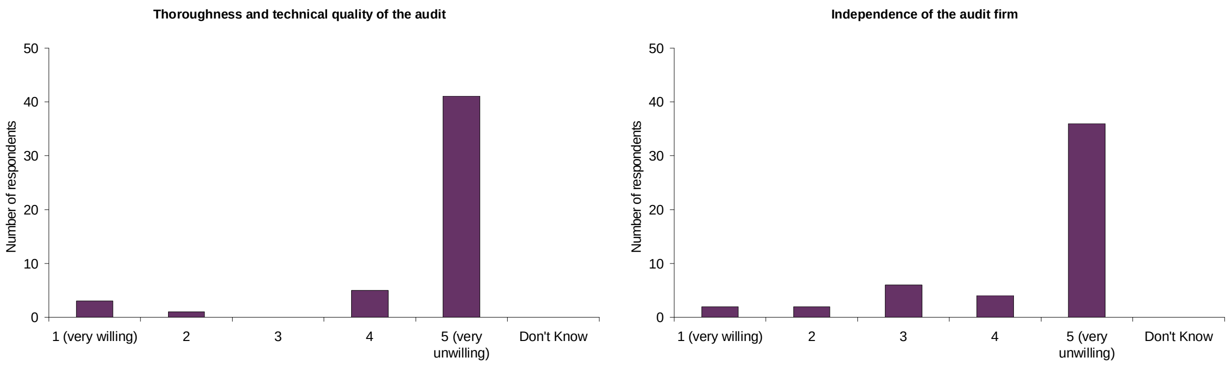
If YES, do you think that these rules were put in place to ensure independence of the audit firm?



Source: Oxera survey.

Figure 4.4b Trade-off from relaxing current ownership restrictions

If it were possible to increase the number of suitably qualified audit firms for your company to choose from, would you be willing to sacrifice any of the following to achieve this? On a scale of 1 to 5, where 1 is very willing and 5 is very unwilling.



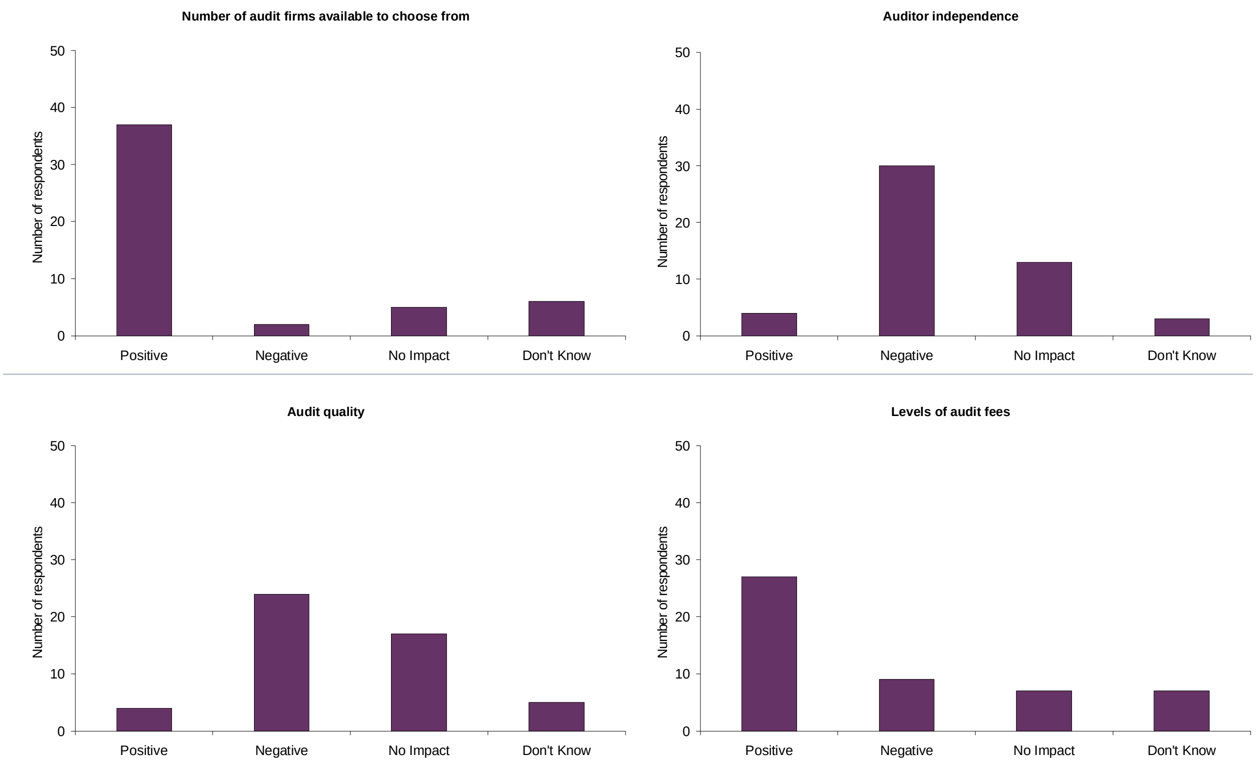
Source: Oxera survey.

4.4.3 The impact on ownership structures

It can be inferred from the responses shown in Figure 4.5a that respondents believe that ownership rules do, in some way, act as a barrier to entry, as it is believed that their relaxation would increase choice in the market and, to a slightly lesser extent, reduce audit fees. However it is also apparent that it is believed that audit quality and independence would be adversely affected by any relaxation of the rules, and Figure 4.5b indicates that the quality of the audit might be compromised by commercial pressures. However, Figure 4.5c suggests that the existence of an independent public oversight body could partly mitigate this potential negative effect.

Figure 4.5a The effect of relaxing ownership rules

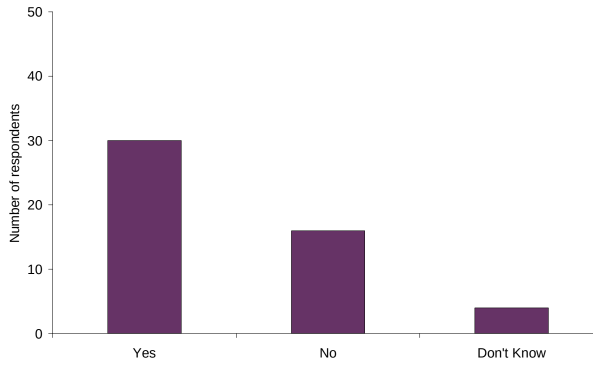
If ownership rules were relaxed, so that non-auditors were allowed to own the majority of voting rights in an audit firm, what impact do you think this would have on the following?



Note: For the 'Levels of audit fees', the 'positive' response refers to a decrease in the fee level.
Source: Oxera survey.

Figure 4.5b Commercial pressure resulting from relaxing ownership rules

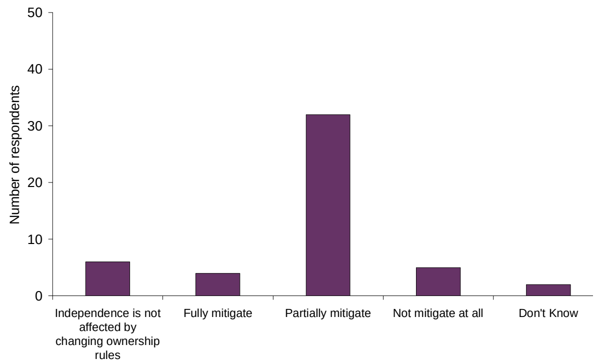
If ownership rules were relaxed, so that non-auditors were allowed to own the majority of voting rights in an audit firm, do you think that audit firms would come under pressure to sacrifice audit quality for commercial gain?



Source: Oxera survey.

Figure 4.5c Public oversight boards—mitigation of potential negative effect on auditor independence

If ownership rules are relaxed so that non-auditors can own the majority of voting rights in an audit firm, to what extent would the existence of an independent public oversight body regulating the audit market help mitigate the potential negative impact of such a change on auditors' independence?



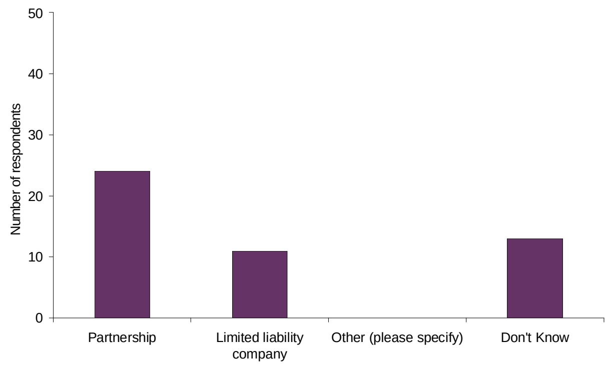
Source: Oxera survey.

4.4.4 The legal form of the audit firm

The survey results depicted in Figures 4.6a and 4.6b show that audit clients believe that audit firms can take the form of partnerships or limited liability companies, and perceive these legal forms to have a positive impact on both audit quality and independence where the former appear to be more than twice as likely to be associated with the highest level of independence and quality than the latter. The results in Figure 4.6c below also indicate that, for the majority of companies, the corporate or legal form of the audit firm would not influence the choice of audit firm.

Figure 4.6a Legal form of the audit firm—impact on independence

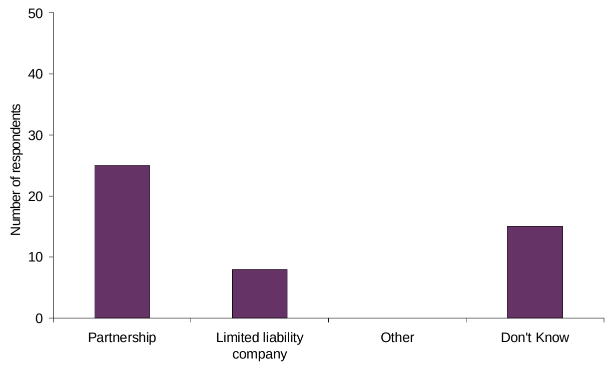
What legal form do you think provides the highest level of auditor independence?[94]



Source: Oxera survey.

Figure 4.6b Legal form of the audit firm—impact on audit quality

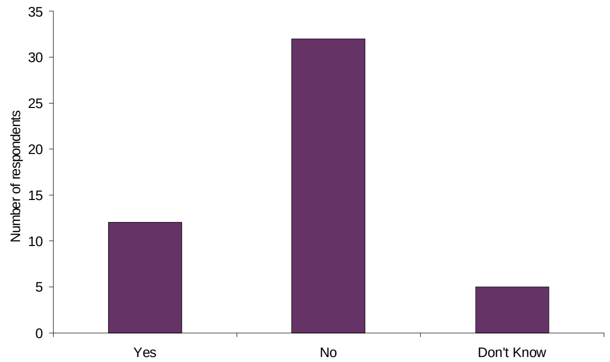
What legal form, do you think, provides the highest level of audit quality?



Source: Oxera survey.

Figure 4.6c Legal form as a choice factor

Would the legal form taken by an audit firm (partnership, limited liability company, other) influence you in your choice of auditor?



Source: Oxera survey.

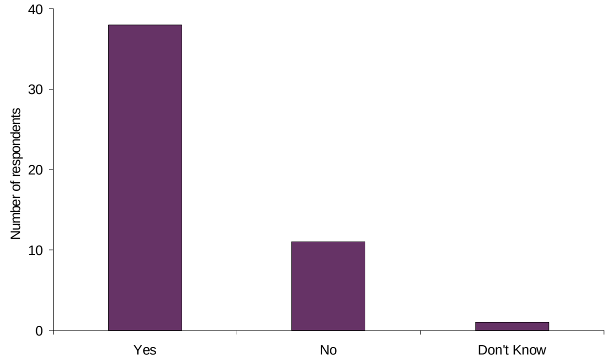
[94] From the research of the literature on corporate form and from interviews undertaken, it is apparent that there may be an association between the partnership form as the common legal form of an audit firm.

4.4.5 The management board

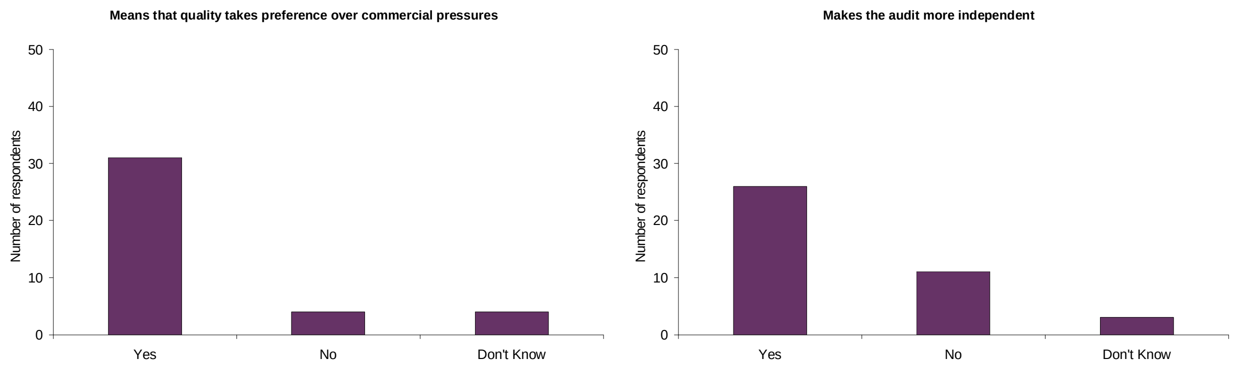
The results in Figure 4.7 show that company respondents believe that quality and independence are positively related to having a majority of auditors on the board. Again, these results should be treated with a degree of caution, as this could reflect misperceptions of what the real drivers of independence and quality are in an audit firm.

Figure 4.7 The composition of the management body and its effects

Do you believe it is necessary for the majority of the members of the management body of audit firms to be qualified auditors?



If YES, please indicate if you think that having the majority of members of the management body as auditors:



Note. Some of the respondents to the following questions replied 'no' or 'don't know' to the previous question.
Source: Oxera survey.

4.4.6 Other factors

Respondents were asked, in a final section, to identify any other factors affecting the independence of auditors. Additional comments that were not covered by the survey questions included self-regulation by accounting bodies as an important factor in ensuring that the statutory audit is independent, as well as the involvement of an audit committee.

When asked to suggest changes that could make the statutory audit more independent, there was a range of comments, from noting that independence was already sufficient, to the need to reinforce the power of the supervisory body and to introduce a public oversight body. Another factor that would improve independence is transparency. In this context, Article 40 of the amended Eighth Directive is designed to improved transparency through increased dissemination of information. More importantly, Article 49 of the Directive, which requires more transparency on the fees charged by auditor to the company, aims to address independence concerns.

4.4.7 Summary

It is important to note here that this survey concentrates on perceptions of independence and quality. The results of the literature survey have shown that there is little agreement on what drives independence and quality, and the importance of ownership structure has been examined infrequently. It could be that, as a result of companies having incomplete information about the internal organisations and structures of audit firms, they are not really in a position to make an informed judgment as to the degree of independence or quality of a particular firm.

The survey highlights that concentration and choice are key concerns for the companies surveyed, but importantly that the companies are not willing to sacrifice auditor independence or audit quality.

More than half the survey respondents were aware of the existence of rules on audit firm ownership. While they believed that a relaxation of these rules would have a positive effect on the choice of audit firm and the level of fees, they also believed that this would be accompanied by a detrimental impact on independence and audit quality. The existence of a public oversight board was viewed to mitigate these negative effects, but only to a certain degree.

The results indicate that respondents believed that partnerships had a positive impact on independence and audit quality. However, the results also suggested that the legal and corporate form of an audit firm had little bearing on the process of choosing an audit firm. With regard to the management board, it was viewed that the majority of the board should be made up of qualified auditors.

4.5 Perceptions of auditors' independence—results for investors in audited entities across Europe

As set out in section 2, investors from across the EU were surveyed and interviewed from two different perspectives. As investors in companies, their views on the statutory audit were sought, as they are the main users of audited accounts. In addition, attempts were made to ascertain the criteria investors might use if they were to consider investing in audit firms following any relaxation of the ownership rules.

With regard to the latter, it became apparent during a number of interviews that the possibility of taking equity stakes in audit firms had not been considered by any of the interviewed investors. Therefore, their perceptions of what investment criteria they might use had not been formed and they were unable to give definitive responses.

The investors that were contacted come from across Europe and a full list of participants can be found in Tables A1.1 and A3.1.

Overall, the results of the interviews and the survey revealed a wide range of responses. There was a contrast between those who felt that there was no link between ownership rules and independence, and those who believed that ownership rules had been put in place to ensure the independence of the audit, albeit with other safeguards also helping to achieve this aim. Elsewhere the view was expressed that the ownership restrictions were not the best or only means of ensuring independence.

Furthermore, some held the view that a distinction needed to be made between quality and independence and, following on from this, that ownership rules had an impact on the former rather than the latter. There was some concern over potential conflicts of interest emerging as a result of outside ownership, although it was felt that these could be potentially mitigated by other safeguards, such as limiting the extent of ownership by an individual investor in a particular audit firm.

In addition, it was felt that the incentives for non-audit owners of audit firms to seek to limit the quality or independence of the audit would be offset by the need to maintain the value of the investment by ensuring that quality and independence were maintained, which, in turn, would maintain the strength of the brand. However, where perceived conflicts of interest remained, an investment in one of the Big Four audit firms would in fact have the adverse effect on choice whereby the investor in that audit firm would now only be able to choose three of the Big Four audit firms.

For those investors who commented on the potential investment in the audit market, they were not convinced that access to capital would necessarily lead to the emergence of a 'quality' audit firm that would compete at the level of the Big Four. One reason for this was the conservatism of the market, akin to that found in the legal profession and other industries where employee owned firms were prevalent, as perceived conflicts of interest remained an important factor.

One investor interviewed commented that, in relation to the audit fee, it could be argued that outside investors would want audit firms to have all capital, including financial capital, rewarded according to risk. It was suggested that the need to factor the remuneration of capital into the audit fee might have an adverse impact on prices from the point of view of the audit client.

As previously noted, most investors had not considered fully the possibility of investing in an audit firm, and their views had therefore not necessarily been formulated in any great detail. With regard to audit firms as an investment opportunity, several of the potential investors suggested that if a sufficiently attractive return were offered, they would consider an investment. However, investors interviewed by Oxera highlighted some factors that had restricted any investment in the past, even in countries where minority stakes by outside owners were allowed. These factors included a lack of reliable financial data being produced by audit firms, particularly in relation to the rates of return that could be generated by the audit business. However, the investors did not see any particular issue that might arise with respect to making an investment in a services company that did not possess substantial tangible assets.

Investors also considered that there would need to be significant changes to audit firms' corporate governance regimes if outside investment were to be obtained. There would need to be evidence that procedures were in place to maintain confidentiality with regard to information gained during the audit process. As part of the changes to the corporate governance regime, it might be necessary for audit firms to appoint independent non-executive directors who could represent the interests of outside owners and mitigate the agency problems that arise once outside ownership is introduced to any company. However, in many countries, the criteria for ensuring the independence of non-executives are very strict, while, in order to maximise the benefits of their appointment, it is also essential that individuals have sufficient relevant experience. It was therefore argued that finding suitably qualified non-executive directors who also met the independence criteria could be problematic for audit firms.

4.6 Summary

Although there is a substantial amount of literature on the concept of independence, the notion of independence is still a difficult concept to define. Actual independence is generally unobservable, leaving perceived independence to be examined most frequently in the economic literature. There are many academic articles that examine the threats to independence and, in particular, their relative importance; however, the review of this literature has indicated that there has been little research into management and ownership composition as a threat to independence.

The frameworks for ensuring independence vary from country to country. For example, in France it is protected by legislation—statutory auditors come under the purview of the Ministry of Justice and activities deemed to jeopardise the independence of statutory auditors are stated in legislation. In contrast, other countries take a high-level approach to independence rather than setting out specific rules and regulations.

The example of the legal profession provides a framework in which liberalisation and independence issues have been examined. Although non-lawyer managers and external ownership of legal firms have been proposed, these have been balanced with measures to protect and ensure lawyer independence by various means.

The results from the survey indicate that independence and audit quality are important factors for companies when considering the choice of auditor, and that they are unwilling to sacrifice either of these to improve choice or concentration in the audit market.

5 Rationales behind the ownership and governance structures of audit firms in Europe

5.1 Overview and main findings of this section

This section describes and analyses ownership, governance and management structures typically adopted by audit firms across the EU Member States.[95] It also examines the potential drivers of the observed structures and their key implications for this study. The analysis presented below focuses on the following issues:

– the adoption of predominant ownership structures by audit firms and the linkages between ownership structures and legal forms of the audit firms in the EU Member States (section 5.2);

– the corporate governance and management structures of audit firms at the national level, and how these structures are affected by the ownership structures of audit firms (section 5.2);

– the ownership and management structures of audit firms in the international context and the relationship between the adopted structures and the issue of auditor liability (section 5.3);

– the drivers for the ownership structures adopted by the audit firms in addition to the legal ownership restrictions (section 5.4).

The discussion of the observed structures needs to be considered in the context of the conceptual framework described in section 2. The following issues are of particular importance in this context:

– **drivers of corporate structures adopted by audit firms**: the economic drivers of adopted structures need to be considered in light of the existing rules (binding constraints);

– **implications of the adopted structures compared with potential alternative structures**: the adopted structures might have implications for audit firms' access to capital.

The conclusions from the review of ownership, governance and management structures are summarised in section 5.4. The primary conclusion is that audit firms seem to derive important benefits from the adopted ownership structures (employee ownership by senior managers), independently of existing legal restrictions on ownership. These benefits include the following (see section 5.4 below for details):

– **human capital**: in the case of audit firms, employee ownership seems to create more economically efficient levels and forms of remuneration for the key employees than alternative ownership forms (eg, investor ownership). Also, employee ownership seems to provide mechanisms for retaining human capital as well as to create incentives for senior employees to mentor junior employees and develop tacit skills, which represent an important component of the audit service;

[95] The terms ownership, governance and management structures are described in section 5.3.

– **signal of quality**: employee ownership and the resulting profit sharing among senior auditors might act as a mechanism to signal the quality of the audit service to the market. This type of signalling is important for the audit firm, as clients of audit firms might face difficulties monitoring the quality of the audit service and thus have to rely on signals sent by the audit firms.

These benefits do not seem to be explicitly linked to the legal restrictions on the ownership of audit firms across different jurisdictions. This conclusion might have important implications for the study, for two reasons:

– it implies that, independently of legal restrictions on ownership, employee ownership would provide important benefits for the audit firms;[96]

– it indicates that, at present, ownership restrictions might not represent a binding constraint on the choice of ownership form by the audit firms.

At the same time, although there currently seem to be benefits of employee ownership for audit firms, there are examples of alternative ownership structures (investor ownership) in the audit market (for example, Tenon in the UK and McGladrey & Pullen in the USA—see Appendix 4).

Moreover, Oxera's interviews indicated that because, financially, the difference between compensating human capital by providing profit shares (employee ownership) and compensating human capital as a cost (investor ownership) might be small, investor ownership could, in theory at least, provide benefits similar to those created by employee ownership in terms of efficient management of the human capital.

It is also noteworthy that one of the primary drivers for adopting an investor-owned structure in the audit market has been the need to raise funds to acquire other audit firms. However, in practice, the merger between Grant Thornton and RSM Robson Rhodes in the UK was between two employee-owned audit firms, which, in principle, might not require a payment to owners.

There is evidence to suggest that, looking forward, the benefits of employee ownership for audit firms might decrease relative to the potential costs:

– current developments in the audit profession (eg, the increasing outsourcing of certain elements of the value chain to low-cost locations) may indicate the changing nature of the audit service and the diminishing role of human capital and increasing scope for monitoring the quality of audit service. This would suggest that the primary benefits of employee ownership (human capital and signalling) might be becoming less important;

– evidence from other comparator sectors—in particular investment banking (see section 4.2)—indicates that an increasing capital intensity of the business might lead to the transition from employee ownership to investor ownership. The more capital is required to finance the business, the smaller appear to be the benefits of employee ownership relative to the costs, such as the limited access to capital (see section 6).

Another observation is that, although the observed managerial and corporate governance arrangements in audit firms seem to be similar to those in investor-owned firms in terms of the structure, the functionality of these arrangements seems to be significantly affected by employee ownership of audit firms.

[96] Employee ownership might also have disadvantages in terms of costs, for example limited access to capital compared with investor ownership. The impact of employee ownership on access to capital is discussed in section 6.

Importantly, the review of the process of decision-making in audit firms seems to indicate that alternative ownership and management structures, where control over the audit firms is with external investors (non-auditors), are unlikely to have a significant detrimental effect on auditor independence. However, the perception of the importance of ownership independence for auditor independence varies from company to company and from audit firm to audit firm (as discussed in section 4).

The above issues are dealt with in detail below.

5.2 International structures of audit firms and networks

This section describes the ownership, governance, and management structures typically adopted by audit firms across the EU Member States at the national level. It begins with a discussion of the ownership structures and legal forms, followed by a description of the governance and management structures. The discussion focuses on the implications of the adopted structures for the decision-making process within a firm in the context of the potential linkages between management structures and the independence of individual audit decisions.

In addition to typical corporate structures and legal forms, some audit firms adopt less common structures (Appendix A4 looks at some examples). These cases include audit firms that are, effectively, subsidiaries of other (non-audit) firms, which might also be publicly quoted. More specifically, certain legal and contractual arrangements allow an audit firm de facto to constitute a part of a listed company, while de jure complying with the independence and ownership requirements.

The section concludes that, although the observed managerial and corporate governance arrangements in audit firms seem to be similar to those in investor-owned firms in terms of the structure, the functionality of these arrangements seems to be significantly affected by the employee ownership of audit firms. In particular, it appears that audit partners seem to have less control over the management of audit firms than investors in investor-owned firms. Thus, the management of audit firms might be able to enjoy greater discretion.

5.2.1 Overview of legal forms and ownership structures

In the EU Member States, most existing national legal restrictions define the legal forms available to audit firms, and impose restrictions on their ownership structures (see section 3). As a result, legal forms and ownership structures adopted by the audit firms need to be discussed in the context of existing restrictions.

Comprehensive information on the legal forms of audit firms in the Member States is not yet available. This should change when the Eighth Directive is fully implemented, as audit firms will be required to make this information publicly available as part of their transparency report.

Legal forms

The choices of legal form and associated ownership structure for any firm are closely related. For example, a firm that wishes to access public equity markets might need to adopt a specific legal form (eg, Aktiengesellschaft (AG) in Germany, plc in the UK, société anonyme (SA) in France, or Spółka Akcyjna (SA) in Poland). At the same time, if a firm wishes to distribute ownership rights among its employees then a partnership-like structure might be appropriate.

The relationship between the legal form and the adopted ownership structure, where the latter often constitutes the driver behind the choice of the former, can be observed in the case of audit firms. The majority of audit firms across the EU Member States are employee-owned. (Ownership structures are described in greater detail below.) Although the legal forms adopted by firms often differ across countries, they are typically related to the chosen ownership structure within the boundaries of national legislation. For example, auditors adopt the following legal forms in Germany, France, UK and Poland (see also section 3).

– **Stock corporation or public limited company**: in Germany, this is equivalent to AG. All companies must have a supervisory board (Vorstand) as well as a management board (Aufsichtsrat), although individuals are prohibited from sitting on both boards at the same time. The minimum capital requirement is €50,000. All publicly traded companies must be an AG, but not all AG are publicly traded. In France, this is broadly equivalent to an SA, a joint stock corporation, or a société par actions simplifiée (SAS), a simplified joint stock corporation.

– **Limited liability company**: in Germany this is broadly equivalent to Gesellschaften mit beschränkter Haftung (GmbH) or a private limited liability company. Only firms with more than 500 employees are required to have a supervisory board (Vorstand). The minimum capital requirement is €25,000. In France, a société à responsabilité limitée (SARL) represents a similar legal form, which can be described as the limited liability company (private).

– **General partnership**: in Germany this is Offene Handelsgesellschaften (OHG), equivalent to the unlimited liability company or the general partnership in the UK. It must have at least two partners, and all partners have unlimited liability. For comparison, in France, statutory audit firms cannot be organised as a ‘société en nom collectif’ (SNC), which can be seen as equivalent to a general partnership.

– **Limited partnership**: in Germany, this is Kommanditgesellschaften (KG), equivalent to a limited partnership in the UK. It must have at least two partners, where at least one partner has liability limited to their individual capital contribution and at least one partner has unlimited liability. In France, the limited partnership structure does not exist as such, but it might be compared with a ‘société en commandite simple’ (SCS)—a partnership with both limited as well as unlimited partners, in which there are two types of partners: those who have unlimited liability with respect to the company’s indebtedness and those who have limited liability.

– **Professional partnership**: in Germany, this is a legal form known as Partnerschafts gesellschaften, broadly equivalent to the limited liability partnership (LLP). All partners have limited personal liability in this case.

– **Association limited by shares**: in Germany this is known as Kommanditgesellschaften auf Aktien (KgaA), a limited partnership with shares. In Poland, the equivalent is Spolka Komandytowa, which is the legal form adopted by some of the smaller professional services firms.

In Ireland, the set of legal forms allowed for audit firms is narrower than, for example, in Germany or France. Irish law stipulates that audit firms cannot adopt the structures of a limited liability company or an LLP. Accordingly, auditors are either sole practitioner accountants or partnerships of accountants.

In the UK—a jurisdiction with some of the largest audit firms of any jurisdiction in Europe—auditors are allowed to choose any legal form; either an individual or a firm can be appointed as a company auditor. A firm is either a body corporate or a partnership. Table 5.1 below presents examples of legal structures adopted by audit firms in the UK. This suggests that the majority of audit firms in the UK are in fact in the form of partnerships.

Table 5.1 Legal forms of audit firms in the UK

Structure	Accounting firms
Limited liability partnership	PwC, KPMG, Ernst & Young, Deloitte & Touche, Grant Thornton, BDO Stoy Hayward, PKF, Mazars, RSM Robson Rhodes, Horwath Clark Whitehall, Moore Stephens, Macintyre Hudson, Cooper Parry
Unlimited liability partnership	Baker Tilly, Bentley Jennison, Chantrey Vellacott, Kingston Smith, Menzies, Scott Moncrieff, Saffery Champness, Wilkins Kennedy, Armstrong Watson and Begbies Everett Chettle
Limited company	Tenon Audit, Nexia Smith & Williamson Audit
Public limited company	HLB Vantis Audit, HLB AV Audit
Group of partnerships	UHY Hacker Young

Source: FRC (2006), 'Professional Oversight Board: Key Facts and Trends in the Accountancy Profession', November, pp. 38–41.

According to the Oxera interviews, in France the audit firms also operate like a partnership , similar to the UK. As noted above, one commonly adopted form in France is the société anonyme, which is similar to the plc legal form.[97]

In this context, it is important to review the characteristics of partnerships, since partnership-like corporate structures are commonly adopted by audit firms across the EU Member States, and partnership forms as such dominate some audit markets. For example, a firm might adopt a limited liability company legal form with ownership distributed among senior managers with no outside shareholders, as in the case of partnerships.

Legal forms adopted by employee-owned firms with partnership-like corporate structures are presented in Table 5.2. For illustrative purposes, the general partnership form is chosen as a benchmark case for comparison. Other types of partnerships are described in reference to the general partnership form. For example, the LLP form (broadly similar to Partnerschafts-gesellschaften in Germany or SA in France) is the dominant legal form adopted by audit firms in the UK, and combines characteristics of both the corporate legal form and a traditional partnership.

[97] For example, the French member firms of KPMG and Mazars are established as SA.

Table 5.2 Key characteristics of the three main forms of partnerships

Legal form	Description
General partnership (United Kingdom) Offene Handelsgesellschaften (Germany) Société en nom collectif (France)	Unlimited personal liability. Each partner has the right to participate equally in the management of the partnership. For tax purposes, the partnership is a pass-through entity; taxes are paid at the individual partner level. An individual or a legal body (such as company) can be a partner in a general partnership.
Limited partnership (United Kingdom) Kommanditgesellschaften (Germany) Société en commandite simple (France)	Constituted by one (or more) general partners and one (or more) limited partners, where relevant. General partners have unlimited liability, and limited partners have liability limited up to the level of their individual capital contributions. Only the general partners perform managerial functions. If limited partners are involved in management, they become liable in the same way as general partners. Both the general and the limited partners invest capital in the partnership, but limited partners may not draw out or receive back any part of their capital contribution.
Limited liability partnership (United Kingdom) Partnerschaftsgesellschaften (Germany) Société anonyme (France)	Partners' (or members') personal liability is limited—ie, it offers reduced personal responsibility for business debts. In contrast to limited partnerships, limited liability is granted to all partners, not just to the 'limited partners' who perform no managerial functions. Limited liability partnership is a corporate body independent of its members.

Source: The Law Commission and the Scottish Law Commission (2003), 'Partnership Law', November; Limited Liability Partnership Act 2000, July; HMRC; Companies House; Business Link.

Legal form and liability

The liability of the owners of the audit firm, described below, is dependent on the legal form of the audit firm, irrespective of the signatory of the audit report.[98]

The LLP offers limited liability to its members, similar to the corporation, and is characterised by a tax pass-through regime, which is similar to partnerships. Furthermore, UK law classifies the LLP as a corporate legal form rather than a partnership per se. One of the main implications of the above is that an LLP exists as a legal entity independently of its members. In particular, the LLP legal form is independent of the status of its members.

The LLP itself is liable for the full extent of the partnerships' assets, while the liability of partners is limited to the amount of money invested in the business and to any personal guarantees that partners may have provided in order to raise finance for the business. Depending on the legislation of individual Member States, a LLP can sometimes shield partners from the consequences of malpractice by an offending partner. This arises because the LLP is established as a separate legal entity, which means that a third party will enter into a contract with the LLP, rather than an individual member of the LLP. A less clear-cut issue is

[98] In contrast to the liability of the owners of an audit firm which depends on the legal form, the signatory of the audit report is liable in all EU countries except for Austria (where, under law,, only the audit firm is liable to the client), and the UK (where the audit firm is the statutory auditor). Source: Commission Staff Working Paper, 'The Legal Systems of Civil Liability of Statutory Auditors in the European Union—Update of the Study Carried out on behalf of the Commission by Thieffry & Associates in 2001', Annex II, supplied to Oxera by the European Commission.

whether the LLP has any liability to make a contribution to the assets in the event of liquidation of the LLP.[99]

Under a general partnership, in contrast to the LLP, partners are typically jointly liable for all debts and obligations owed by the partnership. This means that partners are equally responsible for paying off these obligations. In some Member States, partners may be severally liable, with each partner responsible for paying off the entire debt and obligations of the partnership. Under a general partnership, if any loss or damage arises from any wrongful actions or omissions of any of the partners, each partner is typically jointly and severally liable.

Under the limited partnership, general partners have unlimited liability. If the business were to fail, creditors would therefore have the authority to seize or sell assets belonging to the general partner, such as their home or other personal assets. General partners can be held personally liable for all unpaid partnership debts and obligations, including breaches of fiduciary duties owed to the limited partners. In contrast, limited partners are not liable for the debts and obligations of the partnership or of other partners.

Ownership structures

As noted above, the majority of audit firms in the EU Member States are employee-owned. The key characteristic of this ownership structure is that ownership rights are distributed among the employees of the company.

The ownership of audit firms is typically evenly distributed between the senior employees of the firm. This can be contrasted with other types of employee-owned firms, where ownership is widely spread among all employees. This has implications for the allocation of effective control rights in the audit firm (see sections 5.2.2 and 5.2.3).

While the legal form is often chosen to reflect the ownership structure, it is important to recognise that the ownership structure, rather than the legal form, might have implications for access to capital. The main implications of employee ownership on access to capital are reviewed in section 6. The main possible reasons for why audit firms tend to retain employee ownership, in addition to the European and national legislation, are discussed in section 5.4 below.

At the national level, a typical ownership structure of an audit firm consists of a parent company, which provides audit services and typically takes a partnership-like form, as well as subsidiary companies, which are engaged in related business activities. Although the parent company might not be a partnership, in most cases senior employees would own it. The related activities include a number of professional services such as tax and business advisory services as well as insurance or investment management. The tax advisory business, which often constitutes an important part of the group alongside audit and business advisory services, is either a part of the parent or is registered as a separate entity. Although the precise arrangements differ by company, in practice the dominant structure often combines audit and tax services as two parts of the same entity.

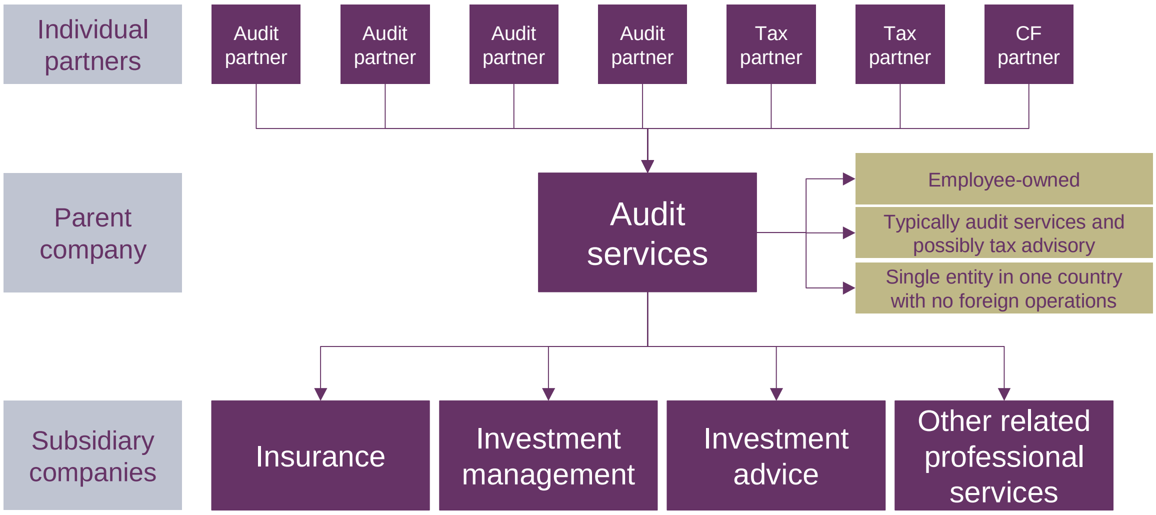
At the national level, the ownership structure of an audit firm typically includes several entities (subsidiaries); however, audit services are often conducted as part of a single corporate entity within a given jurisdiction. In most cases, this entity is the parent company of the group.

A typical ownership structure of an audit firm is illustrated in Figure 5.1 below. In addition to this typical structure, there are examples from the UK (Tenon and Numerica) and USA

[99] Hannigan, B. (2003), 'Limited liability partnerships', University of Southampton.

(McGladrey & Pullen), whereby audit firms have adopted less typical legal structures (discussed in Appendix 4).

Figure 5.1 Typical ownership structure of an audit firm at the national level



Note: CF, corporate finance.
Source: Interviews and review of public sources.

In the case of some firms, partners could be differentiated between the equity and the non-equity (or salaried) partners, where the former are typically referred to as 'members'. In these cases, the actual, legal partners of the partnership are not referred to as 'partners', which may be confusing. For example, as noted by Grant Thornton:

> Within our organisation, the term 'Partner' indicates a member or a senior employee of Grant Thornton UK LLP, who is not in partnership for the purposes of the Partnership Act 1980. Members are those partners with ownership rights in Grant Thornton UK LLP.[100]

Typically, members have voting rights, while equity partners do not. There is also a further distinction between designated members and other members. The senior management roles in the audit firm are often performed by the *designated* members, which typically have responsibilities beyond those assumed by non-designated members. The key differences between a member and a designated member are discussed in the box below.

What is the difference between a member and a designated member?

In general, designated members have the same rights and the same duties towards the LLP as other members. These rights and duties are governed by the LLP Agreement. Designated members have responsibilities in addition to those of other members, which include, in particular:

– appointing an auditor;
– signing the accounts on behalf of the members;
– delivering the accounts to the Registrar;
– notifying the Registrar of any membership changes or change to the registered office address or name of the LLP;
– preparing, signing and delivering to the Registrar an annual return and acting on behalf of the LLP if it is wound up and dissolved.

Designated members are also accountable under law for failing to carry out their legal responsibilities. With agreement from the other members, a member may become a designated

[100] Grant Thornton UK LLP (2005), 'Annual Report'.

member at any time.

Source: Limited Liability Partnership Act 2000, July.

Partners are typically assigned to specific business lines. Often, those representing the audit services business form the majority of all partners in the firm. The second largest group of partners often represents the tax business.

In some audit firms, audit partners do not constitute a majority of all partners. This is possible in some jurisdictions if, for example, some partners representing other business lines (eg, tax or advisory services) comply with the legal requirements to be classified as 'authorised auditors'. In this case the majority of all partners are 'authorised auditors', some of whom might not in effect be undertaking audits.[101]

5.2.2 Corporate governance of audit firms

A high-level description of the governance structures in investor-owned firms in the context of audit firms is provided below.

Corporate governance in investor-owned firms

Before examining governance structures, it is useful to specify what is meant by the ownership, governance, and management structures, since the exact definition of each of these terms often differs by context.

– **Ownership structure**, for the purposes of this report, refers to the distribution of the ownership rights in a firm. The ownership structure defines the legal owners of the firm and typically also defines the distribution of both the voting rights as well as the cash-flow rights among shareholders.

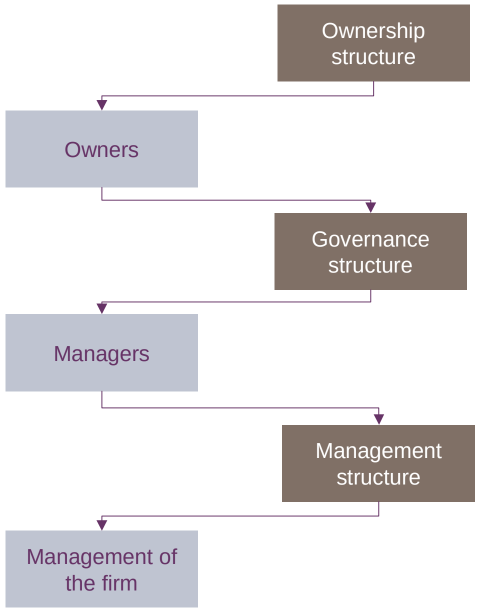
– **Corporate governance arrangements** define the relationship between the firm's owners (principals) and its managers (agents). Effectively, corporate governance describes mechanisms for the firm's owners to exercise control over the firm.

– **Management structures** represent mechanisms through which managers (agents on behalf of the owners) manage firms on a day-to-day basis. These structures also govern the process of making strategic decisions about the firm that are within the realm of managerial discretion.

This is illustrated in Figure 5.2 below.

[101] The same principle applies to the membership of the management body of an audit firm.

Figure 5.2 Stylised illustration of the difference between ownership, corporate governance and management structures



Source: Oxera.

Since owners ask managers to manage the firm on their behalf, in the investor-owned firms corporate governance rules allocate control rights to the management, but also define the limits of managerial discretion—eg, they specify which decisions require board or shareholder approval.

In a sense, corporate governance rules aim to ensure that owners can exercise ultimate and effective control over the firm, that they can monitor management, and, ultimately, secure the required returns on their investments. For example, La Porta et al. (2000) interpret corporate governance in the following way:[102]

> Corporate governance is, to a large extent, a set of mechanisms through which outside investors protect themselves against expropriation by the insiders.

Corporate governance arrangements also govern profit distribution—ie, they specify the process of making the decisions about retention of earnings and dividends payout. They also determine the scope of managerial powers and specify the types of decision that might require board or shareholder approval.

Corporate governance of audit firms

A number of important considerations need to be taken into account when describing the governance structures of audit firms, including the following:

– **ownership structure**—the majority of audit firms are employee-owned. The impact of this ownership structure on the process of internal decision-making and monitoring arrangements, which are determined by the governance structures, needs to be taken into account in light of the potential implications of restrictions on ownership structures imposed on audit firms;

– **legal restrictions**—legal restrictions, at both the national and EU level, govern the ownership composition of audit firms, as well as place limits on the composition of

[102] La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. (2000), ‘Investor Protection and Corporate Governance’, p. 1.

management bodies of audit firms. This also needs to be addressed in the analysis of governance structures.

In the context of this discussion, audit firms are referred to as partnerships (even though they adopt various legal forms) since the internal structures of audit firms, including corporate governance and management structures, resemble those of a partnership, including more or less uniform distribution of ownership rights among senior managers.

Although audit firms are almost exclusively employee-owned, their corporate governance arrangements often closely mirror the corporate governance structures of investor-owned corporations, although some important differences remain.

The main governance body of an audit firm is the supervisory board (also known as the partnership council, the board, the partnership committee, or simply the council). The supervisory board, chaired by the 'senior partner' or the 'managing partner', is typically elected by members for a period of three to five years, depending on the firm. Its key responsibilities lie in the realm of governance issues and might include profits sharing, capital issuance, or approval of new partners, as well as monitoring of the management board. The chairman of the supervisory board (senior partner) also sits on the management board.

The differences in corporate governance structures between investor-owned firms and audit firms largely stem from the ownership structures of audit firms. Since the audit firms are typically employee-owned, the same individuals often own the audit firm and manage it. This implies that, first, shareholders (partners) are the insiders of the firm. Similarly, the management board or the management body is also exclusively made up of insiders. Second, it implies that, in the case of audit firms, corporate governance determines how one type of owner (non-managers, or ordinary partners) monitors the other type of owner with managing rights (managers).

The parent company of an audit firm is typically owned by individual partners who exercise control over the firm in a way that is broadly similar to that of shareholders in the case of a corporate legal form. However, partners can be seen as wearing two 'hats', since they exercise the ultimate control over management and are also employees of the firm, they ultimately report to the same management that they are empowered to control.

This implies that audit firms typically lack any form of explicit outside control over the management and might have a limited degree of effective monitoring. This is to some extent the implication of the adopted ownership structure of audit firms, where managers are the owners.

The management body of a firm often has significant strategic decision-making power. However, in the case of audit firms, the management body might also face limited supervision. The explicit separation of shareholders and managers exists to the extent that partners vote on the strategic decisions put forward by the management, but the scope of their control over management might be limited.

It might be argued that alternative ownership forms (eg, investor ownership) could bring additional external monitoring and control, and potentially have a beneficial effect on auditor independence.[103]

While the corporate governance structures described above are common, they are not universal. For example, Appendix 4 reviews a number of cases where specific audit firms have deviated from the typical structure.

[103] Audit independence is review in greater detail in sections 3 and 4.

Partners' capital contributions and the allocation of voting rights

In a number of audit firms, the required initial capital contribution differs by partner.[104] In some firms, all new partners are asked to contribute the same amount; in others, the capital investment by each partner is the same and each partner has an equal stake in the firm.

Partners can typically withdraw the capital committed to the firm only when they cease to be partners. Furthermore, there are some examples where the members' agreement implies that the repayment of the partner's contribution is delayed relative to the date of retirement or leave. The economics of partners' capital contributions is discussed in greater detail in section 6.1.

Oxera's research indicates that partners (members) of audit firms typically have equal voting rights. In fact, the allocation of voting rights is often not linked to partners' status or seniority within the firm. Furthermore, partners' profit share is typically determined independently of their voting rights.

The 'One share–one vote' study published in June 2007[105] highlighted that there may be costs when separating cash flow and voting rights due to misaligned incentives and the absence of the proportionality rule.[106] These conclusions are in line with the substantial amount of literature on corporate governance and, in particular, the evidence on the negative impact of the separation of cash flow and voting rights on a firm's value. However, in the case of audit firms, separation of control rights from capital provision may improve access to capital, while also ensuring the necessary degree of independence. Nevertheless, this would be dependent on two factors: capital providers do not require a substantial premium for the lack of control (see section 6 for details); and limited control rights allocated to external investors do not impair a firm's decision to invest.

Allocation of profits

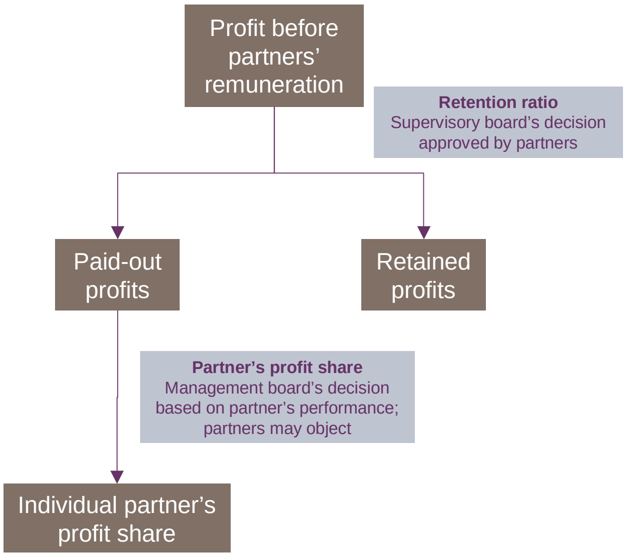
As owners of the business, partners are entitled to a share of the partnership's profits. The allocation of profits involves two important steps: first the retention ratio needs to be determined, which specifies the total share of profits that is distributed to partners; and, second, the profits need to be allocated among individual partners.

[104] An illustrative range for partners' initial contribution (when they join) for mid-tier audit firms in the UK seems to be approximately £25,000 to £300,000.

[105] Institutional Shareholder Services, Shearman and Sterling, and European Corporate Governance Institute (2007), 'Proportionality between ownership and control in EU listed companies', June 4th.

[106] The concept of the proportionality principle is that shareholders with capital at risk in a company should have a say about the conduct of that company, and that their say should be proportionate to the risk they take (ie, one share–one vote).

Figure 5.3 Illustrative process for determining partners' profit share



Source: Annual reports of various audit firms—eg, BDO Stoy Hayward UK LLP (2006).

In many audit firms, the retention ratio is determined at the international level. It is noteworthy, that, for some firms, the profits paid out to partners also incorporate country-specific adjustments for the costs of living.

The decision on the retention ratio is often the responsibility of the supervisory board. Partners typically approve the retention ratio proposed by the supervisory board by vote. Oxera's interviews indicate that cases where partners object to the supervisory board's proposal on the retention ratio are rare. Also, the evidence from the interviews suggests that the retention ratio is usually low and relatively stable over time.

The allocation of profits among individual partners is often the responsibility of the management board or remuneration committee. The profit share of the chairman of the supervisory board (the senior partner) is often also determined by the management board or remuneration committee. In some audit firms, this decision is the responsibility of the senior management remuneration committee, which focuses on setting the profit shares for all members of the supervisory board.

Individual partner's profit share is linked to the partner's performance. This performance might be assessed, for example, using a system of points: the more points, the higher the profit share. The allocation of profits is usually based on a fixed tranche (number of points, which is independent of voting rights), which is often linked to seniority, as well as a variable tranche awarded as remuneration for exceptional work.[107] In principle, any partner may object to the management decision with respect to their profit share.

The Oxera interviews have indicated that partners' profit share does not seem to be linked to their effective capital contributions. However, if the partnership requires additional capital, partners might be asked to contribute. The amount of capital contribution per partner would be linked in this case to their profit share at the time: the higher the profit share, the more the partner might be asked to contribute. Section 6.1 discusses in greater detail the flow of equity capital in a partnership or another legal form with a similar ownership structure and corporate governance arrangements.

[107] The share of total remuneration accruing to fixed relative to variable tranches varies by audit firm typically in the range from 20% to 30%.

The interviews with audit firms indicated to Oxera that a partner's profit share would not change if the partner decided to re-invest in the partnership the profit share allocated to them. For example, if the partner is entitled to a profit share and decides to retain the funds in the partnership, their profit share in the future would not reflect this newly committed capital. Rather, a partner would only be able to take this amount back upon retirement.

Formally, partners are remunerated for the capital invested in the business in the form of an interest on the capital amount. The rate of return on this capital appears to be closer to the firm's cost of debt rather than the cost of equity. In a sense, this capital resembles a fixed-income security from the partner's perspective, and represents an interest-bearing liability from the firm perspective. Therefore, it is important to recognise that, while financial capital is remunerated in a similar manner to a debt obligation, the human capital invested by partners in the firm is remunerated through profit share.

5.2.3 Management of audit firms

The management structure of an audit firm generally refers to a set of arrangements put in place for executives to exercise their managerial control. Several important aspects of the management structure need to be considered:

– **management arrangements**—the mechanisms by which audit firms are managed;
– **managerial powers**—the powers of the chief executive officer (CEO) in a partnership (or comparable legal forms based on employee ownership) compared with a typical corporation;
– **independence**—potential linkages between business decisions and audit decisions;
– **conflicts of interest—**conflicts of interest within a given practice, as well as across different practices and across countries for a global audit firm.

Management structures

A partnership or partnership-like corporate form is typically governed by the members' agreement, a document signed by all members. The key issues related to the management structure of a partnership are typically set out in this document.

In general, the management structures of audit firms appear similar to management structures of corporations. However, the size and functions of management bodies of audit partnerships vary with the size of the audit firm. For example, small audit firms (eg, those with fewer than 25 partners) might not require a separate management body. In this case, partners make managerial decisions collectively. In the case of larger audit firms and, in particular, most of the mid-tier and Big Four firms, more hierarchal management structures are adopted in order to ensure an efficient decision-making process.

The major management body of an audit firm is the management board (other names of the management body include, for example, the management executive or core executive). The core managerial function is typically exercised by the managing partner.

The responsibilities of the management board as a whole include:

– setting and implementing the business strategy;
– strategic management of the firm;
– appointment, appraisal and removal of members and non-equity partners.

The day-to-day management of the firm is typically the responsibility of the managing partner, who is elected by members; the managing partner often appoints other members of the management board.

It might be argued that the managerial powers of the CEO (the managing partner) in the partnership or an equivalent employee-owned firm are greater than those of the CEO in an investor-owned firm. This is the potential implication of the fact that each partner (member) typically has one vote. Thus, in contrast to corporations, where ownership and control rights might be concentrated, these rights are typically dispersed in partnerships and similar employee-owned forms.

The implication of the above is that equal distribution of control powers among many shareholders (partners) might reduce the level of control that those shareholders might be able to exercise over management, where, in this case, the latter would enjoy greater discretion. However, the fact that shareholders are also insiders might empower them to exercise greater control, given more limited asymmetric information.

Another reason why the CEO of an audit firm might have significant decision-making power is because owners of an audit firm are also its employees. Although, as owners, partners might have different views on some strategic decisions than the CEO, as employees they might not want to oppose the management body.

5.2.4 Independent non-executive directors

The composition of the board is often crucial to the corporate governance of any firm or company. Typically, up to around a third of the board members are non-executive directors, who may serve a term of around two or three years. In the case of audit firms, it might be expected that, similarly to other companies, the appointment of independent directors would enhance the corporate governance structure, and could lead to improvements in firms' risk management policies.

There is empirical evidence that suggests that the nomination of independent directors is often associated with a positive share price reaction in the market. The most relevant of these empirical studies in this context are discussed in detail in section 6.3.3. According to a report from the Harvard Institute of Economic Research (2004), independent directors, non-executive chairs and committees composed of independent directors may induce greater rationality and more considered ethics into the corporate governance regime.[108] The report suggests that the directors and chair of the board may only be genuinely independent if institutional investors and public shareholders nominate candidates for directorships.

This suggests that if a requirement were to be introduced, stipulating that a certain proportion of the management board must comprise independent non-executive directors, this may have a positive impact on the governance of audit firms.

The Combined Code on Corporate Governance introduced a number of requirements on independent directors in the UK.[109] The key requirements are that:

– the chairman should hold meetings with the non-executive directors, without the executives present;
– the non-executive directors should appraise the chairman's performance on an annual basis;
– a senior independent director should be elected by the independent non-executive directors; and
– this senior independent director should attend a sufficient number of meetings with a range of key shareholders to develop an understanding of the issues and concerns of the major shareholders.

Under a corporate structure with outside shareholders, the presence of independent directors is often thought to be important in order to address any potential principal–agent problems in

[108] Morck, R. (2004), 'Behavioural Finance in Corporate Governance—Independent Directors and Non-Executive Chairs', Harvard Institute of Economic Research.
[109] FRC (2006), 'The Combined Code on Corporate Governance', June.

so far as they would represent shareholders' interests on the board of directors, while at the same time being independent of the current management of the firm. In the context of audit firms, this role might not be directly relevant under the employee ownership since the same individuals are principals and agents at the same time.

The potential exception could be the role of independent directors as representatives of all partners in the potential conflict of interest between managing partners and the entire body of partners on a firm-wide basis. Although Oxera is not aware of any precedent of independent directors of a private company representing interests of consumers, in some jurisdictions (eg, Germany), representatives of employees are members of the board.

At the same time, the role of independent directors might become important under the outside ownership of audit firms in order to provide additional checks and balances on management in light of potential information asymmetries between outsiders and insiders of audit firms.

5.2.5 Management and supervisory boards

Independent non-executive directors typically sit on the management board of audit firms, which is separate from the supervisory board. Key differences between these boards are highlighted below.

– **Management boards of audit firms**—these typically comprise the senior partner/chief executive and the executive group (which is appointed by the senior partner). The senior partner/chief executive has full executive authority for the management, and is appointed by the board of partners, often for a period of around four years. Typically, the senior partner is responsible for the development and management of professional services, compliance with regulations, development of policies and strategic direction, financial performance, as well as representing the firm on the board of the network.

– **Supervisory boards of audit firms**—these are independent of the management board. Typically, partners elect the supervisory board for a period of around three years. The supervisory board provides guidance to the chairman on matters of concern to the partners. The board is responsible for approving the annual reports and accounts, admitting new partners and overseeing the process of electing the chairman.

– **Management boards of networks**—the board typically comprises around 20 members, including the international chairman and CEO, representatives from the largest member firms (in terms of revenue) as well as representatives from a selected number of firms nominated by the board and the international council to ensure the appropriate mix across geographical and functional units. Typically, the board focuses on business performance and the execution of global strategy, reviews and monitors the procedures of the member firms, and oversees their implementation. The role of networks is discussed further in section 5.2.1.

5.3 Corporate structures of audit firms in the international context

In order to service international clients, audit firms form international networks or alliances.[110] This section reviews the structures of audit firms in the international context. It also describes

[110] Because of the implications for the liability risk of the definition of the network in the Eighth Directive, a number of audit firms suggested to Oxera during the interviews that the term 'alliance' better describes their international structure.

the arrangements between national firms and the international umbrella organisations, which coordinate networks of individual audit firms.[111]

The extensive international networks of the Big Four audit firms represent one of the major competitive advantages of those firms over smaller audit firms. The mid-tier audit firms also have reasonably large international networks, but might differ in terms of scale and the level of coordination across different jurisdictions.

The discussion in this section focuses on:

– the relationships between member audit firms forming an international network;
– the international umbrella organisations, their ownership and management structures, as well as their main functions and responsibilities;
– recent developments in international structures of audit firms, including cross-border mergers between member firms of a single global network (eg, the merger between KPMG firms in Germany and the UK).

5.3.1 Cross-border relationships between audit firms

Audit firms typically deliver audit services nationally. To carry out audits of international clients, they often form international networks or alliances, as noted above. An international network or an alliance represents an important revenue driver for its member firms (see Table A2.2, which shows that 25 of the 50 respondents stated that international coverage was essential). For example, a member firm in one country could refer international clients to members of the same network in other countries. Typically, each member firm has international liaison partners responsible for managing relationships with other member firms and coordinating international audits. Member firms also often second people within the network to increase and improve coordination, and carry the network brand either as their exclusive name or as part of the national brand.

In a representative arrangement, each member of the network is independently owned by its national partners. In this case, there are no cross-border ownership links and no profit-sharing arrangements between member firms, albeit firms contribute financially to the costs of running the umbrella organisation. According to Oxera interviews, the primary motive behind the independent ownership of member audit firms seems to be the unwillingness of individual member firms to share the liability risk of other member firms.

In this context, it is important to consider the recent developments in the cross-border relationships between audit firms of the same network. For example, the German and the UK member firms of the KPMG network announced that they would complete a cross-border merger in 2007. In the post-merger structure, the partners of the UK member firm (KPMG UK LLP) and of the German member firm (KPMG German AG) would become partners of the same single entity (KPMG Europe LLP), which would own the two national member firms. KPMG Europe LLP would be a non-trading entity registered in the UK. Audit services in Germany and the UK would be rendered by the entities that existed prior to the merger. KPMG Europe LLP would be managed by the UK and German partners, and would have two chairmen.[112]

According to Oxera interviews, the main driver for this particular merger appears to have been the higher efficiency of serving international clients on a single basis rather on the basis of two independent entities. Moreover, the strength of the combined UK–Germany firm within the network might also play a role. It is noteworthy that the UK and German member firms,

[111] This section does not represent a full assessment of international networks, but rather an overview of the issues relevant for access to capital.
[112] See, for example, KPMG (2006), 'Proposal to create Europe's largest accountancy firm: KPMG's U.K. and Germany member firms to merge in first stage', press release, October 6th; Consultant-News.com (2006), 'KPMG merger to create Europe's biggest professional services firm', press release, October 6th; European Group of Auditors' Oversight Bodies (2006), 'KPMG Europe LLP: The Anglo-German Merger', presentation.

although both owned by KPMG Europe LLP in the target, post-merger structure, would continue trading in their respective countries and would be subject to different liability regimes.

International structures

Liability regimes, which vary across the EU Member States, might be an important barrier to cross-border integration of audit firms. In this context, the barrier is not necessarily the level of liability risk in one or more countries, but rather the uneven, uncoordinated nature of the liability regimes across different jurisdictions.

For any given network of audit firms, the international umbrella organisation coordinates activities of the network's member firms. The organisation as a legal entity is typically owned by the member firms belonging to the network, where larger member firms participate in the management of the international entity, while smaller firms might not participate. When a member firm joins the network, it is usually asked to provide a financial contribution. In addition, member firms pay annual contributions to the umbrella organisation. The amount of this contribution is often linked to the size of the member firm (eg, national revenues), as well as the revenues derived by the member firm from its participation in the network.

As indicated to Oxera during the interviews, one of the primary objectives of the network's legal structure is to coordinate business development, skills and capabilities development, and the management of liability risk. In particular, the umbrella organisation would aim to limit any recourse of one member firm to another member firm with respect to a potential liability claim.

The interviews also indicated that many audit firms consider that it is easier to manage the liability risk on a country-by-country basis than a global basis. This is because of the divergence of liability regimes across countries, which might be an important barrier for international integration.[113] Since the Big Four are sometimes regarded by audit clients as more integrated internationally than the mid-tier audit firms, the perception of the lack of closer international integration might be particularly damaging to mid-tier audit firms.

The international umbrella organisation is also typically responsible for international and cross-border business development. Oxera's interviews have provided evidence that in some cases, when an audit network expands into a new jurisdiction, the required investment in human capital, business management, and technical expertise can be made by the international umbrella organisation while being ultimately funded by the contributions from all member firms. At least partly for this reason, the international networks of audit firms tend to avoid cross-shareholdings among member firms (ie, the situation where a member firm with a practice in one country would own another member firm with a separate practice in another country), except for cases where it might be the result of certain historical developments (eg, former and present dependent territories of a country where the parent is located).

Governance and management structure of international networks

The members' agreement, signed by all member firms, typically determines the corporate governance and management structure of the international umbrella organisation.

The main governance body of a network of audit firms is the board of directors (sometimes also called the council). Typically, individual member firms vote in order to determine the composition of the board of directors of the international entity.

Although each member firm might have an equal ownership stake in the umbrella organisation, the allocation of control rights between member firms is often non-uniform. For

[113] The issue of the liability risk is discussed in greater in detailed in London Economics (2006), op. cit.

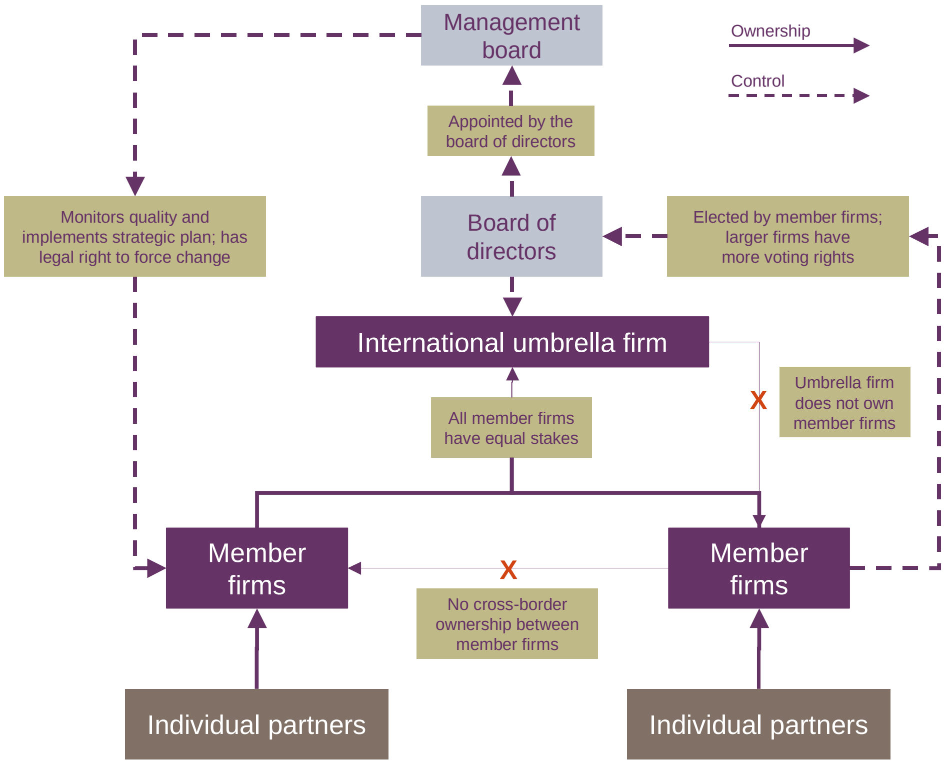
example, the voting rights of a particular member firm might be linked to the size of the firm—eg, they might represent a function of its annual turnover or the number of its multinational clients (ie, the size of revenues derived by the firm from the network). Thus, larger audit firms typically enjoy greater control rights and representation on the board of directors of the umbrella organisation.

US member firms typically dominate the board with a share of, for example, 25–35% of all voting rights in the case of large mid-tier audit firms, due to the size of a typical US practice. In many cases, once the representatives to the board are chosen from among all member firms (where not all member firms are represented), each representative might have just one vote.

The key management body of the umbrella firm is the management board (also known as, for example, the policy board). The CEO, or global head, who is appointed by the board of directors, often selects the members of the management board.

These arrangements are illustrated in Figure 5.4.

Figure 5.4 Stylised illustration of the typical corporate structure of audit firms in the international context



Source: Evidence from interviews and review of annual reports.

Main activities

The umbrella organisations do not typically provide any direct services to clients; that is, they do not undertake audit or non-audit services for clients, nor do they collect revenues from clients. The key activities of the umbrella organisation include quality assurance across the network and the implementation of the network international strategy.[114]

[114] It is noteworthy that the members' agreement, which governs the activities of umbrella firms, seems to be linked to the objectives of the international strategic plan.

The main functions of the board of directors of the umbrella organisation (which could be delegated to the management board) include admission and exclusion of individual firms from the network, as well as the coordination of activities across all member firms. The board might also have significant powers to influence the commercial or professional behaviour of member firms at the strategic level. These include, for example, implicit and explicit controls over some aspects of the member firms' business development, as well as the right to expel or suspend any member firm. The level of integration of firms across the network is often closely correlated with the overall powers of the umbrella organisation. In that respect, mid-tier audit networks are generally seen as more loosely integrated than the Big Four.

During the interviews, it was highlighted to Oxera that the powers of the umbrella organisation with respect to member firms might represent an important factor in determining the network's competitiveness. For example, difficulties in ensuring the quality or the range of available services across all member firms, as well as the level of coordination across jurisdictions, might be one of the key barriers to international expansion and potential entry into new markets by the mid-tier audit firms.

A number of interviewees have indicated that the degree of synchronisation within the network is significantly higher for the Big Four than for the mid-tier audit firms as a result of the historical evolution leading to the creation of the Big Four. A number of mid-tier audit firms appear to be in the process of reviewing the role and the position of the umbrella organisations relative to the member firms. It is broadly recognised that the trend is to delegate more authority to the centre. However, preferences with regard to the degree of centralisation differ across member firms and often act as a barrier to closer integration, at least in the short term.

At the same time, a number of audit firms raised concerns about the relationship between the degree of network synchronisation and the possibility of member firms becoming responsible for liability claims against member firms in other countries. In this context, introducing greater centralisation and coordination across the network seems to pose managerial, organisational, decision-making, as well as legal challenges.

During Oxera's assessment of audit networks, it became clear that there was considerable uncertainty among companies and investors about the organisation of networks and the governance structures adopted within them.

Article 40 of the Eighth Directive requires audit firms to produce annual transparency reports providing further information on, for instance, legal structures, governance arrangements and independence practices, as well as additional financial information.

5.4 Rationales behind ownership and management structures of audit firms

The drivers for the adoption of the most typical ownership and management structures of audit firms, such as partnerships, are discussed below. The key feature of such structures, as explained above, is the more or less uniform distribution of ownership rights among senior managers (partners or members). The analysis presented below provides some important insights into the business considerations by audit firms that might account for the firms' choice of their ownership structures. This is particularly important since this choice might carry costs, as discussed in section 6, through the adverse impact on the cost of capital and access to capital more generally.

The discussion here also informs the analysis of the relationship between the ownership restrictions and the observed ownership structures of audit firms. In particular, it examines whether existing restrictions might represent a binding constraint on audit firms in terms of the adopted corporate structures, or whether they are irrelevant to the choice at hand.

Finally, the linkages between the forms of employee ownership adopted by audit firms, their management structures, and the separation of technical audit decisions from the commercial business decisions are explored. This discussion is important in the context of the analysis of the impact of potential alternative ownership and management structures on the independence of audit decisions.

5.4.1 Business drivers for employee ownership

Audit firms are typically employee-owned, even in jurisdictions where alternative ownership structures and legal forms are available to them—typically the form of this ownership structure closely resembles a partnership, even if the actual legal form adopted by the firm is different. Therefore, a critical question arises about the economic rationale for audit firms to choose this form of ownership. This section examines the possible drivers and addresses the likely implications of identified drivers for access to capital and entry of audit firms into new markets.

Although employee-owned firms are not common in the industry, firms in the services sector often adopt this form of ownership. In particular, employee ownership is one of the prevailing modes of organisation, in law, audit, management consulting, and healthcare services, among others.[115][116]

Two types of driver appear most relevant for explaining why audit firms are predominantly employee-owned. Employee ownership might be adopted in order to:

– **signal the quality of services**—this form of ownership signals to clients the high quality of services of the audit firm, by introducing the sharing of profits between across partners;

– **develop tacit human capital**—to create the appropriate level and form of remuneration, including optimal compensation schemes and retention of human capital, as well as to create incentives for senior employees to mentor junior employees and create tacit skills.

Academic literature also discusses other types of driver for employee ownership. Although these drivers provide important insights into the economics of ownership structures of audit firms, they appear to have less explanatory power in explaining the observed ownership patterns. These include:

– **reducing the costs of decision-making**—incentives to reduce agency costs and the costs of corporate decision-making (the costs of ownership and management);

– **reducing tax liabilities**—to benefit from advantageous taxation rules;

– **reducing the costs of market contracting**—to reduce the transaction costs between the firm and the labour force (the costs of market contracting).

This sub-section describes the potential economic phenomena that underpin these drivers; it also assesses the extent to which audit firms might adopt the partnership form of ownership to reduce the costs of market imperfections, create specific incentives, or optimise tax payments. The evidence presented below can be used to understand why audit firms might choose to be partnerships, even if this form of ownership might limit their access to financial capital and if other forms were fully allowed by the legal and regulatory framework.

[115] Hansmann, H. (1996), *The ownership of enterprises*, Cambridge, MA: The Belknap. Press.

[116] Throughout this section ‘partnership’ refers to an employee-owned firm rather than to a particular legal form.

Signalling the quality of services

The audit service can be characterised by two distinct features: difficulty in monitoring its quality; and close relationship between quality and human capital. Levin and Tadelis (2002) suggest that, given these characteristics, profit sharing adopted in partnerships may make them more profitable than corporations. The authors base their analysis on the assumption that a corporation makes decisions with the intention of maximising profits, while an equal-sharing partnership would like to maximise the profits per partner. This profit-sharing mechanism makes a partnership relatively less inclined to expand its labour force in comparison to a corporation. Given the distribution of talent in the labour market, this selectivity translates into a higher-quality threshold for employment, and (to the extent that human capital plays an important role in production, for example, for audit quality) a higher-quality product. In equilibrium, the partnership structure might be more selective than a corporation and deliver a higher-quality product than that which would have been delivered under the alternative form of ownership.

In particular, Levin and Tadelis (2002) concluded that:[117]

> We show that when there are no problems with market monitoring, a profit maximizing corporation hires efficiently while partnerships provide too high a level of quality. With less effective market monitoring, however, both corporations and partnerships are tempted to reduce quality and hire less able workers, hoping to benefit in the event that the market does not discern this loss of quality. Corporations consequently move away from efficient production as market monitoring deteriorates, generating less profits, but partnerships move closer to efficient hiring (though profits per partner decrease). This leads to our main result: if market monitoring is sufficiently reliable, corporations perform better than partnerships, while if market monitoring is weak, partnerships are strictly more profitable than corporations.

Auditor independence is part of the quality of the audit service. As indicated in Levin and Tadelis (2002), as market monitoring deteriorates, partnerships perform better in terms of quality than corporations. Thus, it might be argued that partnerships might be more efficient than corporations in ensuring the independence of audit decisions.

Levin and Tadelis (2002) also suggested that, in practice, many partnerships combine productivity-based compensation with straight profit sharing. Even when productivity measures are used, however—as in the case of many law firms and audit firms, as discussed above—there is typically a significant amount of sharing, as suggested by the authors.

The strength of the argument put forward by Levin and Tadelis (2002) seems to depend on three key factors, which are often assumed to be present in the case of the audit profession:

– the ability of markets to monitor audit quality (and, in particular, the time horizon over which the quality of past audits would be revealed);
– the importance of human capital for audit quality; and
– the extent to which audit firms adopt profit-sharing agreements.

Developing tacit human capital

It might be argued that audit firms rely on the tacit skills of their employees—ie, skills that can be acquired only through close on-the-job contact with an expert mentor. The problem with tacit skills is the difficulty of enforcing the mentoring of junior employees by senior employees, which is costly and binding for individual senior employees, despite the important benefit to the firm as a whole. For example, Morrison and Wilhelm (2003) argued that

[117] Levin, J. and Tadelis, S. (2002), ‘A Theory of Partnerships’, SIEPR Discussion Paper No. 01-28.

partnerships provide a solution for this contracting problem and act as a mechanism for ensuring the development of tacit skills among employees of audit firms.[118]

Because their financial capital is tied up in their firm, the partners have a strong incentive to protect the reputation of their firm. Promoting an unskilled agent to the partnership would ultimately damage its reputation and thus lower the value of the senior partners' stake. Hence, Morrison and Wilhelm (2003) argued that partners will mentor junior employees to protect their partnership's reputation and to preserve the value of their partnership stake.

Morrison and Wilhelm (2003) also noted that because it is hard to prove the possession of tacit skills, partnerships depend on their reputations to attract customers and command high fees for their services. In this respect, reputation could be thought of as the market's perception of the quality of audit firm's mentoring and training process, and thus the skilfulness of firm's human capital.

Morrison and Wilhelm (2003) propounded that one of the drivers for the transition of investment banks from employee ownership to public ownership was the increasing standardisation of the investment banking service. This implied that the importance of tacit human capital decreased, while the importance of capital-intensive technology increased. Thus, the need to finance technology and the decreasing importance of tacit human capital drove investment banks away from employee ownership.

A parallel can be drawn with current developments in the audit market, where there appears to be a tendency to outsource some parts of the audit value chain to low-cost locations. In particulate, highly standardised services, such as technical audit, seem to be outsourced. For example, the US branch of PwC has outsourced the preparation of US tax returns to compliance centres run by PwC Singapore, PwC India and PwC China to benefit from the skills and cost savings available in Asia.[119]

Thus, where the tacit human capital represents an important component of the audit service, employee ownership might have benefits. Where technology is important (standardised services), the benefits of alternative forms of ownership might outweigh those of employee ownership (this is indirectly supported by the evidence on outsourcing). It might be noteworthy that rules-based rather than principles-based audit would diminish the role of tacit human capital and increase the role of capital-intensive technology.

Reducing the costs of decision-making

In general, there are two broad categories of costs associated with a given form of ownership:

– the costs of delegation of decision-making from shareholders to managers;
– the costs of collective decision-making.

In the context of this study, it is important to review these cost categories and assess whether the partnership form of ownership (as well as other forms of employee ownership) could be adopted to reduce such costs.

– **Delegation to management**—the delegation of decision-making to management might be associated with agency costs of separation of ownership (cash-flow rights) and control.[120] One might expect these costs to be lower in employee-owned firms than in

[118] Morrison, A. D. and Wilhelm, Jr., W.J. (2004), 'Partnership Firms, Reputation, and Human Capital', *American Economic Review*, **48**, 1682–92. See, also, Morrison, A.D. and Wilhelm, Jr., W.J. (2007), 'Investment Banking: Past, Present, and Future', *Journal of Applied Corporate Finance*, **19**:1, 42–54.
[119] PwC (2006), 'Global Annual Review', p. 46.
[120] Jensen, M.C. and Meckling, W.H. (1976), 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', *The Journal of Financial Economics*, **3**, 305–60.

investor-owned firms because employees are insiders of the firms, which is the case in audit firms (as discussed in section 5.1) and might be better informed than potential outside capital providers. It follows that employee ownership would be expected to dominate in those circumstances and those sectors where investors are in a particularly poor position to monitor management, or where there is particularly severe informational asymmetry between investors and managers.

– **Collective decision-making**—where many people share the ownership rights of a given firm, there are likely to be differences in opinion concerning the firm's policies and programmes. In order for the owners to make decisions, they need to employ a collective choice-making mechanism. When the interests of individual owners are diverse, collective decision-making might be associated with costs. These costs could be of two types: inefficient decisions failing to maximise the aggregate surplus of owners; and the costs of the decision-making process. Therefore, one might expect to observe employee ownership in those circumstances where there are fewer differences among employees who participate in ownership in terms of the type of work they do, type of skills, and where the corporate structure is less hierarchal.

According to Hansmann (1996), professional firms are unlikely to experience significant separation of ownership and control, and are therefore unlikely to carry agency costs associated with such separation, as they are typically small and closely held. This seems to suggest that employee ownership observed in the professional services sector and, in particular, for audit firms is unlikely to be driven by an attempt to reduce the agency costs of delegation of decision-making to managers.

However, a counterargument could be developed with reference to the audit business. The nature of the audit service is such that it is difficult to observe the quality of audit decisions. Given that managerial decisions and audit decisions might interact (see section 5.2 for a more detailed discussion of this issue), there might be significant information asymmetry between investors and managers—in particular, if the investors are unqualified auditors.

This might lead to high agency costs if the firm is investor-owned. Correspondingly, the partnership form, where individual partners are qualified auditors, might potentially reduce the cost of asymmetric information. The strength of this argument seems to depend on the degree to which managers of an audit firm could intervene in the audit decision and on the degree to which the quality of the audit service might be unobservable to unqualified individuals.

Hansmann (1996) suggests that the cost of collective decision-making:

> seems to play a surprisingly strong role in determining where employee ownership is viable.

This is because, in the professional services sector, where employee ownership is most widely observed, the employee owners (eg, the audit partners) perform similar types of work and have similar status within the firm. These two conditions are required for the employee ownership structure to reduce the costs of decision-marking.

The results of Oxera's analysis of the management and governance structures of the audit firms seems to indicate that these structures typically mirror structures adopted by corporations. In particular, as discussed above, there seems to exist a hierarchal structure of partners' seniority in audit firms. Moreover, partners' profit participation is linked to their performance and seniority rather than equalised across partners.

This suggests that not only do partnerships have hierarchal managerial structures, but also that different partners may have varying levels of status within the firm. They might also have divergent interests because of different profit shares. In this respect, the costs of decision-making in audit firms that adopt partnership structures are unlikely to be significantly lower than in traditional investor-owned firms. In light of this evidence, partnerships in the audit sector do not seem to act as a mechanism for reducing the costs of decision-making.

Furthermore, as discussed earlier, CEOs of audit firms might be perceived as having greater explicit and implicit powers than one would expect to observe in the case of a corporation, although this conclusion is difficult to test empirically. It could be argued that this might increase the costs of collective decision-making, in particular those associated with failures to maximise the aggregate welfare of owners.

Reducing tax liabilities

Tax law in most EU Member States seems to be generally in favour of partnerships compared with corporations. Net earnings distributed to members typically escape (at least to some degree) the corporate income tax that is levied on net earnings distributed to investors in investor-owed firms.

Typically, profits are shared among members of the partnership, and individual members (not the LLP) are responsible for paying income tax on these profits. Income or gains of the LLP are treated for tax purposes as the income or gains of members, in the proportions specified in the members' agreement. The LLP itself does not pay corporation tax. Instead, partners are considered self-employed for tax purposes, and must therefore include details of any profits they receive from the partnership in their individual self-assessment tax returns. [121] Generally, partners are not liable for the unpaid tax of another partner. The profits of each partner are taxed separately—there is no joint partnership assessment. [122]

A detailed evaluation of the tax advantages of partnerships is outside the scope of Oxera's study. The academic literature tends to reject the hypothesis that taxation could explain why audit firms are established as partnerships. First, as suggested by Levin and Tadelis (2002) with reference to the USA:[123]

> in recent years the tax code has evolved in such a way that corporations and partnership can practically face the same type of tax schedules given that they are carefully designed.

Second, taxation cannot explain the distribution of the partnership form of ownership across sectors. In particular, it does not provide reasons for why the partnership form is generally more often found in the professional services sector.

Reducing the costs of market contracting

An attempt to reduce the costs of contracting for labour might represent one of the key drivers of the employee ownership structures, and, specifically, for adopting a partnership form of ownership.

In this context, it is important to review the major types of cost of contracting for labour that could be reduced by the employee ownership, and to explore arguments on whether an attempt to reduce these costs might explain why audit firms are typically partnerships.

– **Asymmetric information**—because of the difficulty in monitoring individual employees, a degree of moral hazard necessarily affects market contracting for all but the simplest types of labour. Employee ownership offers each employee an incentive to monitor their

[121] Business Link, 'Set up and register a limited liability partnership (LLP)'.

[122] HM Revenue and Customs (2006), 'Partnerships: Help Sheet for the Partnership Tax Return', December.

[123] Levin, J. and Tadelis, S. (2002), 'A Theory of Partnerships', SIEPR Discussion Paper No. 01-28.

fellow employees and to apply pressure on them not to shirk, an incentive largely lacking in an investor-owned firm.[124]

– **Lock-in**—after working for a given firm for a number of years, an employee's skills may become specialised to that firm. The firm might therefore occupy a position of monopsony in the market for this employee's skills—ie, these skills might not be easily transferable to another firm. This could be described as a lock-in problem. One might expect employee ownership to arise where this type of lock-in is particularly severe.[125]

– **Strategic bargaining behaviour**—under investor ownership, management often possess information about the firm that employees do not, including information about the firm's future prospects (eg, contraction and expansion plans). Similarly, employees often possess knowledge that management do not concerning the employee's own opportunities and preferences, including the minimum required wage. The resulting asymmetries in information provide the incentive for both labour and management to adopt bargaining strategies, such as strikes and lock-outs, which raise the transaction costs of reaching an agreement.[126] One strong advantage of employee ownership is its potential to reduce or eliminate these costs.

– **Communication of employee preferences**—employee ownership might better align employees' preferences with respect to the desirable compensation structure with the actual compensation provided by the company.

A number of attempts have been made in the literature to assess the empirical evidence as to whether the costs of contracting for labour could explain the cross-sectoral distribution of ownership structures, and, in particular, whether they explain the concentration of employee-owned firms in sectors such as professional services firms, including audit firms.

In general, the empirical evidence does not support the hypothesis that employee ownership acts as a mechanism for reducing the costs of market contracting.[127]

Despite this, the former types of firms are largely investor-owned, while the latter are employee-owned. Hansmann (1996) therefore concluded that:

> The existing distribution of employee-owned firms clearly cannot be explained just in terms of the cost of market contracting.

This indicates that adoption of a partnership form of ownership by audit firms (as a type of employee ownership) might not be primarily driven by the attempt to reduce the costs of market contracting.

Summary

Figure 5.5 summarises the main drivers of the partnership form of ownership discussed above. It also illustrates a potential assessment of the arguments in favour of each identified driver in the case of audit firms.

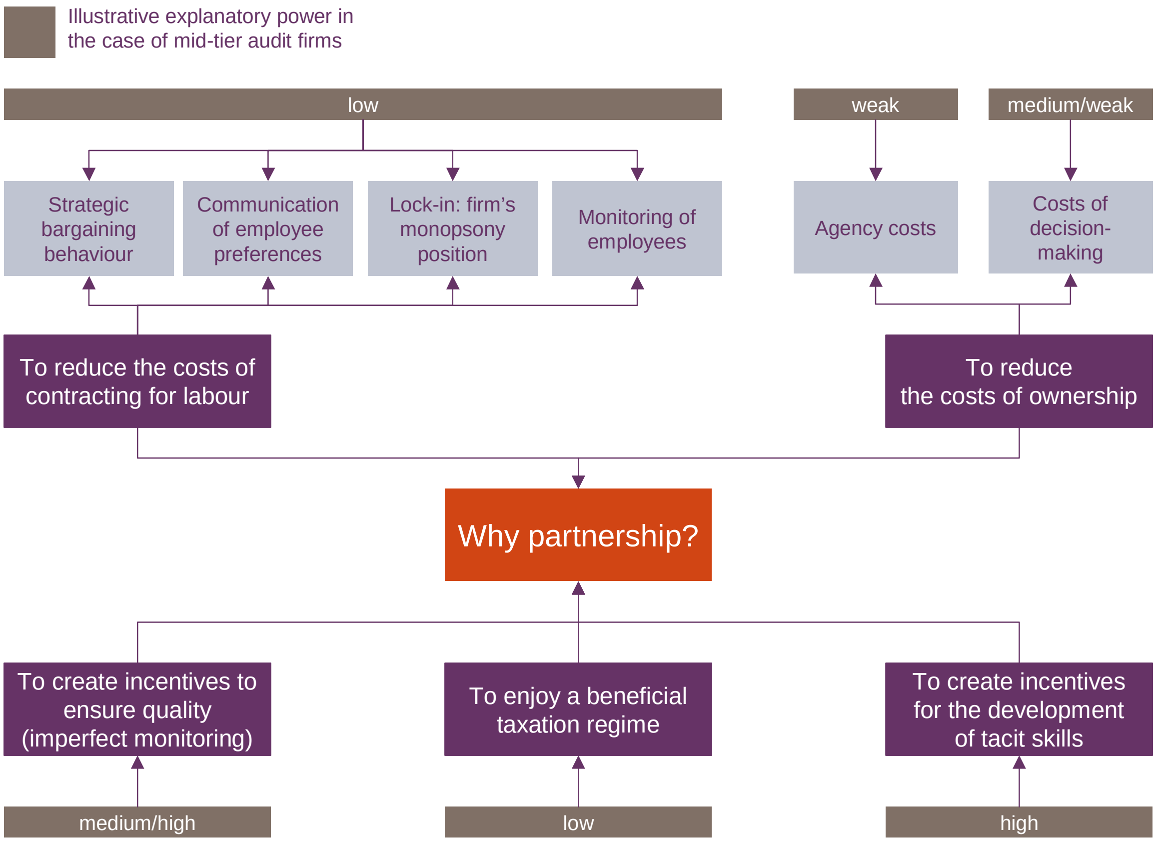
[124] See, for example, Armen, A. and Demsetz, H. (1972), 'Production, Information Costs, and Economic Organisation', *American Economic Review*, **777**; Jensen, M. and Meckling, W. (1979), 'Right and Production Functions: An Application to Labour-Managed Firms and Codetermination, *Journal of Business*, **469**; Russell, R. (1985), 'Employee Ownership and Employee Governance', *Journal of Economic Behaviour and Organisation*, **6**:3, 217–41.

[125] See, for example, Blair, M. (1995). 'Ownership and Control', Brookings Institution, Washington, DC, which argues for a policy of giving employees increased ownership rights in order to protect employees' investments in firm-specific human capital. This argument is discussed further below in this section.

[126] See, for example, Kennan, J. and Wilson, R. (1989), 'Strategic Bargaining Models and Interpretation of Strike Data', *Journal of Applied Econometrics*, **4**, S87–S130.

[127] For example, Hansmann (1996) suggests that the benefits of employee ownership in terms of reducing the costs of contracting for labour seem greatest in the case of large-scale hierarchal firms, while there are comparatively more modest gains among professional firms, including audit firms.

Figure 5.5 Selected drivers for adopting a partnership form of ownership



Source: Literature review.

The main drivers behind the partnership form of ownership were discussed as part of the Oxera interviews. Interviewees from audit firms have indicated that motivating and rewarding employees seem to be primary reasons for adopting a partnership structure. For example, as suggested by interviewees, a partnership structure might have an important perception role for partners—the 'ownership of the firm' notion. This might help in retaining and motivating employees.

Increasing the scale of the business was mentioned as a key factor that might trigger the future potential move away from the partnership structure and towards the corporate form.[128]

The critical conclusion from this section is that there appear to be important drivers behind audit firms' choices of partnership structures, where such choice is available. Therefore, audit firms might choose to adopt partnership structures, even if this implies certain costs in terms of, for example, access to capital. In this context, it is important to distinguish between physical or financial capital and human capital. Partnership forms of ownership might imply barriers to raising financing, but might be necessary in order to recruit, retain and further develop human capital.

5.4.2 Implications of employee ownership on the independence of management and audit decisions

Section 5.2.3 reviewed the management structures of audit firms. The implications of the observed management structures for the relationship between technical audit decisions and business decisions of the audit firm are derived below. This discussion is important for the

[128] See Morrison, A.D. and Wilhelm, Jr. W.J. (2007), 'The Demise of Investment-Banking Partnerships: Theory and Evidence', *Journal of Finance*, forthcoming.

analysis of the potential implications of alternative ownership and management structures of audit firms for auditor independence.

Audit and business decisions

Given the regulations concerning the composition of management bodies of audit firms designed to ensure independence, as discussed in section 4, it is useful to consider the separation of strategic business decisions from audit decisions. The former typically include decisions to expand into a new market (eg, targeting a certain type of client), hire new staff, or acquire new offices, whereas the latter concern audit sign-offs and specific client relationships.

The interaction between the audit decisions and business decisions is important to the extent that alternative corporate governance and management structure arrangements, at least in theory, might have a different potential impact on the degree of independence of individual audit decisions. For example, the independence of an individual audit decision might be compromised if the management structure of an audit firm were to allow for significant interference by senior management in the decisions by individual audit partners. Furthermore, outside shareholders might theoretically have a further influence on management, and, in turn, have an indirect impact on individual audit decisions.

Oxera's interviews of audit firms indicate that the risk of compromising independence in the way described above appears small. Since business decisions are the primary responsibility of the management bodies—the managing partner and management board—and the audit decisions (which require auditor's independence) are the responsibility of the lead auditor on a given assignment—the audit partner—the interaction between these two decision-making channels is normally minimal. At the same time, there is potential for implicit pressures from the management of the audit firm on the lead auditor with respect to certain decisions, such as whether to retain the client or offer a special discount.

According to the interviewees, senior management does not have any day-to-day involvement in audit assignments. In fact, partners leading specific audit assignments discuss the details of the audit with the technical department and, where relevant, also with the head of audit, rather than with the senior management. Furthermore, the head of audit might not sit on the management board, although this is rare. At the same time, it is unclear to what extent senior management might be able to influence some specific aspects of the audit relationship with a client more generally.

In principle, the management board is responsible for the assessment of risk with regard to audit assignments in general, and for decisions on whether the audit firm should work for a particular client. Importantly, it seems that, depending on the audit firm, the senior management has an important role in deciding whether to continue a relationship with a given client where such a relationship is under review for a particular reason.

Summary

It is informative to consider an alternative ownership structure where external investors (not an auditor or an audit firm) have control over the audit firm. Moreover, it is useful to assume that, in this hypothetical alternative structure, the majority of members of management bodies are also not authorised auditors. Potential implications of this management and ownership structure on auditor independence are discussed below.

The review of management structures of audit firms suggests that it is theoretically possible that outside investors might be able to exercise a degree of influence on the general approach adopted by the senior management with regard to, for example, client retention or the acquisition of specific clients. It is conceivable that they might set preferences for the retention or termination of a relationship with a certain group of clients.

However, the strength of such influence is likely to be limited for a number of reasons:

- it is unclear why, in the long term, incentives faced by external investors and senior management, representing external investors, would be fundamentally different to those of individual audit partners. In particular, any explicit or implicit compromise of an audit decision for short-term gains could represent a risky strategy;
- the separation of technical audit decisions from business discussion (discussed above) would make it difficult for the external investor to influence the outcomes of individual audit assignments;
- outside ownership could improve the corporate governance of audit firms and introduce external monitoring of the audit firms (eg, through the mechanism of independent directors). Dispersed ownership could provide additional commercial gains (through the provision of greater capital to the audit firm), while at the same time, mitigating the risk of an adverse impact of external ownership on auditor independence.

On balance, the review of the decision-making process of audit firms seems to suggest that alternative ownership and management structures, where the voting rights and management of audit firms are with external investors, are likely to have limited (if any) detrimental effect on the auditor independence.

5.5 Overall conclusions on ownership and governance structures of audit firms

The above analysis of drivers and implications of typical ownership, governance and management structures of audit firms in Europe provides a number of conclusions of critical importance for the present study.

Rationales behind ownership structures

- The review of evidence suggests that employee ownership seems to provide important benefits to audit firms. These benefits are largely driven by the efficient management of human capital possible under employee ownership, and by the signals of high quality of the audit service that employee ownership sends to the market.
- Recent developments in the audit market and potential future trends (eg, increasing outsourcing of certain elements of the audit service value chain and a focus on rules-based audit) might suggest that, looking forward, the relative importance of human capital might be diminishing to some extent, such that the benefits of employee ownership might become less important.
- Human capital represents a significant share of the overall capital of the audit firms. Financially, the difference between compensating human capital by providing profit shares (employee ownership) and compensating human capital as a cost (investor ownership) is small. For this reason, the employee ownership currently observed among audit firms might be driven by legacy, and it might be possible to manage human capital as efficiently in an investor-owned structure.
- Key activities of the umbrella organisation include quality assurance across the network as well as the implementation of the network's international strategy.[129] Challenges involved in ensuring the quality and range of available services across all member firms, the extent of coordination between Member States, as well as the potential for cross-

[129] It is noteworthy that the members' agreement, which governs the activities of umbrella firms, seems to be linked to the objectives of the international strategic plan.

border liability claims, may represent critical barriers to potential entry into new markets by mid-tier firms.

Potential implications of alternative structures

– The review of the process of decision-making in audit firms seems to indicate that alternative ownership and management structures, where the control over the audit firms is with external investors (non-auditors), are unlikely to significantly impair auditor independence.

– This is the result of two key phenomena: the separation of audit decisions from business decisions is likely to complicate the influence of senior management on the outcomes of individual audit assignments (though client strategy might be influenced relatively more easily); and it is unclear why, in the long term, the interests of external investors would be fundamentally different to those of individual audit partners.

– At the same time, there seems to be some perception (highlighted in section 4) among listed companies that independence of ownership is linked with the independence of audit decisions. Moreover, some (but not all) audit firms also seem to believe that their clients are likely to perceive independence of ownership as a factor influencing the independence of audit decisions. The need for auditors to be independent is not in dispute. However, Oxera's interviews indicated that the importance of *ownership* independence for auditor independence in general is perceived differently in different countries. For example, in France and Germany, it appears that ownership independence is perceived to be more important than it is perceived to be, for example, in the UK and Spain.

Sections 6 and 7 explore the impact of the ownership rules and structures on, respectively, access to capital and competition. The implications of the analysis in section 5 for the inherent trade-off between the positive effect of the current ownership rules on independence, on the one hand, and their possible negative effect on access to capital and competition, on the other, are set out in greater detail in section 8.

6 Implications for access to capital

Audit firms might require access to capital for a variety of reasons, including for funding human capital, working capital, office development or funding of new investments. If an audit firm were to attempt to expand into a new market, this could imply the necessity to raise additional capital, internally or externally, for the required amount of financing, in order to gain a sufficient foothold in the new market. This implies that an assessment of the sources of capital that can obtained by audit firms, as well as the implications of audit firms' adopted corporate forms for the cost of raising capital, may influence the competitive landscape in the audit market.

Section 5 indicated that a significant number of audit firms throughout Europe are established as some variant of a partnership structure. This might have important implications for both the cost and access to capital, as explored in this section.

Interviews undertaken by Oxera have revealed that audit firms have access to a variety of capital sources, including capital from partners or members, long-term loans, as well as working capital loans from commercial banks, which might be secured against the audit firm's assets. Typically, the capital contribution of audit partners or members tends to be either fixed or linked to the value of the audit firm.[130] In the latter case, the member's capital contribution depends on a multiple of profits or goodwill.

The ease with which audit firms—in particular, mid-tier audit firms—can access sources of capital may be influenced by the corporate structure adopted by these firms. The adopted structures have implications for access to capital to the extent that these might depart from the optimal (cheapest) way of obtaining financing.

In theory, under certain key assumptions, it is a well-established principle that the cost of capital for a firm should be independent of the ways in which that firm obtains financing. Under perfect capital markets (where there are no taxes or transaction costs), seminal work by Modigliani and Miller (1958) showed that the market value of the firm is independent of its capital structure.[131] Instead, the value of the firm is determined by the rate of return on its underlying assets, rather than by the mix of securities that the firm issues. However, for this finding to hold, a number of critical assumptions are required—these assumptions rarely hold in practice.

In the audit market, restrictions on ownership and the corporate form adopted by audit firms in particular imply that a number of critical assumptions underpinning the above principle are breached. This is a result of limitations on the extent of ownership that could be assumed by potential investors.

For illustration purposes, a key breach that implies that the cost of capital is no longer independent of the firm's capital structure arises as a result of the corporate form that is adopted by the majority of audit firms. As discussed in section 5, the majority of audit firms are employee-owned and often adopt partnership-like structures. As members in audit firms

[130] Audit firms across Europe tend to be 100% employee-owned, regardless of the actual ownership structure or corporate form. Typically, ownership is distributed more or less evenly among senior managers of the firm, also known as 'partners'. Although this arrangement is indeed typical of partnerships (where stakeholders might be referred to as 'members'), similar ownership structures are often replicated in the case of other legal forms adopted by audit firms, such as limited liability companies. Given that the actual corporate form differs by firm and jurisdiction, in this section, all stakeholders or senior managers who own stakes in an audit firm are referred to as 'partners' or 'members'. This should not be interpreted as implying that partnership is the dominant legal form adopted by audit firms across Europe.

[131] Modigliani, F. and Miller, M.H. (1958), 'The Cost of Capital, Corporation Finance and the Theory of Investment', *The American Economic Review*, June 3rd, 261–97.

are often required to commit capital when joining the audit firm, this means that a substantial proportion of audit members' wealth and human capital is implicitly invested in the audit firm. Audit partners both invest their human capital in the audit firm and are dependent on the performance of the firm for their financial remuneration. Thus, members will be exposed to the risk of the audit firm and may not be able to commit capital to a number of other investments as they have already committed significant capital to the audit firm.

This contrasts with a 'typical' investor, who invests in many different assets with different risk profiles and is therefore less exposed to the performance of just one of the assets. Finance theory suggests that investors are not remunerated for holding risk that is specific to one particular type of asset (ie, the audit firm), as part of this risk could be mitigated by holding a number of assets with different risk profiles (assuming that investors can diversify across different assets). From the perspective of finance theory, this implies that members are inefficiently exposed to risk that is specific to the audit firm. As a consequence, members require remuneration in the form of higher returns for exposure to idiosyncratic risks (ie, due to the lack of diversification).

This section examines each of the potential breaches from the 'optimal' financing structure (ie, a structure without any restrictions on ownership). The objective of the analysis is to assess the potential cost to the audit firm of the ownership restrictions, which lead to the audit firm having to adopt a particular ownership and corporate structure in terms of both the availability and the cost of financing.

The cost of financing to the firm (the cost of capital) represents the opportunity cost of raising finance. It is the rate of return that the investor in the audit firm would have been able to earn on an alternative investment that carries the same amount of risk. In contrast, the availability of capital (access to capital) reflects the ease with which audit firms can obtain the necessary funding. This reflects the possibility that the audit firm may not be able to attract sufficient finance to undertake all the potential investment projects with a positive pay-off. This situation might arise if potential (allowed) investors are capital-constrained or if external investors are not able to obtain the relevant information about the audit business, and, as such, may not be able to accurately perceive the risk involved in committing funds to the firm. Such capital rationing also implies that some audit firms may not be able to attract a substantial amount of capital at any price (ie, at any cost of capital), as a result of a number of factors. These factors are explored further in this section.

The analysis presented below focuses on the relationship between audit firms' corporate structures and access to capital, as well as the cost of capital. Following the examination of the drivers of audit firms' corporate structures presented in previous sections, the focus here is on examining the consequences of the adopted corporate structures for both access to (and the cost of) capital.

The analysis presented in this section is based on an examination of existing research, empirical evidence and the Oxera interviews, depending on their applicability in the context of this section. To augment these key sources, findings of cases and studies are examined in light of the audit market and adapted to the context of this study. These sources of evidence are used to identify the relative importance of each linkage between audit firms' corporate structure and these firms' access to capital. In particular, each source of empirical evidence has been critiqued to determine the strength of the applicability of the results to the audit market. For each potential breach, the findings of key cases and studies are examined in light of Oxera's research on the audit market and adapted to the context of this study.

The objective of the analysis here is to assess the potential cost to an audit firm of adopting a particular ownership and corporate structure, in terms of both the availability and the cost of financing. Therefore, this section seeks to identify potential linkages between audit firm's corporate structures and access to capital. Essentially, the research discusses the relative importance of each linkage between audit firms' corporate structures and these firms' access to capital.

6.1 Sources and uses of capital for audit firms

As discussed in previous sections, audit firms are established in a variety of corporate forms, although it is particularly common for them to be employee-owned—for example, either through being established as partnerships owned by members or as a limited liability company owned by senior managers.

Such forms of ownership carry potentially important implications for the ways in which audit firms access financing, as well as for the expected rate of return on capital committed to the firms.

The use of debt and equity capital by audit firms is discussed below. The main types of financial capital that audit firms can access include:

- members' capital;
- direct long-term loans; and
- working capital loans.

Since audit firms do not typically raise funding from capital markets, the restricted forms of raising financing might have important implications for the price of capital raised, as well as for the arrangements governing employees' contributions to equity.

6.1.1 Equity capital—contributions from partners

Like any other businesses, audit firms are continually making financing decisions about whether to raise new equity. These might include a decision to retain a share of profits attributed to members; a decision to ask members to contribute further capital to the business; or a decision to invite additional members to join the firm, or to promote existing employees to members. In this respect, two types of new equity capital can be distinguished: new contributions from members, and retained earnings.

For any audit firm, a set of specific arrangements typically governs the process of raising capital from members' contributions. When a member joins, they are asked to contribute capital to the firm.[132] Members typically contribute capital only once, upon joining.

There seem to be two broad approaches for setting the required contribution from new members.

- Some audit firms require a fixed contribution from all new members—importantly, the value of the contribution would not be linked in this case to the value of the ownership stake in the firm. Under this approach, in any given year, the value share of the audit firm as a whole is not explicitly incorporated in the value of the new member contribution. However, the value of the required contribution might be reviewed periodically, with a view to incorporating any changes in the value of the audit firm over the period.

- An alternative approach attempts to explicitly relate the required contribution to the value of the audit firm. This is typically done by linking the required contribution with the multiple of the firm's profits or the goodwill.

The second approach might provide the audit firm with an amount of capital more closely reflecting the ownership rights issued by the firm (ie, the member's share); it might also lead to higher required contributions by the new members. In contrast with the first approach, under the second approach, an increase in the firm's market value will be directly reflected in

[132] Based on the Oxera interviews, illustrative estimates range from £25,000 to £300,000.

the contribution required by partners. This implies that if the value of the firm is increasing, the latter approach is likely to lead to higher capital contributions required from partners.

To finance their contributions, members typically take out bank loans. The details of the arrangement in place differ by firm. In some circumstances, the borrowing is in the form of an unsecured loan, made directly to the new member. In other cases, funds lent to members might be secured on the firm's receivables, or might be broadly related to the existing revenue-generation capacity of the firm. The terms of borrowing might also be influenced by the member's age, with more established auditors potentially being able to secure loans against their own assets (eg, in the form of an equity loan).

When members retire, they receive their initial contribution back. Depending on the approach adopted to establish the value of the contribution, the amount returned to a member might or might not be directly related to the market value of the firm. In many audit firms, members only receive back the amount of the initial contribution, adjusted for inflation.

In some audit firms, when the member leaves, the initial contribution is repaid after a period of time rather than immediately. For example, a repayment structure could include four instalments over a two-year period.

It appears that the purpose of the contributions from new members is primarily to incentivise members to commit their human capital to the firm, and, to a lesser extent, to provide financing to the audit firm.

6.1.2 Equity capital—retained earnings

Retained earnings could be thought of as new investments in the firm made by existing members. Typically, audit firms use retained earnings to finance their working capital needs. Oxera interviewees indicated that the network may review the financial performance of member firms, requiring member firms to achieve particular retention ratios, and may also stipulate a minimum capital requirement. The interviewees indicated that the typical retention ratio is stable over time (eg, at 30%), but varies across firms.

Based on the published financial accounts, Table 6.1 shows that the retention ratio for BDO Stoy Hayward and Grant Thornton is similar to the respective ratio for Ernst & Young—around 21–23%.

Table 6.1 Retention ratio (%)

	Ernst & Young	BDO Stoy Hayward	Grant Thornton
Profit before members' remuneration (£m)	294.0	70.0	54.9
Payments to, or on behalf of, members (£m)	230.0	53.6	43.4
Retention ratio (%)	21.8	23.4	21.3

Note: Amounts reported for Ernst & Young and BDO Stoy Hayward are based on the year ending on June 30th 2006. In contrast, the amount reported for Grant Thornton is based on the year ending June 30th 2005.
Source: Oxera, based on the UK annual accounts of the respective firms.

For a number of smaller audit firms, the Oxera interviews have indicated that the retention ratio could be substantially lower. In this respect, it is important to recognise that, due to the nature of the audit business, a significant part of total expenditure to be financed might be in the form of operating costs. For example, launching a new office might require leasing an office building and hiring new staff. Both lease payments and increased payroll could be part of operating costs. Although higher operating costs would not require retaining earnings, they would lead to lower earnings per member.

To summarise, although the actual retained earnings might be fairly low, new expenditure, in the form of higher operating costs, is implicitly financed from earnings.

6.1.3 Debt capital

In the same way as banks lend to public corporations, they might also finance employee-owned firms. The Oxera's interviewees indicated that the majority of mid-tier audit firms in Europe have direct loans from banks (on a commercial basis). Bank loans are typically used to finance working capital, and might be secured against audit firms' tangible assets, which predominantly comprise working capital.

The majority of representatives of audit firms interviewed by Oxera have indicated that their firms currently face no difficulties in raising new debt capital, and that they enjoy a significant debt capacity. For example, many firms maintain a level of committed but undrawn debt facilities to enable them to fund initiatives without the need for new financing arrangements.

In this respect, it is important to recognise that audit firms' debt capacity might be closely linked (if only implicitly) to the value of tangible assets, as well as to the scope of existing client relationships. Thus, a large-scale, long-term capital investment in excess of tangible assets might face capital constraints defined by the existing business relationships. At the same time, expanding the audit business requires specific types of investment, and is unlikely to require large investments in tangible assets. This is discussed in greater detail below.

As indicated during the interviews, in theory the Big Four would appear to be able to raise capital (around €3m–€4m) through bonds. If bonds were issued by the Big Four to raise this level of capital, this is more likely to be done through private, rather than public, issues.[133] This is because there are high flotation costs (including investment banking and legal fees) and other transaction costs associated with public debt issues, which mean that it may not be cost-effective to issue bonds to raise this level of finance through public markets. Furthermore, empirical evidence reported by Krishnaswami et al. (1999) found that public bond issues are only cost-effective if they exceed €75m, while private placements are cost-effective for smaller issues.[134]

It is envisaged that if the smaller audit firms were to attempt to issue bonds, these firms would face greater challenges than the Big Four, as potential private lenders may be less informed about these firms, compared with the Big Four. Such information asymmetry problems may further restrict these firms' ability to raise finance through bond issues. Limits on audit firms' ability to raise capital through bond issues may further restrict mid-tier audit firms from raising sufficient finance to enable expansion into the international market.

However, the analysis of the financial accounts of BDO Stoy Hayward UK and Grant Thornton UK compared with Ernst & Young UK does not directly support this conclusion. As shown in Table 6.2, the ratio of net debt of Ernst & Young in the financial year ending June 2006 to net cash flow is lower than in the case of BDO Stoy Hayward or Grant Thornton over a similar period. In addition, Ernst & Young appears to have greater capacity to support higher debt levels. Baker Tilly & Co Limited did not appear to report any debt on its balance

[133] Bonds issued through private and public placements also differ in a number of key areas, including the design of bond covenants, the extent of monitoring by lenders, and the ease with which bonds can be renegotiated. These issues are outlined in Kwan and Carleton (2004). First, bonds issued through private placements are more likely to have restrictive covenants than publicly issued debts, as covenants are typically tailored to fit the unique borrowing situation. Second, bonds issued through private placements tend to be monitored directly by the private lender, while CRAs monitor public issues of bonds. Third, the renegotiation of bond covenants occurs relatively frequently in private placements, while the modification of a public bond covenant is often limited, as this requires the consent of a large number of bondholders. Kwan, S. and Carleton, W., T. (2004), 'Financial Contracting and the Choice between Private Placement and Publicly Offered Bonds', Federal Reserve Bank of San Francisco and University of Arizona', Federal Reserve Bank of San Francisco Working Paper Series.

[134] Krishnaswami, S., Spindt, P.A. and Subramaniam, V. (1999), 'Information asymmetry, monitoring and the placement structure of corporate debt', University of New Orleans, March.

sheet for the year ending March 31st 2006. Indeed, this is also the case for Baker Tilly International.[135]

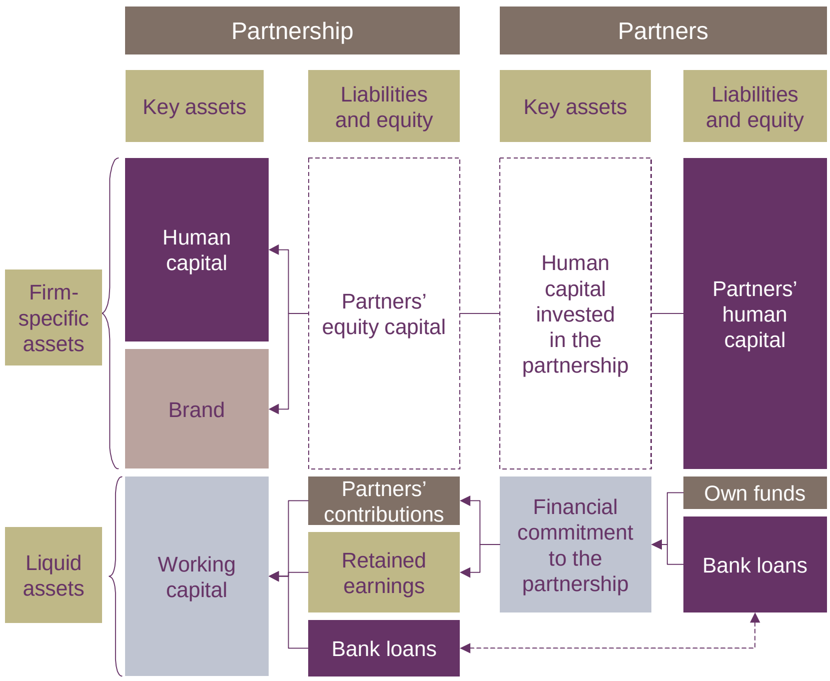
Table 6.2 Net cash flow to net debt (£m)

	Ernst & Young	BDO Stoy Hayward	Grant Thornton	Baker Tilly & Co Limited
Bank overdraft			0.8	
Bank loans	30.0	13.2	9.0	
Obligations under finance leases	5.0	2.3	12.7	
Other creditors		1.2	1.5	
Total net debt	**35.0**	**16.7**	**23.7**	**n/a**
Net cash flow from operating activities	284.0	72.1	50.8	–0.03
Net cash flow/net debt	**8.1**	**4.3**	**2.1**	**n/a**

Note: Amounts reported for Ernst & Young and BDO Stoy Hayward are based on the year ending on June 30th 2006. In contrast, the amount reported for Grant Thornton is based on the year ending June 30th 2005. The figure reported for Baker Tilly & Co Limited is based on the year ending March 31st 2006 and represents cash flow from operating activities.
Source: Oxera, based on the UK annual accounts of the respective firms.

A stylised illustration of the main sources and uses of capital for audit firms is shown in Figure 6.1. This also provides an illustration of the importance of assets such as human capital and brand for the audit business. The issues related to the impact of these assets on access to capital are discussed further below.

Figure 6.1 Stylised illustration of the sources and uses of capital for audit firms



Source: Oxera.

[135] Baker Tilly & Co Limited (2006), 'Report and Financial Statements for the year ended 31 March 2006', and Baker Tilly International Limited (2006), 'Accounts for the year ended 30 June 2006.'

6.2 Potential factors affecting audit firms' access to capital in light of the adopted ownership and management structures

The ownership and management structure of an audit firm, which is subject to regulatory restrictions, might influence both access and the costs of funding. This is examined below using the following methodology:

- assessment of the impact of adopting a 'model' or typical ownership and management structure (where such structure is typical of audit firms in general) on the level of returns required by investors in audit firms;
- analysis of the issues noted above in light of other potential ownership and management structures, and, in particular, the extent to which alternative structures might allow for access to funding at a lower cost;
- examination of the hurdle rates for investment in the audit business in light of the adopted ownership structures—ie, the required rate of return to investors for committing capital to the firm, where members or partners are the potential investors;
- analysis of the impact of audit firms' size on the cost of capital, where the size of a given entity (examined from the financial perspective) might be influenced by regulation (eg, liability exposure);
- analysis of the impact of the current ownership and control restrictions of audit firms on the required returns to investors.

6.2.1 Required returns on investments in audit firms

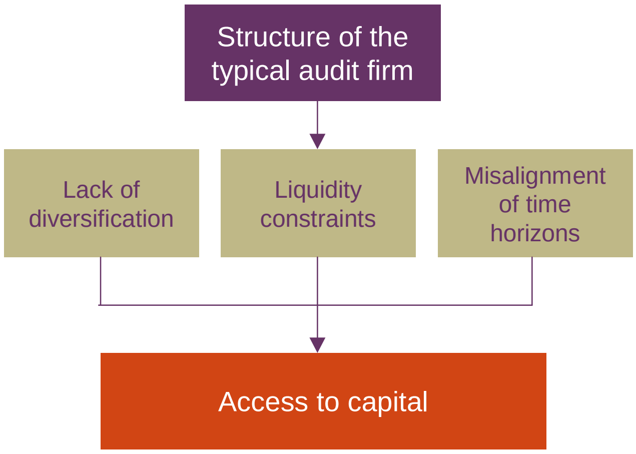
The level of returns that may be required by potential investors in audit firms needs to be examined, as this could have implications for audit firms' access to capital. To do this, the following features of a typical business structure of an audit firms need to be analysed (see Figure 6.2):

- **lack of diversification**—as audit partners (members, or shareholders) may invest a large percentage of their total wealth in the audit firm, members may not be able to optimally diversify their portfolio of investments;

- **liquidity constraints**—audit partners' (members, or shareholders) commitment to a particular audit firm is not easily transferable (eg, their stakes in the firm cannot be traded);

- **misalignment of time horizons**—audit partners (members, or shareholders) may only be willing to commit capital to the audit firm if their expected investment horizon is aligned with the actual expected returns on a given investment under consideration or business investments by audit firms in general. For example, if partners expect to receive a return from their investment over the relatively short term, while returns from investments are not expected to materialise over this period, audit partners may be deterred from committing funds to the audit firm.

Figure 6.2 Relationship between audit firms' corporate structure and access to capital



Source: Oxera.

Lack of diversification of capital providers to audit firms

Since audit partners or shareholders typically commit capital to an audit firm in their capacity as members or shareholders of the firm, the required return to capital of an audit firm is closely related to the required return to individual members. This applies in the simplified case where audit firms have no access to other sources of capital, which might be the effect of current ownership rules—eg, the firms have no access to public capital markets except for minority stakes.

The analysis of the rate of return required by audit partners (or the cost of capital of an audit firm) can be based on the same principles as executive compensation in the case of a company owned by executives or an individual entrepreneur as a sole or majority shareholder in their business. Similarly, access to capital in the case of audit firms might be determined by individual members' willingness to commit capital at a certain price (the required rate of return).

Similarly to a corporate executive or an entrepreneur, members' investments are made up of their actual, financial capital and their commitment of human capital, which is likely to be reflected in the market value of assets. Since a substantial proportion of members' private wealth and human capital is necessarily invested in the audit firm, members are exposed to significant risk that is specific to the audit firm. This is important in the context of considering, for example, barriers to expansion of mid-tier audit firms into new markets for large audits, since it may restrict a firm's access to capital that is necessary for expansion.

The impact of members' inability to fully diversify their investments on an audit firm's access to capital can be examined by analysing the empirical investigations into the implications of under-diversification for access to capital across different industries. In this context, numerous studies have analysed the implications of the lack of diversification required, for example, by the capital asset pricing model (CAPM) for the price and access to capital—a selection of the most relevant studies is examined below.[136]

The empirical investigations that have been examined (and are discussed in section 6.3 below) cover the following aspects.

– **Returns required for holding firm-specific risk**—several empirical studies have investigated the returns required by investors if they are exposed to firm-specific risk. In

[136] The CAPM is the model most commonly used to estimate a firm's cost of capital. Essentially, the model relates observed returns to a measure of the risk-free rate and market returns.

this light, investors can be considered as similar to audit partners, members or audit firms' shareholders more broadly. As a significant proportion of their wealth is invested in the audit firm, members may not be able to fully diversify their investments.

- **Returns required by entrepreneurs for investing in private businesses**—to the extent that an entrepreneur invests a substantial proportion of their private wealth in their business, they may be considered to be in a similar position to that of an audit partner. Therefore, examining the returns required by private entrepreneurs may provide additional insight into the returns required by audit members over and above the hypothetical price of capital from the public markets.

- **Compensation required by executives**—several empirical studies have compared the cost to the firm of issuing compensation in the form of equity and stock options with the value placed on such remuneration by executives. As the design of such remuneration may lead to executives becoming under-diversified, this can provide further insight into the level of returns that may be required by audit partners or members.

Liquidity constraints on ownership stakes in audit firms

Members' commitment to the audit firm is not easily transferable since their stakes are not traded—for example, usually they cannot be sold for cash at any point in time. In order to examine the implications of the illiquid nature of members' stakes for an audit firm's cost of capital, results from the empirical studies that have analysed the returns required by investors from investing in illiquid stocks may provide certain insights. Several studies have used empirical data to analyse this issue and are explored below.

Misalignment of time horizons between potential investments in audit firms and investors' expectations

Audit members may only commit capital to the audit firm if their expected returns horizon is aligned with the actual investment horizon for the business. If the period over which returns might be expected to materialise is substantially longer than that over which audit members expect to receive a return from their investment, the mismatch in time horizons may deter investment in the first place.

Private equity investors typically require returns to arise from any investment over a relatively short time horizon; in this light, these investors can be considered as similar to those audit members that have a limited time until retirement. Several studies have examined the investment behaviour of private equity fund managers. The results of such studies have been analysed in order to provide insight into the implications of the misalignment in time horizons for mid-tier audit firms' access to capital.

However, if the investment required to enter a new audit market, for example, has an expected long-term horizon, funding for this investment might not become available under certain ownership structures. Long-term investors might be required, for example, for business expansion of an audit firm if such expansion implies an asset–liability mismatch for existing investors (eg, members or partners).

6.2.2 Size of audit firms and access to capital

According to multi-factor asset pricing models, such as Fama–French, small firms pay a premium in terms of the expected rate of return simply for being small. This means that any restrictions on the size of audit firms might raise the cost of capital of those firms. In particular, two factors might need to be considered: first, an international network of audit firms, which raises capital locally, might face a higher cost of capital than a global corporation; second, mid-tier audit firms might face a higher cost of capital than the Big Four.

The smaller size and the looser network structure of mid-tier audit firms may have implications for these firms' access to capital, as well as the cost of capital. For example, in 2004, the global fee income for the largest mid-tier firm was more than four times lower than for the smallest Big Four firm: €2,657m compared with €11,840.[137] This is discussed further in section 6.3.2.

Numerous empirical studies have looked at the relationship between the returns required by investors and the market capitalisation of the firm (a proxy for firm size). The results from such studies have been analysed in order to provide additional insights about the implications of current ownership and governance structures of audit firms for the level of returns required by investors in such firms.

Smaller size has often been associated with a higher required rate of return, for several reasons:

– smaller companies are typically characterised by growth opportunities which pose business and financial risks in contrast to established franchises;
– large firms often have significant intangible assets, including valuable brands;
– in the case of larger firms, economies of scale and scope mean that certain risks might be mitigated;
– behavioural factors, such as market visibility, reputation and recognition, often influence investors' decisions.

Additionally, there have been several empirical investigations of particular difficulties faced by small and medium-sized enterprises (SMEs) when accessing capital. For example, limited liquidity in financial markets may have a disproportionate impact on smaller firms. Potential investors in these firms may require higher returns as remuneration for the greater perceived risks of investing in small company stock. The most relevant of these studies that have examined challenges faced by SMEs have been examined in this context.

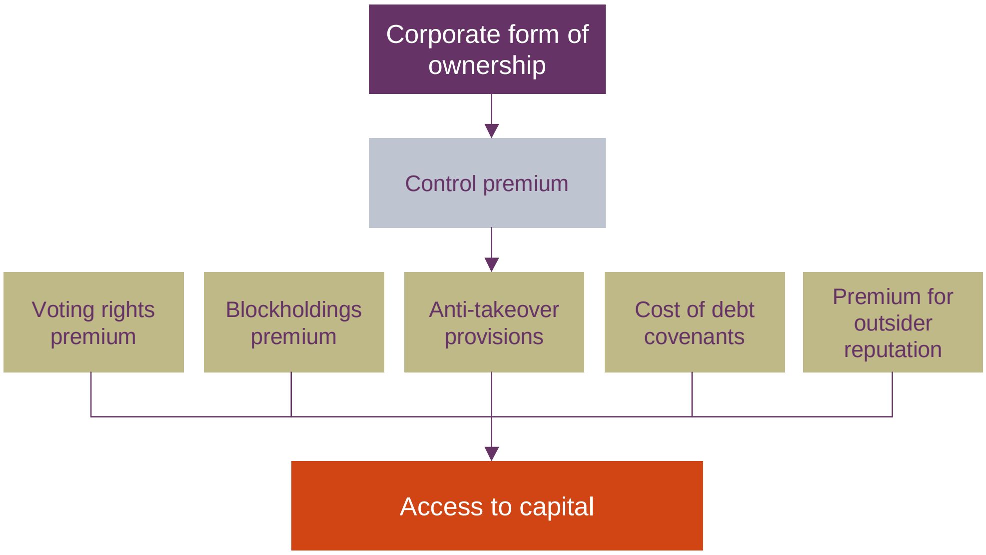
6.2.3 It is also worth noting that the above factors might influence firms' ability to attract capital under any form of ownership. In particular, capital markets tend to exhibit a valuation premium associated with size. Factors such as the form of the international network are likely to have an impact on all firms in the sector.Impact of the ownership and control restrictions on access to capital

A further important area of investigation is the impact of the current ownership and control restrictions on audit firms' ability to access the public capital markets from the perspective of the control and voting rights available to potential outside investors (see Figure 6.3). As the current restrictions limit the control of any outside shareholders over the key decisions of the audit firm, this may have implications for the level of return required by outside investors—ie, investors who are excluded from influencing the firm's management might require greater returns to compensate them for the lack of control.

To examine the level of returns that might be required by outside shareholders for minority stakes or the lack of control rights, empirical studies that have analysed the returns required by investors where they have influence over the key decisions of the firm's management have been examined for this study. This provides some insight into the returns required by investors if they do not have a significant influence over a firm's key decisions.

[137] Based on information from Oxera (2006), 'Competition and choice in the UK audit market', report for the DTI and FRC, April.

Figure 6.3 The impact of ownership and control on the cost of capital



Source: Oxera.

To investigate the level of return required by investors if they do not have control over the key managerial decisions, the following aspects have been examined in greater detail.

– **Voting rights premium**—several empirical studies have examined the price that investors are willing to pay to obtain the voting power in order to take part in key managerial decisions. The results from the most relevant studies have been examined in order to understand the returns that might be required as a form of remuneration for the lack of control.

– **Blockholdings premium**—numerous studies have investigated the price paid by investors for blocks of stock that are sufficiently large to represent a certain voting power to shareholders, such that shareholders are able to exert influence over the firm's management. The current ownership and control restrictions limit the size of (and in certain countries, local regimes prohibit) the ownership stake that can be obtained by outsiders. Either the restrictions are completely binding by prohibiting any outside ownership (for example, only certain professionals are allowed to own stakes in German audit firms), or the restrictions are binding as they limit the allowed size of the ownership stake below the level that would be preferred by investors. The results from the studies that have analysed the blockholdings premium could provide additional insights into the cost of capital of audit firms.

– **Anti-takeover provisions**—as strong anti-takeover provisions weaken the rights of shareholders relative to management, the impact of these provisions on the cost of raising capital may be implicitly similar to the current ownership and control restrictions on audit firms. Empirical studies have analysed the impact of the introduction of anti-takeover provisions on firms' share price performance.

– **Cost of debt covenants**—as covenants on bonds may prevent the firm from engaging in financing activities that may dilute the value of bondholders' debt, these covenants may act to limit shareholders' discretion. As the current restrictions on the management board composition of audit firms may prevent investors from influencing key managerial decisions, the results from these empirical studies may provide additional insights into the impact of limits on managerial discretion.

– **Premium for outsider reputation**—empirical investigations have analysed the reaction of investors to the appointment of outsider directors to a firm's management board. As the current managerial restrictions seem to limit such appointments, this may have implications for the level of return required by investors.

The analysis presented in the following sections explores these issues in greater detail in order to inform about the impact of these factors on audit firms' access to capital.

It is important to stress that this section does not address the question of whether corporate structures adopted by audit firms are a result of the rules and regulations imposed on these firms, nor does it look at whether they are the result of a firm's own decisions driven by, for example, business considerations to retain necessary human capital. The focus of this section is purely on the potential cost of the adopted ownership and management structures.

6.3 Capital rationing and the cost of capital in the audit market—the analysis

The analysis of access to capital is of particular importance because the majority of audit firms are not listed on public capital markets.[138] This has the likely effect of increasing the cost to audit firms of raising capital, and, correspondingly, it might be restricting audit firms' access to capital. Access to capital might be restricted not only due to price, but also due to capital rationing (existing capital providers' unwillingness or inability to access additional capital in the absence of alternative investors).

At the same time, private ownership might be important for the business model adopted by audit firms. In particular, it might constitute a channel through which audit firms acquire and retain human capital, and therefore might be critical to the business model.[139] As the majority of audit firms are privately owned (ie, auditors themselves are owners), a firm's profits do not need to be directed towards the remuneration of outside shareholders. Instead, audit members are able to share in the firm's total profits. However, the restrictions on the type of capital providers implied by the business model might have a negative impact on access to capital.

A further question that needs to be addressed in this context is what the current ownership and control *restrictions* imply for audit firms' access to public capital markets. In general, the restrictions in place effectively limit, and in some Member States, completely prohibit, the size of the potential investment by outside shareholders. They also limit the representation, and in some cases, local regimes prohibit any representation, of outsiders on the management board. Such restrictions may have an impact on audit firms' cost of capital (and increase the firm's hurdle rates for capital commitments), as outside shareholders may require higher returns to compensate for the limited size of their potential stakes.[140]

The factors that might influence the level of remuneration required by audit members and alternative capital providers to audit firms are examined below in light of the existing ownership restrictions. As indicated above, this is likely to have a direct implication for the cost to audit firms of raising finance. Moreover, the specific business characteristics of audit firms are investigated to the extent that these are related to the ownership and control of audit firms.

[138] Exceptions include Tennon Group, Vantis and Numerica.

[139] As discussed in section 6.1, for those audit firms that are established as partnerships, the term 'audit members' represents the members.

[140] Under the scenario where capital is not unlimited, financial theory states that investment should only be undertaken in projects where the pay-off from the project (the return) would exceed a minimum acceptable threshold (the hurdle rate). The hurdle rate should be higher for riskier projects and should also reflect the mix of equity and debt that is used to fund the project.

6.3.1 Required returns on investments in audit firms

The returns required by audit partners or members are likely to be closely related to the cost of capital of audit firms, and, therefore, firms' access to capital. The required rate of return or the hurdle rate for capital investments among audit firms will therefore be affected by numerous factors that have an impact on partners' or members' expected returns.

Many audit members in effect invest a large proportion of their total wealth (including the expected value of their future cash flows) in the audit firm. This is similar to the position of corporate executives, but significantly different from the typical exposure of a fully diversified investor, as members' future earnings are highly dependent on the performance of a single company—the audit firm.

Since audit members' human capital represents a substantial part of total members' assets, members are not optimally diversified—ie, members commit their human capital to the audit firm and are also dependent on the firm's performance for their financial remuneration.[141]

This lack of diversification implies that the members' required rate of return might be expected to be much higher than that implied by the traditional asset pricing models, such as the CAPM, which assume that investors are able to invest in a diversified range of companies.

The CAPM only allows for remuneration for the systematic risks that cannot be eliminated by investing in a wider range of assets. If members' required rate of return were to be estimated using the CAPM, this would most likely significantly underestimate the cost of capital, since it would not provide any remuneration for exposure to risks that are specific to the audit firm (idiosyncratic risks).

However, members might expect remuneration for the idiosyncratic risks, not just for the systematic risks that cannot be diversified away with an optimal investment portfolio. This might have significant implications for the required rate of return on members' investments in an audit firm.

Moreover, in the context of this study, it is important to consider the above issues in the context of the returns required by audit members of a mid-tier audit firm on the potential investments required to expand into the market for larger audits (such as the market for larger non-listed audit clients). As discussed in section 7, any potential entry by mid-tier firms into the market for larger audits may be characterised by a number of sequential investment and expansion steps. Oxera (2006) characterised a possible expansion strategy that involved three key steps.

- establishing a foothold in the lower end of the FTSE 250 by gaining up to ten medium-sized clients;
- expanding and consolidating the firm's position in the FTSE 250 by acquiring up to 20 additional clients among the FTSE 250 companies.
- establishing a significant foothold in the lower end of the FTSE 100 by gaining up to ten large clients from the group of the largest listed companies, but refraining from expanding into highly specialised sectors such as banking or insurance.[142]

The investments that would be required to undertake such an expansion strategy include human as well as financial capital. In particular, there may be a mismatch between the time it takes for a mid-tier audit firm to build up a sufficient foothold in the market for larger audits to

[141] In this context, human capital represents the skills of the audit member, including both educational attainment and on-the-job experience.
[142] Oxera (2006), op. cit., p. 97.

earn returns on the investment and an investment horizon that would be acceptable to audit members. This issue is explored further in the analysis of asset–liability mismatch.

Lack of investors' diversification in the mean–variance framework—implications for access and cost of capital

From a theoretical perspective, the impact of individual members' under-diversification on the required rate of return—and, hence, cost of capital—can be analysed in the mean–variance framework, which is a central tenant in modern financial theory. This framework is based on the assumption that returns from any investment follow a particular pattern (the normal distribution), and, as such, returns can be completely described by their mean (measure of the average) and their volatility (the variance). As a result of this framework, investors' utility can be measured solely through the mean and variance of returns on a given investment.

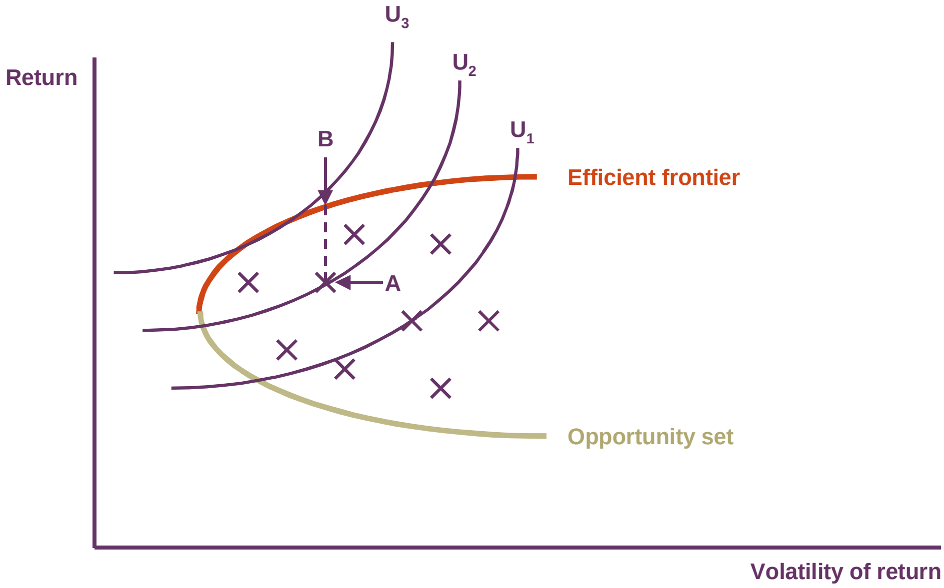
In the mean–variance framework, investors require higher returns as the amount of risk (measured by the volatility of returns) increases. Illustrations of potential preferences towards risk and return are shown in Figure 6.4 below through the (indifference) curves U_1 to U_3. Each indifference curve represents combinations of risk and return that give the same utility to the hypothetical investor. All combinations of risk and return along the indifference curve U_3 confer greater utility than U_1, as this enables a higher return to be achieved, for the same level of risk.

Rational investors are able to invest in portfolios that lie on or inside the opportunity set—this set represents the combinations of risk and return (ie, investments) that can be obtained by the investor. The crosses illustrate some of the combinations of risk and return that could be obtained by a hypothetical investor. Rational investors will not invest in portfolios that offer lower returns for the same level of risk. As such, rational investors that can invest in a diversified set of companies will only invest in portfolios that lie along the efficient frontier (the set of investments that maximise the return for each level of risk).

As individual audit members may not be able to fully diversify their investments, they may be forced to choose a combination of risk and return that is inefficient (not located on the efficient frontier), such as point A. If individual auditors had been able to fully diversify their investments, they may have been able to obtain an efficient combination represented by (say) point B, which would also confer greater utility.

Hence, the gap between points A and B represents the cost of the lack of full diversification—the additional required return to a hypothetical investor (eg, audit partner or member) on their investment in the audit firm.

Figure 6.4 Illustration of the implications of members' lack of full diversification in the mean–variance framework



Note: The opportunity set represents those investments that can be obtained by the investor. The efficient frontier represents those investments (within the opportunity set) that are optimal in the sense that they offer maximum expected return for some given level of risk, or, conversely, minimum risk for some given level of expected return. Source: Oxera.

This sub-optimal level of diversification means that audit members must be compensated for the firm's total risk, including both idiosyncratic and systematic risk, which is likely to have significant implications for the willingness to commit capital and hence audit firms' access to capital to fund potential investment opportunities.[143]

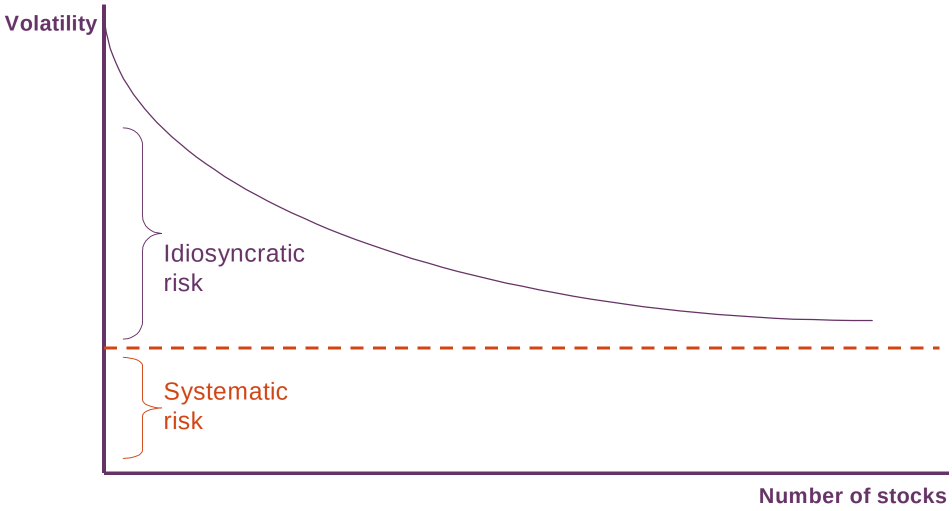
Figure 6.5 below illustrates that the total risk of an audit firm will comprise the systematic and idiosyncratic (non-systematic) components.[144] The CAPM assumes that because an investor is able to invest in a larger number of stocks, the idiosyncratic risk declines, but systematic risk is maintained at a certain level.[145]

[143] Idiosyncratic risk is specific to an individual firm, but can be eliminated by investing in a diversified portfolio (while maintaining the same level of expected returns). In contrast, systematic risk relates to market-wide risk (such as changes in economic growth), which cannot be fully diversified.

[144] The CAPM links the expected returns on stocks to the returns on the market (such as the FTSE All-share index) and the returns on a risk-free rate (such as the yield on government bonds).

[145] The optimal amount of diversification will depend on correlations between stocks in investors' portfolios; the benefits of diversification are higher when the correlation between stocks is greater. Investors will only be remunerated for the proportion of risk that cannot be diversified away ('systematic risk'). Statman (2002) found that the optimal level of diversification exceeds 120 stocks. Statman, M. (2002), 'How much diversification is enough?', October.

Figure 6.5 The impact of diversification on risks (in the CAPM framework)



Source: Oxera.

The CAPM predicts that the market only rewards systematic risk, not idiosyncratic risk. Hence, investors will only be remunerated in the form of higher returns for holding systematic risk, as they can eliminate idiosyncratic risk by investing in a number of different stocks (portfolios).

However, in contrast to the predictions of the CAPM, individual audit members may not able to fully diversify their investments and may therefore require remuneration (in the form of higher returns) for facing both idiosyncratic and systematic risk.

To examine the possible extent of this remuneration, the empirical evidence from different industries about the returns required when investors are not able to fully diversify is examined and applied to the context of the audit market. The returns required by audit members for exposure to risk specific to the individual audit firm are analysed from the following angles:

– returns required by investors that are not able to fully diversify their portfolios (see returns for holding idiosyncratic risk);
– returns required by individuals who have a strong influence over the performance of a firm (control premium);
– returns required by individuals whose financial remuneration is significantly dependent on the success of this firm (see returns required by entrepreneurs);
– evidence from the remuneration required by corporate executives who are not able to fully diversify their investments (see executive compensation).

Returns for holding idiosyncratic risk

Several studies have investigated the returns required by investors for holding idiosyncratic risk. A study by Spiegel and Wang (2005) found that returns on stocks listed on the NYSE, AMEX and NASDAQ between 1962 and 2003 increased with the level of idiosyncratic risk.[146] The results of this study support the results of a similar investigation undertaken by Xu and Malkiel (2004). These authors found that if investors are not able to fully diversify their investments, returns on stocks are affected by the amount of idiosyncratic risk.[147]

[146] Spiegel, M. and Wang, X. (2005), 'Cross-sectional Variation in Stock Returns: Liquidity and Idiosyncratic Risk', Yale School of Management and International Centre for Finance.
[147] Xu, Y. and Malkiel, B. (2004), 'Idiosyncratic Risk and Security Returns', AFA New Orleans Meetings, May.

Another such investigation by Fu (2005) examined the relationship between stock returns and idiosyncratic risk for stocks listed on NYSE, AMEX and NASDAQ between July 1963 and December 2002.[148] To measure the idiosyncratic risk of an investment in a given security (stock), Fu (2005) adopted a common asset pricing model—the Fama–French model—which relates returns on a stock to the market, size and book-to-market factors.[149] The idiosyncratic risk was measured as the volatility (measured by the standard deviation) of the difference between the stocks' actual returns and the predictions of the Fama–French model.

Fu (2005) found that under-diversified investors required (additional) remuneration for holding idiosyncratic risk.[150] Fu (2005) also found that stocks that are expected to have higher idiosyncratic risk earn higher returns: every 1% increase in idiosyncratic risk was found to increase returns by around 0.16–0.20% per month.[151] Table 6.3 indicates that the return on stocks with the lowest levels of idiosyncratic risk was around 0.6%, while stocks with the highest idiosyncratic risk had returns of around 3.5%.

Table 6.3 Premium for idiosyncratic risk (%)

	Portfolio				
Measure	**Low**	**2**	**3**	**4**	**High**
Value-weighted portfolio returns	0.85	0.98	0.94	1.07	1.62
Equal-weighted portfolio returns	0.61	0.76	0.67	0.73	3.41
Equity beta	**0.95**	**1.12**	**1.26**	**1.36**	**1.40**
Median market value of equity ($m)	128.7	118.0	60.2	32.4	15.4
Median book-to-market ratio	0.87	0.78	0.76	0.69	0.57
Idiosyncratic volatility	7.78	10.03	13.17	17.18	24.29

Note: Low represents the 20% of stocks with the lowest expected idiosyncratic volatility over the forthcoming month. High represents the 20% of stocks with the highest expected idiosyncratic volatility over the forthcoming month. Portfolios are formed on stocks listed on NYSE, AMEX and NASDAQ. The equity beta measures the relationship between returns on a stock and the returns on the overall market (such as the FTSE All-share index), and therefore captures the firm's financial and business risk. A value for the equity beta in excess of unity would indicate that the risk of the firm is higher than the overall market average. The book-to-market ratio measures the accounting value of the firm, relative to the market's perceptions of the firm's value. A book-to-market ratio in excess of unity would suggest that the market values the prospects of the firm poorly compared with the firm's accounting value.
Source: Fu (2005), op. cit., p. 51.

These results suggest that if the return required by audit members were to be estimated from the standard CAPM approach, this would be likely to underestimate the required return. Such an approach would not remunerate risk that is specific to an individual firm, as this idiosyncratic risk could be eliminated by investing in a diversified portfolio.

The empirical results can be used to suggest that members may require *additional* returns, above the remuneration for systematic risk obtained from the CAPM, for exposure to risk that is unique to the audit firm (ie, idiosyncratic risk).

[148] Even though the study is based on the US stock market, the results might be applicable to other countries, especially given the long time period analysed in the study and the range of stocks (from three different indices) included in the analysis.
[149] Fama, E. and French, K. (1993), 'Common risk factors in the returns on stocks and bonds', *Journal of Financial Economics*, **33**, 3–56. Fama and French augment the CAPM by including factors that proxy for the size of the company as well as the book-to-market ratio. The book-to-market ratio refers to the book value of the firm, expressed as a ratio of the market value of the firm. Fama and French (1993) found that stocks with a higher book-to-market ratio ('value stocks') had higher returns than stocks with lower book-to-market ratio ('growth stocks'). Additionally, the authors found that small cap stocks had higher returns than stocks of larger companies.
[150] Fu, F. (2005), 'Idiosyncratic risk and the cross-section of expected stock returns', June, University of Rochester.
[151] Ibid., p. 49.

The additional premium required by audit partners or members (ie, the investors in audit firms) is likely to depend on a number of factors, some of which are specific to the audit firm, such as its financial and business risks. The results from the Fu (2005) study indicate that the audit member may require a higher *additional* premium to invest in a small audit firm compared with a larger firm.[152] As the additional premium depends on a variety of factors, it is difficult to quantify the magnitude of the uplift that would need to be applied to the required return that is estimated from the CAPM approach. Indeed, it is possible that the additional return required by members exceeds the estimates in Fu (2005), given the members' limited diversification opportunities.

Returns required by entrepreneurs

As audit members invest a large percentage of their personal net worth in an audit firm, and as the success of an audit firm may depend on individual auditors' own personal contributions, the members' situation might be compared with that of entrepreneurs. For example, entrepreneurs typically risk their own financial investment and also forgo the opportunity to undertake additional work for labour income while running their own business (in the same way as the partner works in the audit firm).

Empirical studies that have looked at the returns required by entrepreneurs from the firms in which they invest are particularly relevant to audit firms, which are typically privately owned. A variety of empirical studies have examined the returns that may be required by entrepreneurs; two relevant studies are discussed below.

Muller (2004) examined the extent to which owners of private companies are under-diversified, and whether these owners are remunerated for exposure to such idiosyncratic risk.[153] The results of the study are based on a sample where the average owner has limited collateral and faces difficulties obtaining unsecured loans from banks, and as such, has around 30–40% of their net worth invested in the firm. In comparison, audit members may invest an even greater proportion of their net worth in the audit firm.

Muller (2004) found evidence of a positive relationship between the extent of under-diversification and returns, which, in equilibrium, can be used to infer the cost of equity capital.[154] According to Muller (2004), an increase of ten percentage points in the share of equity of an individual owner (relative to their net worth) led to an increase in the return on equity by 9.2 percentage points.[155] This provides further empirical evidence to suggest that audit members may require remuneration for exposure to the unique risk of the audit firm.

The finding of a positive relationship in the Muller (2004) study between the owners' investment in the firm and returns on the stock was attributed to two factors. First, as owners were able to select the projects in which they invested, this provided a channel to ensure that returns were sufficient to provide for the exposure to idiosyncratic risk (the cost of under-diversification). Second, if the owners also managed the firm, they were found to exert greater effort to ensure its future profitability.

To an extent, both of the above-noted factors are also applicable to the audit market. First, members have a degree of influence over the use of the funds they are required to commit to the firm. Second, as discussed in section 5, the partnership structure represents one way to provide incentives in an attempt to ensure that employees maximise their work effort.

[152] Table 6.3 shows that smaller firms (as defined by the market value of equity) were found to have greater idiosyncratic risk, and correspondingly, higher returns.

[153] Muller, E. (2004), 'Underdiversification in Private Companies—Required Returns and Incentive Effects', Centre for European Economic Research, Discussion Paper No. 04–29, July.

[154] Stock returns observed on the market include both systematic and idiosyncratic risk. Under the CAPM framework, the cost of equity only provides remuneration for exposure to systematic risk and not idiosyncratic risk.

[155] Muller, E. (2004), op. cit., p. 28.

A further empirical investigation that has implications for the audit market is that undertaken by Polkovnichenko (2002). He examined whether entrepreneurs require a premium to invest in a private business by modelling the decisions by risk-adverse entrepreneurs on whether to work for hire or to start their own business. The author assumed that there was a fixed-scale private project, which required both a substantial cash investment and commitment of human capital by the entrepreneur. He found that entrepreneurs required a return of about 0.4–1.2% above a diversified benchmark to invest in a private business.[156]

In Polkovnichenko (2002), the estimates of the premium required by entrepreneurs to invest in the private project were also segmented according to the entrepreneur's financial wealth. As shown in Table 6.4, the premium increased with the amount of investment, but declined with the entrepreneur's wealth.

Table 6.4 Premium required by entrepreneurs to invest in a private business (%)

Parameter	Variant	Benchmark	Variant
Wealth ($'000)	194.00	250.00	250.00
Investment ($'000)	120.00	88.00	120.00
Premium	**2.34**	**1.16**	**2.19**

Source: Polkovnichenko (2002), op. cit., p. 9.

The findings from the Polkovnichenko (2002) study suggest that the remuneration required by audit members for not being able to fully diversify their investments might be sensitive to the level of funds that members are required to commit to the firm.

Evidence from executive compensation

To examine the level of returns that may be required by audit members as remuneration for the lack of diversification, evidence on the compensation required by executives (who may also not be fully diversified) can be examined.

Meulbroek (2000) analysed the returns required by executives that are unable to fully diversify their risks by examining the value attached by executives to stock- and option-based compensation, and comparing this with the cost to the firm of issuing such compensation.[157] She found that members of firms listed on NYSE, AMEX and NASDAQ in December 1998 valued stock- or equity-based remuneration at less than its market value. The awarding of stock- or equity-based compensation would increase the sensitivity of members' financial wealth to the future performance of the firm.

In the context of this study, the results of the Meulbroek (2000) study suggest that audit partners or members may not be able to fully diversify their portfolio of investments, and as a consequence, may hold a sub-optimal portfolio of investment; as a result, members may value stock- or equity-based compensation at less than the market value.

This suggests that under-diversified investors may require remuneration in the form of higher returns for exposure to idiosyncratic risk. The estimates from Meulbroek (2000) of the uplift that would need to be applied to returns so that an under-diversified individual would be indifferent between investing in an undiversified portfolio and the market (say, the FTSE All-share index) are shown in Table 6.5 below.

[156] Polkovnichenko, V. (2002), 'Human Capital and the Private Equity Premium', University of Minnesota and the Federal Reserve Bank of Minneapolis, April.
[157] Meulbroek, L.K. (2000), 'The Efficiency of Equity-Linked Compensation: Understanding the Full Cost of Awarding Executive Stock Options', Harvard Business School.

Table 6.5 Estimates of the premium to returns (%)

	Return premium	
Degree of under-diversification	Mean	Median
100	9	8
75	8	6
50	6	5
25	3	2

Note: 100% under-diversification refers to 100% of the investment portfolio being constrained to a single stock (such as the audit firm). The same results are obtained from both stock- and option-based remuneration.
Source: Meulbroek (2000), pp. 35 and 40.

Similar to Polkovnichenko (2002), Meulbroek (2000) found that the premium required for the lack of full diversification increased with the amount of members' wealth invested in the firm. Hall and Murphy (2001) also showed that the required premium rose more rapidly for those individual auditors who are more risk-averse.[158]

Findings from the empirical studies suggest that as a high proportion of audit members' net worth is tied up in the audit firm, members may not be able to fully diversify their risks, and instead may require remuneration in the form of higher returns for exposure to these risks. Polkovnichenko (2002) and Meulbroek (2000) have provided estimates of the level of remuneration that may be required by members for exposure to the unique risk of the audit firm (idiosyncratic risk). The respective estimates can be viewed as the potential upper and lower bounds on the premium required by audit partners in the context of this study, as shown in Table 6.6.

Table 6.6 Estimates of the premium required by members for exposure to the idiosyncratic risk of the audit firm (%)

	Estimate of premium	Author
Lower bound	0.4–2.0	Polkovnichenko (2002)
Upper bound	5.0–6.0	Meulbroek (2000)

Note: Estimates reported from Meulbroek (2000) are based on the assumption that the degree of under-diversification lies between 50% and 75%.
Source: Based on Polkovnichenko (2002) and Meulbroek (2000).

The size of the premium required by audit members is likely to be sensitive to a variety of factors, including the amount of funds that members are required to commit to the firm; moreover, the premium is likely to rise as the member's stake in the firm increases.

Liquidity and transferability of capital investments in audit firms—implications for cost of capital

Audit members' stakes in the audit firm are not easily transferable; for example, their investments cannot be sold in public capital markets.

To an extent, audit members' personal investment is transferable, as they can leave the audit firm to join another such firm where they might expect similar returns on their investment and commitment of human capital. However, their commitment to a particular audit firm is not liquid, in that it cannot be traded. This might imply a higher required rate of return than in the

[158] Hall, B. and Murphy, K.J. (2001), 'Stock Options for Undiversified Members', Harvard Business School, Harvard NOM Research Paper No. 00-05, November, p. 43.

case of capital committed to a firm or a project by a typical investor who can typically sell their stake to a third party.

Although there has been limited research on the required rate of return on private, non-transferable investments, researchers have examined the returns that may be required by investors for investing in illiquid stocks. This research is applicable in this case since audit members' commitment of capital might be considered illiquid.

For example, Spiegel and Wang (2005) have examined the returns required by investors to invest in illiquid assets.[159] The authors based their analysis on a sample of monthly stock returns from firms listed on the NYSE, AMEX and NASDAQ between January 1962 and December 2003, and measured liquidity through cost-based measures. This enables the liquidity of stocks to be quantified from the financial loss incurred by a trader from a particular transaction. Following such an approach, Spiegel and Wang (2005) found that returns on stocks were decreasing in liquidity. This implies that illiquid investments would require a premium on the risk-adjusted, expected rate of return.

Another empirical study that has examined the same issue is that by Dimson and Hanke (2002).[160] These authors looked at returns from equity-linked bonds that provide the same pay-off as an investment in an equity index, but are relatively illiquid.[161] Based on data from the London Stock Exchange, Dimson and Hanke (2002) found that these securities sold at a discount to their underlying value, and had higher expected returns. The authors illustrated that the premium associated with illiquidity may be around 1–3%, as shown in Table 6.7.

Table 6.7 Illiquidity premium (%)

	Index to which the equity index bond is linked			Average
	All-share	Europe excl. UK	Small cap excl. IT	
Institutional investor	0.48–0.63	1.19–1.50	2.31–2.40	1.33–1.51
Retail investor	1.38–1.53	2.09–2.40	3.21–3.30	2.23–2.41

Source: Dimson and Hanke (2002), p. 24.

The Dimson and Hanke (2002) findings illustrate that the magnitude of the illiquidity premium varies according to the type of investor, and is consistently around 1% higher for retail investors than for institutional investors.[162]

As audit members represent individual investors, estimates of the premium for retail investors may be more applicable than those for institutional investors. This suggests that members may require remuneration in the form of additional returns of around 2% for committing capital, which cannot be readily transferred.

Asset–liability mismatch

If audit partners or members are asked to commit capital to a business expansion, their expected investment horizon must be aligned with the actual expected returns on their investment. If members' expected returns (a liability from the firm's perspective) are based

[159] Spiegel, M. and Wang, X. (2005), 'Cross-sectional Variation in Stock Returns: Liquidity and Idiosyncratic Risk', Yale School of Management, September.

[160] Dimson, E. and Hanke, B. (2002), 'The Expected Illiquidity Premium: Evidence from Equity Index-Linked Bonds', December, London Business School, p. 2.

[161] Ibid., p. 2.

[162] Institutional investors are entities with large amounts of capital to invest, which may include pension funds, investment banks, insurance companies and mutual funds. In contrast, retail investors are often smaller and typically represent individuals who purchase a small amount of securities for themselves.

on a shorter horizon than the expected returns on the investment (an asset from the firm's perspective) then an asset–liability mismatch might arise.

To the extent that members' commitment of capital (human capital as well as financial investment) is not transferable and cannot be traded (ie, members cannot sell their stakes in the business at the end of their investment horizon), they might be unwilling to commit capital to projects where they cannot recover their investment within their investment horizon.

The problem of asset–liability mismatch, as set out above, might be important since it might significantly restrict audit firms' access to capital. In particular, in the absence of alternative sources of financing or to the extent that such alternative sources are ill-suited to securing the assets that are critical to the audit business (eg, human capital), an audit firm might not be able to undertake NPV-positive projects due to asset–liability mismatch.

For example, it may take at least 10–15 years for a sufficient number of suitable companies to put their audit out to contract so that a non-incumbent can build up its initial market foothold in the market.[163] This could be even longer if a new entrant were to find itself at a disadvantage to the incumbents in terms of the likelihood of winning each tender. Therefore, the low tendering rate is likely to prolong the expected investment horizon to break even on an investment in, for example, expansion into the market for large audits (see section 7.4 for the entry model).[164]

The investment horizon of the audit members providing the capital for the necessary investment may be relatively short. In the Oxera (2006) study, some interviewees indicated that the individual investment horizon of audit members could be as short as 3–5 years.[165] As existing members would only benefit from the returns on the investment that are realised prior to their retirement, and, in particular, members might significantly discount any returns beyond the 3–5-year investment horizon, this suggests that most of the expected rewards from making the investment may represent limited value to existing members, and would accrue to audit members who had not made the initial investment. This mismatch is likely to have significant implications for access to capital.

To the extent that audit members require returns to materialise over a relatively short period, members may be viewed as similar to private equity investors and/or entrepreneurs. Private equity investors typically provide finance in return for stakes in companies they expect to produce significant cash returns within a limited number of years. According to the British Venture Capital Association, returns to private equity investors typically materialise within 4–6 years, despite most private equity funds typically having a life of around 10–12 years.[166] There are also further similarities in the context of the required rate of return:[167]

– **illiquidity of capital stakes**—capital committed by private equity investors is also highly illiquid. Similar to audit members, private equity investors have limited exit opportunities for a number of years once capital has been committed;

– **quality and access to information**—similar to the audit partners or members, private equity investors typically actively participate in the target firm management; both of these groups can therefore be regarded as informed investors with limited problems of asymmetric information between the owner and the manager;

[163] This is based on the assumptions followed in the Oxera (2006) study.

[164] Oxera (2006), p. 95.

[165] Oxera (2006), p. 95.

[166] British Venture Capital Association (2001), 'How to Invest in Private Equity', March.

[167] It is important to note that this comparison does not imply that private equity investors might be suitable investors in audit firms.

– **monitoring role of investors**—under some circumstances, venture capitalist investors may act in a strategic role, providing advice to the firm's management. Similarly, entrepreneurs are typically heavily involved in the day-to-day running of the firm, and are likely to be able to directly influence the firm's future cash flows.[168]

A range of studies has examined the behaviour of private equity funds, and the factors that explain the returns materialising to the private equity investors. For example, a study by Ljungqvist and Richardson (2003) was based on a database of the largest institutional investors in private equity between 1981 and 1993, where the average holding period was around 14 quarters.[169] The authors examined the investment behaviour of private equity fund managers and the determinants of returns to the funds' limited members.[170]

They found that the funds exited their portfolio companies, returning capital to their limited members (typically via an IPO or sale) more rapidly if public market investors were willing to pay more for them. Funds were found to invest capital and exit their portfolio companies more quickly during times when there were more investment opportunities available, which led to an improved return on the investment.

This evidence is significant since it indicates that short investment horizons might be critical to the commitment of capital by certain types of investors. Audit members might be expected to have particularly short investment horizons and might lack a clearly defined exit strategy or indeed clear exit options.

A further investigation by Lerner et al. (2005) examined the drivers of returns on private equity investment in the USA between 1991 and 1998.[171] The authors found that the performance of private equity funds, as measured by the internal rate of return (IRR), increases with the length of time that the private equity fund has been established. Additionally, a negative relationship was observed between the limited member's average private equity commitment and the fund's performance; the larger investors tended to under-perform the average investor. For every 1% increase in the private equity commitment of the individual member, the fund's IRR declined by approximately 0.2%.[172]

Lerner et al. (2005) suggest that the relationship between the size of the limited member's capital commitment and the performance of the fund can be explained if there are severe capital constraints in the industry. If there are restrictions on the amount that limited members can invest into each fund, and this is combined with constraints on the rate at which new fund managers can enter the industry, limited members with larger endowments may be forced to invest in new funds. As there is evidence that new funds may under-perform the industry, this may explain the negative relationship between the size of the limited member's capital commitment to the fund and the fund's performance.

To some extent, the negative relationship between the capital committed by the limited member and the performance of the fund could have implications for the level of return required by audit partners or members. This evidence suggests that the returns that materialise from any investment in the audit firm may not adequately remunerate those members who are required to contribute significant financial capital to the firm.

[168] Cuny, C.J. and Talmor, E. (2003), 'The Staging of Venture Capital Financing: Milestone V. Rounds', Texas A&M University and London Business School.

[169] Ljungqvist, A. and Richardson, M. (2003), 'The Investment Behaviour of Private Equity Fund Managers', Stern School of Business, New York University, October, p. 19.

[170] Private equity funds are typically structured as limited partnerships. The funds are managed by general members, while investors (the limited members) commit capital to the fund. The general members identify and monitor investments and design exit strategies on behalf of the limited member.

[171] Lerner, J., Schoar, A. and Wong, W. (2005), 'Smart Institutions; Foolish Choices?', Working Paper 4523-05, MIT Sloan School of Management, January.

[172] The IRR is the discount rate that when applied to the future cash flows generated by an investment is such that the return on the investment is zero.

Empirical studies analysing the level of returns required by entrepreneurs to invest in private businesses have been discussed in the previous section. To this extent, the requirement by entrepreneurs for returns exceeding those generated from a diversified benchmark may also broadly capture the impact of entrepreneurs' short investment horizons.

In particular, it is of interest to examine more closely the magnitude of the potential mismatch, as well as to compare members' investment horizons with those of alternative capital providers. For example, public capital markets are typically assumed to provide long-term capital. Bodie (1995) explained this feature of the capital markets as follows: as the probability that stocks earn less than the risk-free rate of interest declines over time, investors with longer-term horizons may be more likely to obtain higher returns.[173]

Gaspar et al. (2005) investigated how the investment horizon of shareholders affected the market for corporate control.[174] Short-term investors were found to have fewer incentives to monitor the firm; this becomes apparent during M&A activity.

– **Target shareholders**—the more short-term the investment horizon of the shareholders of the target firm, the lower is the premium that is paid for the target firm. In the case of target firms, Gaspar et al. (2004) found that if the average time that an investor holds a stock in their portfolio declines by four months (from 15 to 11 months), the premium paid to target firms falls by 3%.

– **Bidder shareholders**—the impact of an announcement of a merger on the bidder's share price becomes more negative if the bidder's shareholders have shorter investment horizons.

These results imply that the shorter the investment horizon, the lower the level of 'returns that are likely to accrue to investors. To the extent that audit members have short-term investment horizons, these results may indicate that the returns that materialise over the audit member's investment horizon may not provide sufficient remuneration for members. This may restrict the audit firm's ability to access the necessary capital to expand into the market for larger audits, given the adopted ownership form.

Members' leverage and access to capital

As audit members are typically required to contribute funds when joining the audit firm, this leads to individual auditors—particularly, the younger partners—borrowing funds in order to be able to contribute the required capital to the audit firm. As a consequence, these partners may be more highly geared than is optimal.[175] From the theoretical perspective, this problem can be examined in the mean–variance framework, as illustrated in Figure 6.6 below (and similar to Figure 6.4 above).

For illustrative purposes, it is assumed that there are two groups of partners (investors), one of which is more risk-averse than the other. The preferences of those investors who are more risk-averse are illustrated by the indifference curves U_1 and U_2. The indifference curves illustrate the combinations of risk and return that confer the same utility to a hypothetical investor. In return for bearing greater risk, the more risk-averse investors require remuneration in the form of higher returns. In contrast, investors who are not so risk-averse may require a lower degree of remuneration to compensate for increases in risk; these preferences are represented by the indifference curves U_1* and U_2*.

[173] Bodie, Z. (1995), 'On the Risk of Stocks in the Long Run', *Financial Analysts Journal*, May–June, 18–22.
[174] Gaspar, J., Massa, M. and Matos, P. (2005), 'Shareholder Investment Horizons and the Market for Corporate Control', *Journal of Financial Economics*, **76**, 135–65.
[175] In this context, gearing represents the amount of debt held by the individual audit member.

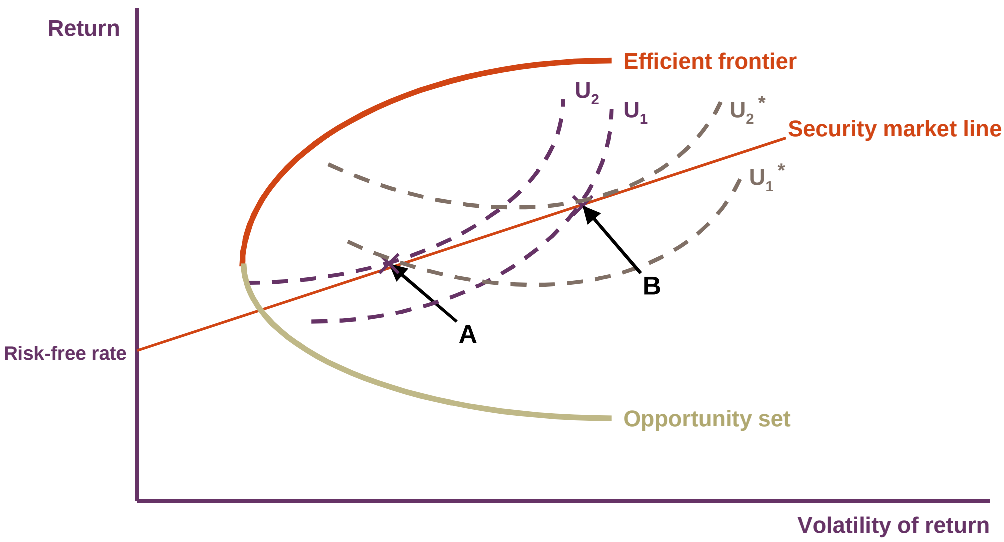
As discussed above, individual partners or members may not be able to fully diversify their investments. As such, they will be located somewhere along the security market line. This line represents inefficient combinations of risk and return from the perspective of a fully diversified investor. If members were able to fully diversify their investments, they might be able to invest in combinations along the efficient frontier, where a higher return would be achieved for the same level of risk.

If it is assumed that individual members may not be required to contribute significant amounts of capital upon joining the audit firm, but are still not able to fully diversify their investments, members could be located at a point such as A. However, if individual members are required to contribute funds to the audit firm, and this can only be achieved by borrowing, this may move members to a point such as B. The distance between A and B represents the proportion of the total investment that the individual auditors may be required to borrow.

Depending on the risk-aversion preferences of the individual audit partner or member, committing funds to the audit firm through borrowing may be associated with a lower level of utility. For risk-averse members (whose preferences are represented by indifference curves U_1 and U_2), this may be associated with a lower level of utility—the member moves from point A on indifference curve U_2 to point B on indifference curve U_1. In contrast, for members who are less risk-averse, the borrowing may be associated with a higher level of utility—the executive moves from point A on indifference curve U_1^* to point B on indifference curve U_2^*.

Partners or members might need to borrow in order to commit capital to the firm. The critical observation is that risk-averse members might require additional compensation for being forced to move to point B (when they are forced to borrow and commit capital to the firm in the absence of the optimal level of diversification). This compensation would be required to equal the difference between U_1 and U_2 in utility terms. The additional compensation would imply a higher required return and therefore a higher hurdle rate for any new investment.

Figure 6.6 Impact of individual auditors' leverage (in the mean–variance framework)



Source: Oxera.

This example has illustrated the impact that audit members' leverage may have on the hurdle rates in the audit business. However, the size of this effect is difficult to measure. In particular, the capital that members may be required to contribute when they join the audit firm may be small compared with the NPV of their earnings during their tenure at the firm.

Several empirical studies have analysed determinants of discount rates applied by individuals to future income streams. Such studies are relevant to the extent that they provide insights about how audit partners' hurdle rates may change with their age and income.

One such study, Praag and Booij (2003), found that an individual's discount rate declines with both age and income.[176] This supports the previous analysis that younger audit partners may have higher hurdle rates. This would subsequently have an adverse impact on the audit firm's access to capital.

More generally, it may be difficult to estimate accurately a generic hurdle rate for the younger audit members, as this rate is likely to depend on a number of factors, including individual preferences towards risk. Wong (2005) has shown that more risk-averse individuals are likely to be less inclined to invest in risky portfolios, and will be more conservative when evaluating the risks associated with their investments.[177] As discussed above, this suggests that the risk preferences of the individual audit partner are likely to significantly influence each member's hurdle rate, which may form the basis of the decision on whether to undertake a particular investment.

6.3.2 Characteristics of audit firms and access to capital

The cost of capital of audit firms and therefore the hurdle rates for investment in the audit business may be higher than that of multinational corporations of similar size (eg, in terms of revenue). This is because the capital of audit firms is typically raised at the national level of the individual audit firm (ie, one member firm of the network) rather than at the global level.

Similarly, cash-flow rights of audit members and other potential investors may be primarily or exclusively linked to the specific audit firm rather than the network as a whole. This implies that an individual audit firm, being much smaller than the international network, might face greater challenges to raise capital in comparison with the national subsidiaries of multinational corporations, or, indeed, the global holding companies of similar size (eg, by revenue) in other sectors.

To investigate this issue more closely, Oxera has examined empirical studies analysing the required returns associated with investments in SMEs. To the extent that this evidence points at a SME premium, audit firms might face greater challenges in accessing capital than firms of comparable size in other sectors.

Evidence on the small-company premium

Numerous empirical studies have examined the premium that investors require for investing in small companies (the 'size effect').

> The size effect has been investigated empirically for a large number of countries and numerous studies have attempted to provide an explanation for the puzzle.[178]

This premium could reflect the following three broad components:

- an equity return premium to compensate for higher trading costs (including the cost of lower liquidity);
- an interest rate premium on the cost of debt finance; and
- premia on the costs of raising capital (for both debt and equity).

Fama and French (1992) found that the predictions from the CAPM of the returns on small cap stocks were lower than the returns that actually materialised.[179] For firms listed on

[176] Praag, B.M.S. and Booij, A.S. (2003), 'Risk Aversion and Subjective Time Discount Rate: A Joint Approach', University of Amsterdam, April.
[177] Wong, G. (2005), 'Does the More Risk-averse Investor hold a Less Risky Portfolio?', Monash University, November 15th.
[178] Van Dijk, M.A. (2006), 'Is Size Dead? A Review of the Size Effect in Equity Returns', RSM Erasmus University, May, p. 33.

NYSE, AMEX and NASDAQ between 1963 and 1991, Fama and French (1992) found that smaller companies had higher average returns, even when controls were made for other factors, including the returns on the market (such as the FTSE All-share index) and firms' book-to-market ratios.

Van Dijk (2006) has summarised estimates of the small-company premium across countries, based on a variety of empirical investigations (see Table 6.8 below).

Table 6.8 Small-company premium, selected countries (%)

Country	Premium	Market value of the largest to the smallest[1]	Period
Belgium	0.52	188	1969–83
Finland	0.76	133	1970–81
France	0.90	n/a	1977–88
Germany	0.49	n/a	1954–90
Ireland	0.47	n/a	1977–86
Netherlands	0.13	n/a	1973–95
Spain	0.56	228	1963–82
Switzerland	0.52	99	1973–88
UK	–0.47 to 0.61	182[2]	1988–97 and 1973–92

Note: [1] Denotes the average market value of the firms in the largest size portfolio relative to the average market value of the firms in the smallest size portfolio. [2] Indicates that the statistic is not reported for the estimate of the premium of –0.47.
Source: Van Dijk (2006), op. cit., p. 33.

There might be a number of explanations for the size premium:

– the size of the stock represents a factor that is rewarded in the market;
– the size premium remunerates investors for the higher costs of trading and the possibility that smaller stocks may be less liquid; and
– the CAPM assumption that investors are rational may not hold.

Brown and Ferreira (2004) found that investors are remunerated for exposure to the idiosyncratic risk of small firms.[180] For firms listed on NYSE, the authors examined returns on the portfolios of firms grouped by market capitalisation and length of listing. As shown in Table 6.9, the idiosyncratic risk of small firms was found to be a highly significant and positive predictor of returns.

[179] Fama, E. and French, K. (1992), 'Common Risk Factors in the Returns on Stocks and Bonds', *Journal of Financial Economics*, **1**, 43–66.
[180] Brown, D.P. and Ferreira, M.A. (2004), 'Information in the idiosyncratic volatility of small firms', University of Wisconsin-Madison and ISCTE Business School-Lisbon, September.

Table 6.9 Premium for small-company[1] idiosyncratic risk (%)

Period	Estimate
July 1962–December 2001	
Value-weighted	0.705
Equal-weighted	0.209–1.645
July 1962–December 1999	
Value-weighted	0.490–0.658
Equal-weighted	0.320

Note: Only estimates that are statistically significant at the 5% level are reported. [1] A small company is defined in Brown and Ferreira (2004) as a company with market capitalisation below the median market capitalisation of all issues.
Source: Brown and Ferreira (2004), op. cit., p. 46.

Further evidence on the size of the small-company premium can be obtained from the UK regulated sectors. The UK water sector regulator, the Office of Water Services (Ofwat), for example, has applied a small-company premium to the cost of capital of water-only companies, ranging from 0.3% to 0.9% depending on the company size. [181] The relationship between the small-company premium and the company size in this context is presented in Table 6.10.

Table 6.10 Ofwat's bands for the small-company premium, 2004 (%)

Regulatory capital value	Small-company premium (gross of tax shield)
<£70m	0.9
£70m–£140m	0.8
£140m–£250m	0.7
£280m–£700m	0.3

Source: Ofwat (2004), 'Future water and sewerage charges 2005–10: Final Determinations', December.

While this evidence provides support for the hypothesis stated above, the estimates presented above might significantly underestimate the potential effect of size on cost of capital for audit firms. This is because the empirical estimates are based on the evidence from capital markets; audit firms, being privately held, might be expected to face a greater premium in terms of the required rate of return on any potential investment.

Evidence from SMEs

Results of the empirical studies broadly suggest that the size of the audit firm is likely to influence its cost of capital, and that smaller firms may have higher costs of capital. Additional factors that may influence access to capital for mid-tier audit firms can be examined by analysing empirical investigations of the financing structure of SMEs.

For example, a report by HM Treasury (1998) presented evidence that SMEs might have a higher cost of capital as a result of greater dependence on short-term loan finance.[182] In particular, lenders may be more reluctant to issue long-term debt to smaller companies, and

[181] Not only do regulators in the UK allow companies to earn the small-company premium where appropriate, but there are also precedents when the UK Competition Commission (CC) has included a small-company premium in the estimate of the cost of capital. For example, in the home credit investigation, the CC noted several reasons for why there might be a premium on the cost of debt and equity for small firms. Among these, it includes the reason that there might be less publicly available information for investors (see CC (2006), 'Home credit market investigation—Annex 3.5', November.
[182] HM Treasury (1998), 'Smaller Quoted Companies, A Report to the Paymaster General', November, p. 13.

banks may be more likely to impose stricter terms on smaller firms.[183] The perceived risk of lending to smaller companies may be significantly greater for medium- and long-term loans, than at the shorter end of the market. [184]

Small firms may be more reliant on bank finance because they may be less able to issue publicly traded securities, as discussed in section 6.1.[185] Table 6.11 below shows that, although there are differences between European countries, bank credit accounts for a large share of SME debt financing, relative to large-scale enterprises.

Table 6.11 Bank debt as a percentage of total debt for firms in selected countries

Country	Small and medium-sized enterprises	Large-scale enterprises
Belgium	46.5	50.1
France	48.8	21.3
Germany	57.4	29.9
Italy	66.4	27.3
Netherlands	54.9	35.9
Spain	66.5	50.4

Notes: The figures refer to 1998 for Belgium, France and Italy and to 1997 for the other European countries. Only non-financial firms are considered. SMEs are defined in Bonarcossi di Patti and Gobbi (2001) as companies with a turnover of less than €40m. Large-scale enterprises denote companies with more than 250 employees.
Source: Bonarcossi di Patti, E. and Gobbi, G. (2001), 'The Changing Structure of Local Credit Markets: Are Small Businesses Special', *Journal of Banking and Finance*, **25**, 2209–37.

Given that SMEs are largely dependent on a single type of finance, they are also likely to be more vulnerable to economic cycles, and any consequent reductions in the availability of bank credit. SMEs may face tighter constraints than large firms in raising finance in economic downturns due to their being less able to switch to external capital markets as an alternative source of finance.[186]

The actual costs of debt for SMEs are also difficult to obtain and are often influenced by idiosyncratic, firm-specific factors and their banking relationships. For illustration purposes, Table 6.12 presents a selection of the costs of debt for firms listed on the London Stock Exchange of different sizes.

Table 6.12 Implicit median interest rates for large and small quoted companies, 1999–2001 (%)

FTSE 100	FTSE 250	FTSE Small Cap	FTSE Fledgling	Alternative Investment Market
7.1	7.3	8.2	8.8	8.6

Note: The implicit rate is calculated as the interest rate payments of each firm over the total amount of short- and long-term debt.
Source: Bank of England (2003), 'Finance for Small Firms—A Tenth Report', April.

[183] Orser, B., Riding, A. and Swift, C. (1994) reported in Equinox Management Consultants Ltd (2000), 'Informal Equity Capital for SMEs: A Review of the Literature', prepared for Industry Canada, March.
[184] HM Treasury (1998), op. cit., p. 33.
[185] See Berger, A. and Udell, G. (1998), 'The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle', *Journal of Banking and Finance*, **22**:6, 613–73.
[186] For example, an evaluation of bank lending to SMEs and switching costs in the UK is contained in Cruickshank, D. (2000), 'Competition in UK Banking. A Report to the Chancellor of the Exchequer', HMSO.

Furthermore, there is evidence to suggest that SMEs throughout Europe face difficulties accessing other forms of finance, such as mezzanine finance.[187] Mezzanine finance represents hybrid forms of finance that have features of both debt and equity, including subordinated loans, participating loans and convertible bonds.[188]

Apart from the problems inherent in financing SMEs, the availability of credit to SMEs could also be adversely affected by current trends in the European banking markets. An important develop is the Basel II proposals to make regulatory capital more correlated with the riskiness of banks' loan exposures. To the extent that SMEs involve a higher credit risk to banks than larger enterprises, this may induce banks to reduce the number of loans to SMEs in favour of less risky loans to large companies. Also, as SMEs are more dependent on bank financing, any changes in banks' regulatory capital requirements will have a relatively greater impact on SMEs than on larger corporations, regardless of risk considerations.

These problems accessing finance may be compounded for professional services firms, as such firms may have limited collateral. This in turn may lead to capital rationing for SMEs and mid-tier audit firms, limiting their potential to undertake new investments. This could be associated with a cap on parts of the capital budget, or due to a higher cost of capital when weighing up the merits of potential investments. Where debt is the source of capital, small firms may not be able to compensate for an increase in working capital requirements by undertaking additional borrowing.[189] This represents a form of hard capital rationing and arises when constraints are externally determined (such as firms being unable to borrow). The results of the empirical investigations have suggested that a premium may need to be applied to the cost of capital for small firms. This may be particularly relevant given that the cost of capital for SMEs, relative to the market, has been rising in recent years.[190] The magnitude of this premium will depend on a variety of factors, such as the size of the firm or country of operation.

This evidence suggests that mid-tier audit firms may face greater problems accessing capital than the Big Four, for example. Even though the majority of audit firm's finances are currently composed of the capital contributed by members, this evidence suggests that if audit firms were to require greater capital in order to finance expansion plans, these firms might not be able to rely on banks to provide the necessary size of investment. Hence, other alternative sources of funds would need to be accessed, which may hinder mid-tier audit firms' access to capital.

6.3.3 Impact of the explicit ownership and control restrictions on the cost and access to capital by audit firms

A critical issue for audit firms' access to capital is the potential impact of the current ownership and control restrictions on their ability to access public capital markets. Current restrictions limit the size of the ownership stake that can be obtained by outside investors, and in certain countries, local regimes prohibit outside investors from owning any stakes in audit firms. For example, only certain professionals (including tax advisers, lawyers and patent attorneys) are allowed to own stakes in German audit firms, while minority stakes are prohibited in Greece.

These restrictions that limit the size of the ownership stake that could be obtained by outside shareholders may be binding in two ways: outsiders may be prohibited from owning any stake in the audit firm; and in those countries where outsiders are allowed to own a partial

[187] European Commission (2007), 'Mezzanine Finance, Final Report', Roundtable between bankers and SMEs, May.

[188] Subordinated loans are unsecured and rank behind senior debt (in the event of bankruptcy). Participating loans are those where the returns depend on the performance of the business. Convertible bonds give the right to acquire shares in the company instead of accepting the repayment of the bond.

[189] Banque de France (1997), 'French Manufacturing Firms and the Capital Gap since 1985, A credit rationing approach', Working Paper D 97/78, June.

[190] HM Treasury (1998), 'Smaller Quoted Companies, A Report to the Paymaster General', November, p. 20.

stake in the audit firm, the maximum size of the allowed stake may be lower than preferred by investors.

Furthermore, the restrictions limit the representation of non-auditors on the management board. This may have an influence on audit firms' access to capital as outside shareholders may require higher returns to compensate for the limited size of their stake.

The potential impacts of restrictions on voting rights and ownership rules on audit firms' access to capital are examined below, before analysing the impact of restrictions on outside representation on audit firms' management board.

The impact of restrictions on voting rights and ownership rules

The potential impact of restrictions on audit firms' access to capital is examined here by looking at the results from a range of empirical studies. The objective is to assess the potential magnitude of the impact of the restrictions on the hurdle rates for capital commitments to the audit business.

Current restrictions on *voting rights* limit the potential influence of outsiders on audit firms. This suggests that the outside investors may demand additional remuneration (in the form of higher returns) to compensate for limited control in the case of investments in audit firms. To examine whether investors may require higher returns where their influence on the firms' decision-making is limited, empirical studies have compared the premia that investors are willing to pay to invest in assets (securities) that include or exclude voting rights.[191]

For example, based on firms listed on NYSE, AMEX and NASDAQ, Zingales (1995) found that investors paid a premium (up to 10% more) for shares with superior voting rights, as shown below.[192]

Table 6.13 Voting rights premium (%) according to Zingales (1995)

	Mean	Median
Voting rights premium	**10.47**	**3.02**
Traded volume of superior voting shares relative to inferior voting shares	0.44	0.18
Proportion of votes held by small shareholders (those with less than 5% of votes)	0.55	0.51
Proportion of voting shares (relative to the total number of outstanding shares)	0.43	0.44
Percentage of votes controlled by the largest shareholder	32.33	28.38
Probability that market votes are pivotal	0.41	0.41
Probability that inferior voting shares pay a larger dividend than superior voting shares	0.38	0.00
Market capitalisation of both classes of stock ($m)	355.9	92.3

Note: The proportion of voting shares measures the concentration of voting power; for example, on average, all the voting power is concentrated in 43% of the common stock. The voting rights premium is defined as the difference in the price of these two classes of shares, adjusted to account for the possibility that a small preferential dividend may have been paid to the inferior voting class.
Source: Zingales (1995), op. cit., p. 1060.

Similarly, Megginson (1990) examined data from over 100 British companies between 1955 and 1982 that had two or more common share classes, with differential voting rights.[193] The average voting rights premium (of around 13%) was found to be similar to estimates obtained by Zingales (1995) for the USA (see Table 6.14 below).

[191] Such shares may allow the superior voting class to elect the majority of directors (generally around 75%), with the inferior voting class electing the remainder.
[192] Zingales, L. (1995), 'What Determines the Value of Corporate Votes?', *Quarterly Journal of Economics*, **CX**, 1075–110.
[193] Megginson, W.L. (1990), 'Restricted Voting Stock, Acquisition Premiums and the Market Value of Corporate Control', *The Financial Review*, **25**:2, May.

Table 6.14 Voting rights premium (%) according to Megginson (1990)

	All companies
Voting rights premium	**13.3**
Number of instances when the price of:	
superior voting rights shares exceeds restricted voting rights shares	13,555
superior voting rights shares is not different from restricted voting rights shares	2,051
restricted voting rights shares exceeds superior voting rights shares	740
Superior voting rights share class as a proportion of total voting power	0.943
Superior voting rights share class as a proportion of total common equity capital	0.384

Note: The superior voting class represents around 94% of the total voting power of these firms, but only 38% of the total common equity capital. The voting rights premium is defined as the ratio of the price of the superior voting share to the restricted voting share.
Source: Megginson (1990), op. cit., p. 186.

The results of these studies suggest that voting shares could trade at a price that is at least 10–13% higher than shares with inferior voting rights. This indicates that higher returns may be required by investors to invest in firms where their influence on the firm will be limited, such as audit firms. In particular, if outside investors are deprived of voting or control rights, they are likely to require higher returns on their investment.

More specifically, in the context of audit firms, this would indicate that ownership rules might have an implicit impact on the price of capital for audit firms. From the perspective of outside investors, audit firms would be required to offer higher returns in order to compensate for the lack of control. This suggests that ownership restrictions are likely to be costly.

As the current restrictions limit the size of the ownership stake that could be obtained by non-auditors—and in certain countries, local regimes prohibit any stakes—this also suggests that investors would require higher returns as a form of remuneration for the limits on their *ownership rights*.

The results of empirical studies that have analysed the trading price of large blocks of stock are examined below. In those countries where outside investors (non-auditors) are allowed to own a partial stake in the audit firm (providing this does not exceed 49%), the limited size of blocks of stock in an audit business might imply a discount to its true value and hence a higher required rate of return.

These results are also relevant when examining the potential implications of current ownership restrictions being removed and replaced with limits on the maximum size of ownership stakes.

Numerous studies, such as Barclay and Holderness (1989), Dyck and Zingales (2004) and Nenova (2003), have found that large blocks of stock trade at a price that is higher than their security value. These authors have shown that large blocks trade at premia of between 10% and 20% over their security value.

In general, the premium has been found to depend on the magnitude of the block; the transfer of a 20% block does not carry the same amount of control as the transfer of a 51% block. Similarly, the transfer of a 30% block, when another shareholder controls 20%, carries less control than the transfer of the same block when the rest of the shares are dispersed.

For example, Barclay and Holderness (1989) analysed over 50 block trades between 1978 and 1982 that involved at least 5% of the common stock of NYSE and AMEX corporations (see Table 6.15). The authors found that blocks (representing at least 5% of common stock) traded at prices around 20% above their security value.[194] The block premium was found to reflect expectations that voting power could be used to secure benefits that are unavailable to other shareholders, such as sufficient voting power to exert pressure on the firm's management. The authors found that the premium increased at a decreasing rate with firm size, and at an increasing rate with the proportion of the firm's outstanding common stock transferred in the block.

Table 6.15 20% block premium in the USA, 1978–82 (%)

	Mean	Median
Premium of block trade price over exchange price	**20.4**	**15.7**
Total block premium[1]	$4.1	$1.0
Block premium as a percentage of block purchase price	13.1	14.0
Block premium as a percentage of total market value of the firm's equity	4.3	2.1
Percentage of common stock in block trade	20.7	17.4
Reported price of block trade	$25.9	$9.7
Total value of common stock		
Firms with block trades	$118	$40
All NYSE and AMEX firms	$597	$108

Note: [1] Defined as the difference between the block trade price and the exchange price, multiplied by the number of shares in the block. Blocks represent at least 5% of common stock.
Source: Barclay and Holderness (1989), op. cit.

Dyck and Zingales (2004) have estimated the blockholdings premium for blocks that confer at least 10% of the stock in a variety of countries across the EU. For those control blocks that represent at least 10% of stock, the block premium was found to be around 1% in the UK, rising to around 58% in the Czech Republic (see Table 6.16 below).[195]

[194] Barclay, M.J. and Holderness, C.G. (1989), 'Private benefits from control of public corporations', *Journal of Financial Economics*, **25**, 371–95.
[195] Dyck, A. and Zingales, L. (2004), 'Private benefits of control: An International comparison', *Journal of Finance*, **59**, 537–600.

Table 6.16 10% block premium across the EU, 1990–2000 (%)

Market	Mean	Median	Minimum	Maximum
Austria	38.0	38.0	25.0	52.0
Czech Republic	58.0	35.0	1.0	217.0
Denmark	8.0	4.0	–1.0	26.0
Finland	2.0	1.0	–7.0	13.0
France	2.0	1.0	–10.0	17.0
Germany	10.0	11.0	–24.0	32.0
Italy	37.0	16.0	–9.0	164.0
Netherlands	2.0	3.0	–7.0	6.0
Poland	13.0	12.0	2.0	28.0
Portugal	20.0	20.0	11.0	30.0
Spain	4.0	2.0	–3.0	13.0
Sweden	7.0	3.0	–1.0	22.0
UK	1.0	0.0	–6.0	17.0
Average	**15.5**	**11.2**	**–2.2**	**49.0**

Note: The block premium is measured as the difference between the price paid for a control block and the share price two days after the announcement of a block transaction, divided by the price after the announcement (and multiplied by the proportion of cash-flow rights represented in the controlling block). As such, the block premia are defined as a percentage of the firm's equity. Only those completed purchases of blocks of at least 10% of the stock and transactions that result in the acquirers moving from holding less than 20% of shares to a position where they have assembled more than 20% of the shares were examined.
Source: Dyck and Zingales (2004), op. cit., p. 551.

In contrast to Barclay and Holderness (1989) and Dyck and Zingales (2004), Nenova (2003) estimated the premium associated with the transfer of blocks that represent at least 50% of the voting power.[196] As illustrated in Table 6.17, Nenova's (2003) estimates of the control block varied widely across countries.

[196] Nenova, T. (2003), 'The value of corporate voting rights and control: A cross-country analysis', *Journal of Financial Economics*, **68**, 325–51.

Table 6.17 50% block premium across the EU, 1997 (%)

	Without additional controls		Additional controls
Market	**Mean**	**Median**	**Mean**
Denmark	0.84	0.29	0.84 to 0.92
Finland	–5.03	0.52	–0.02 to 2.07
France	28.05	27.47	26.65 to 28.05
Germany	9.50	4.93	7.47 to 9.49
Italy	29.36	29.93	28.84 to 28.88
Sweden	1.04	0.43	1.04
UK	9.57	7.21	9.21 to 10.67
Average	**10.48**	**10.11**	

Note: The block premium has been estimated using two techniques. 'Without additional controls' represents the estimate of the premium obtained from scaling the vote value by the probability of a control change. 'Additional controls' represent the estimate of the premium obtained from controlling for the probability of votes being demanded during a control change, as well as non-vote-related sources of share value.
Source: Nenova (2003), op. cit., pp. 334 and 336.

It is difficult to compare estimates of the premium across the 5%, 10% and 50% blocks as a result of the different samples and countries selected by the investigators. However, in the context of audit firms where ownership restrictions were to be removed and replaced with limits on the maximum size of ownership stakes, the empirical findings reported in this section may provide a broad indication of the extent to which the cost of capital may change with the size of the ownership stake.

For example, in the UK, the average premium for blocks conferring at least 10% of the stock was found to be around 1%, and this rose to around 10% for blocks that represented at least 50% of the voting power. In France, the premium rose even more quickly as the degree of control transferred by the stock increased. A premium of 2% was paid for blocks that represented at least 10% of the voting power, and this rose to 28% for those blocks associated with at least 50% of the voting power. This suggests that there is a positive relationship between the price investors are willing to pay and the degree of control that is transferred.

This in turn suggests that investors require remuneration in the form of higher returns when investing in companies where their ownership may be limited. This may restrict audit firms' access to capital. To the extent that the limits on outside ownership are in place in order to maintain auditors' independence, this highlights the likely trade-off between independent (private) ownership of audit firms and their cost of capital, and hence the access to greater amounts of capital.

Anti-takeover provisions

The current restrictions on the ownership and control of audit firms may also be compared with anti-takeover provisions, to the extent that provisions limit the possibility of outside ownership.

Although, in contrast to ownership rules, the anti-takeover provisions are set by corporate bylaws, adopted ownership and governance structures of audit firms (reflecting the ownership rules and restrictions) are also chosen by audit firms. Therefore, their impact on outside investors might be similar. As such, this section examines the results of empirical studies that have analysed the impact of anti-takeover provisions on share price performance and returns on investments.

Numerous studies, including Mahoney et al. (1996) and Gompers et al. (2003), have reported that the adoption of anti-takeover provisions has an adverse impact on firms' share price performance, as the provisions reduce the rights of shareholders relative to those of management.[197]

To the extent that such provisions have a negative impact on price, they imply a higher required rate of return and hence a higher hurdle rate for outside capital to be committed to the business.

Based on nearly 300 large corporations that adopted anti-takeover provisions between 1984 and 1988, Sundaramurthy et al. (1995)[198] found that the introduction of provisions designed to reduce cumulative voting rights (ie, which restrict shareholders' rights to accumulate votes in favour of a particular management) had a significant adverse impact on share price performance (see Table 6.18).[199] The introduction of such provisions was found to lead to a 0.5% decline in 'abnormal' returns.

Table 6.18 Impact of anti-takeover provisions on share prices in the USA, 1984–88

Anti-takeover provision	Multiplier[1]
Classified board provisions	0.132
Reduction in cumulative voting provisions	–0.523*
Fair price amendments	–0.093
Anti-greenmail provisions	–0.054
Supermajority approval provisions	–0.249

Note: [1] The multiplier represents the decline in cumulative average abnormal returns (measured over a period 50 days before the announcement of the anti-takeover provision and five days after it) following the introduction of anti-takeover provisions. Cumulative average abnormal returns represent the difference between the observed return and the *normal* return. * Represents estimates that are statistically significant. Fair price amendments require approval by the majority of stockholders for the transfer of control if the bidder does not offer a 'fair price'. Anti-greenmail provisions prohibit the private repurchase of sizeable blocks of stock at a premium.
Source: Sundaramurthy et al. (1995), op. cit.

The results of Sundaramurthy et al. (1995) illustrate that firms' returns, relative to the market, may fall following the introduction of anti-takeover provisions. These findings are relevant to the extent that they provide a broad indication that investors require higher returns in the presence of restrictions on ownership and control.

The results indicate that the current ownership restrictions may prevent audit firms from gaining access to potentially cheaper sources of capital. If audit firms were to raise capital from outside investors, these firms would need to remunerate investors for not being able to exert a significant degree of influence over the management of the audit firm.

For example, the current restrictions, by preventing an outside investor from owning the majority of the audit firm, may require an uplift of around 10% and 28% to be applied to the

[197] Mahoney, J.M., Sundarmurthy, C. and Mahoney, J.T. (1996), 'The Differential Impact on Stockholder Wealth of Various Antitakeover Provisions', Federal Reserve Bank of New York; Gompers, P., Ishii, J. and Metrick, A. (2003), 'Corporate Governance and Equity Prices', *Quarterly Journal of Economics*, **118**, 107–155.
[198] Sundaramurthy, C., Mahoney, J.M. and Mahoney, J.T. (1995), 'Board Structure, Anti-takeover Provisions and Stockholder Wealth', Federal Reserve Bank of New York Research Paper No. 9516.
[199] Classified board provisions segment the board of directors into classes, with one class standing for election each year. As a result, a new majority stockholder would have to wait for two annual meetings to attain majority representation on the board before being guaranteed a successful proposal of a merger for stockholder vote. A reduction in cumulative voting provisions restricts the rights of stockholders to accumulate votes in favour of a particular director or board of directors, which reduces the ability of minority stockholders to elect their nominees as directors. Fair price amendments require supermajority voting approval by stockholders for the transfer of control if the bidder does not offer a 'fair price' (which is often defined as the highest price paid by the bidder for any shares acquired in the target firm during a specified period). Anti-greenmail provisions prohibit private repurchase of a sizeable block of stock at a premium. Supermajority requirements to approve mergers stipulate the percentage of shareholder approval for mergers, which is higher than the threshold requirements; these requirements may block a bidder from implementing a merger even where the bidder controls the target's board of directors, since approval by stockholders may remain below the specified percentage.

cost of capital of the audit firm (in the absence of such restrictions) in the UK and France respectively. Increasing the permitted degree of outside ownership in the audit firm is likely to correspond to a reduction in the audit firm's cost of capital. For example, if the stipulated level of auditors' control in the firm were to be reduced from 51% to 10%, the uplift that would need to be applied to the audit firm's cost of capital (in the absence of such restrictions) would decline to 1% and 2% in the UK and France respectively.

Impact of restrictions on the management composition

As current restrictions on management board composition limit (and in some Member States, local regimes completely prohibit) the influence of outsiders on key management decisions, this may affect investors' willingness to commit capital and hence audit firms' effective access to capital. As investors may prefer ownership rights to match control rights, if both ownership and control rights are restricted, this may restrict access to capital.

As the current restrictions concentrate ownership and control in the hands of auditors, outsider investors (eg, creditors) might not be able to exert significant influence over the audit firm. While this may be important for independence (see section 4), this may have implications for audit firms' access to capital.

Several empirical studies have investigated the impact of bond covenants that, for example, limit managerial discretion on the cost of raising finance. This is of interest in the context of ownership restrictions on audit firms to the extent that outsiders might not be able to restrict managerial discretion in the case of audit firms, and hence might require higher returns on their capital. For example, based on a large dataset of public bonds issued between 1989 and 2001, Reisel (2004) found that bond covenants restricting financing activities led to a reduction in the cost of debt of 72 and 61 basis points for covenants restricting financing activities and investment activities respectively (see Table 6.19).[200]

Table 6.19 Impact of covenants on the cost of debt in the USA (%)

Type of covenant	Without covenants Mean yield	With covenants Mean yield	Difference in yields
Restrictions on			
financing activities	2.43	1.71	0.72*
investment activities and asset sales	2.37	1.77	0.61*
payouts	1.73	3.18	–1.45*

Note: * Represents a statistically significant difference in yields on bonds with and without restrictive covenants. Restrictions on financing activities include covenants that limit the further issuance of debt, as well as sale lease-back transactions. Restrictions on investment activities include covenants that prohibit risky investments and mergers. Restrictions on payouts limit dividends and other distributions to shareholders.
Source: Reisel (2004), op. cit., p. 35.

To the extent that limits on managerial discretion are associated with a reduction in the cost of debt capital, this suggests that potential investors in audit firms may require higher returns as a form of remuneration for the lack of influence on managerial discretion that is imposed by the current ownership restrictions.

Similarly, if the current restrictions on the management board signal to investors that managerial decisions may not be adequately monitored, this may have implications for audit firms' ability to attract outside capital.

[200] Reisel, N. (2004), 'On the Value of Restrictive Covenants: An Empirical Investigation of Public Bond Issues', Rutgers University, December.

In this context, it is therefore important to examine the results of studies that have analysed the impact of the appointment of outside directors on companies' share price performance. Rosenstein and Wyatt (1990), for example, examined the implications of announcements of external appointments on the share price performance of firms listed on NYSE, AMEX and NASDAQ between 1981 and 1985 (see Table 6.20).[201] They found that the appointment of outside directors had a positive impact on share prices. The size of the impact can be explained by the extent to which the estimates captured the unanticipated reaction in the market to announcements that occur relatively frequently.

Table 6.20 Impact of outside directors on share prices in the USA (%)

	Multiplier[1]
All sample	0.0022*
Large firms	0.0011
Small firms	0.0034*

Note: [1] The multiplier represents the difference between the firms' observed returns and the *normal* return. Large firms are defined as those firms where the market value of equity exceeds the median value for all firms listed on the NYSE. * denotes that the multiplier is statistically significant.
Source: Rosenstein and Wyatt (1990), op. cit., p. 185.

Rosenstein and Wyatt (1990) found that announcements of the appointment of outside directors had a greater impact on smaller firms. This suggests that benefits associated with adding an outside director, in terms of technical expertise and information, may be more valuable for smaller firms, while additional monitoring associated with the appointment of outsiders may be less important for larger firms. To the extent that the current ownership restrictions limit the monitoring of managerial decisions, the results of the Rosenstein and Wyatt (1990) study may suggest that the current ownership restrictions have a significantly greater adverse impact on the smaller audit firms.

These results suggest that investors may require significant premia on the returns from capital committed to audit firms in the presence of the current ownership and control restrictions, where the latter limit investors' influence on decision-making. In other words, in the presence of existing restrictions, audit firms may face high hurdle rates for any form of capital to be committed to the business. Implicitly, this could mean capital rationing and inability to obtain capital for new investments to the extent that such investment opportunities do not offer investors sufficient returns to compensate them, for example, for limited control.

The evidence presented above also suggests that if the current ownership restrictions were to be replaced with, for example, limits on the size of a single investment in an audit firm (concentration limits), the negative implications for access to capital would not be completely removed. For example, if the current ownership rules were replaced with the introduction of a restriction that limited auditors' control of the audit firm to only 10%, potential investors may still require remuneration for not having full control of the audit firm, although the premium would be expected to be significantly smaller than under the 51% rule.

6.4 Other potential barriers to raising capital by audit firms: liability, size and the nature of the assets

The results presented in the previous section indicate that the presence of the ownership and management rules is likely to result in higher required rates of return from potential investments in the audit business. This is likely to be the case from the perspectives of audit

[201] Rosenstein, S. and Wyatt, J.G. (1990), 'Outside directors, board independence and shareholder wealth', *Journal of Financial Economics*, **26**, 175–91.

partners or members (ie, insiders), as well as alternative capital providers (outsiders). The results also suggest the possibility that audit firms face a degree of capital rationing. Both imply limitations on audit firms' access to capital.

Nevertheless, the removal of the current ownership and control restrictions may not guarantee audit firms having greatly improved access to capital. The potential benefits arising from the removal of the restrictions need to be examined in light of other barriers to raising capital faced by audit firms. In particular, other features of the audit market, not related to the ownership restrictions, may influence firms' access to capital directly and via the chosen ownership and management structures.

Even in the absence of ownership rules, audit firms might face a trade-off between adopting alternative ownership structures and hence benefiting from cheaper financing and, for example, securing human capital by preserving the current structure, to the extent that the this structure encourages members to remain with the firm. This implies that, in the absence of rules, firms might still choose the current ownership structures, even if this implies a higher cost of raising capital.

Critically, the Oxera interviews have indicated that the ability of mid-tier audit firms to expand and secure the necessary capital (such as human capital or brand value) might not be closely related to improvements in outside investors being able to invest in audit firms. As such, changes to ownership rules might not be critical to mid-tier audit firms' expansion into the market for large audits.

Other features of the audit market that might constitute barriers to access to capital need to be examined in this context to the extent that they might have implications for the marginal benefits of removing the ownership restrictions on access to capital. For example, limited availability of commercial insurance against liability risk may mean that mid-tier audit firms are required to self-insure. This may lead to the perception by investors that the expected returns arising from any investment in mid-tier audit firms are low when taking into account the downside scenario of a liability claim. As such, investors may not be willing to commit capital to audit firms in the presence of significant exposure to liability.

Similarly, since human capital, brand and having an international network typically represent the core assets of audit firms, it is also important to analyse the implications of these factors for firms' access to capital. In particular, ownership forms chosen by audit firms might be required to secure human capital in the first place, while also limiting access to financial capital, which is less important.

The intangible nature of a majority of audit firms' assets may also restrict these firms' use of debt financing, as a result of their limited collateral. Additionally, investors may perceive firms with largely intangible assets to be inherently more risky than other alternative investments.

These issues are examined in greater detail below.

6.4.1 Liability and monitoring as barriers to raising capital

In a number of Member States, audit firms are required by law to have a minimum level of insurance coverage. Theoretically, the coverage is designed to ensure solvency in the case of liability claims, and to protect against the potential costs of financial distress. Large claims of this kind may occur relatively infrequently, but could have a significant adverse impact on the audit firm and hence on its investors.

As a result of the costs of potential liability claims (which differ across Member States), potential investors in audit firms may be relatively averse to exposure to liability risk. The larger audit firms may be able partly to self-insure against liability risk. For example, the London Economics report for the European Commission (2006) reported that the Big Four rely heavily on captives—mutuals owned by member firms that act to mitigate risk across the network—while the mid-tier networks are more dependent on the marketplace to provide insurance.[202]

If insurance from the marketplace is effectively more expensive (for example, due to asymmetric information or moral hazard) then mid-tier firms might face higher costs.

An alternative way in which mid-tier firms could access insurance would be to diversify such risks in the capital markets. However, mid-tier audit firms may not be able to diversify such risks effectively due to the size and selection of their mandates, which suggests that these firms may need to rely on the external insurance market.

More generally, in order for the risk of liability claims to be insurable, the risk must be diversifiable and predictable, in terms of both its frequency and size. As London Economics (2006) reported that audit liability claims could take up to 5–10 years to be fully resolved, this may create uncertainty about the required level of provisions.[203] The same study reported that the lack of risk diversification opportunities, the unpredictability of claims, as well as the related volatility in awards and settlements, could restrict the development of insurance programmes for auditor liability.[204]

Other features of the audit services business may also influence the development of such insurance programmes. For example, the insurer may not be able to observe the effort exerted by the auditors during the audit, or the quality of the audit product. The audit firm may also have insider knowledge about the likelihood of a claim arising against the audit firm.

These issues may be compounded in the audit market compared with other sectors where consumers are more easily able to observe the quality of the firm's assets. As a result of these factors, insurers may limit coverage or increase premia, which could lead to a sub-optimal allocation of risk within each risk class.

London Economics (2006) reported that both the level and the amount of commercial insurance have fallen substantially since the start of the 1990s, which has meant that audit firms' insurance programmes only provide partial coverage for professional liability.[205] As such, audit firms are required to cover the uninsured part of the risk themselves. This may mean that once audit firms have exhausted the cover provided by their networks' captives and commercial insurers, the remaining source of funds may be the members' income.

The presence of liability risk means that there is the possibility that claims may be issued against the audit firm that may have a significant adverse impact on the firm (the extreme downside scenario). As such, the presence of liability risk might cause the expected mean returns arising from any investment in the audit firm to be relatively low. As audit firms may be able to insure only partly against liability risk, potential investors in these firms may require remuneration in the form of significantly higher returns for holding such risks. This may restrict audit firms' access to capital and may lead to firms forgoing projects with a positive NPV. In the extreme case, investors might not be willing to provide any capital in the presence of such risks.

Furthermore, audit firms may face significant information asymmetries when raising capital. As potential investors in audit firms may not be able to observe or monitor the effort exerted by the auditor during the audit (moral hazard problem), especially when their personal exposure is limited, this may lead to unwillingness by investors to commit funds to audit

[202] London Economics (2006), 'Study on the Economic Impact of Auditors' Liability Regimes', Final Report to DG Internal Market and Services, September, p. 92.

[203] London Economics (2006), op. cit., p. 102.

[204] London Economics (2006), op. cit, p. 6.

[205] London Economics (2006), op. cit., p. 99.

firms. This may arise even though there is no a priori reason to expect auditors to engage in actions that compromise quality, as the consequences of such actions are unlikely to be in the auditors' own interests. Indeed, as discussed in section 5, in industries, such as professional services, where problems of asymmetry in information arise, this may be an important driver of the decision to adopt a partnership structure. If the degree of information asymmetry declined, this may provide greater incentive to move away from the partnership structure.

As the quality of the audit product cannot easily be observed and errors from auditing may only materialise with time, these problems may be compounded in the audit market compared with other sectors. Quality assurance procedures (such as inspections by independent audit regulators) should enhance the level of monitoring and observation by outsiders. Indeed, investors in audit firms receive full access to confidential inspection reports, which contain details of the public oversight bodies' view of internal quality procedures.

Even without these problems, investors in audit firms may be averse to investing in companies that face the possibility of catastrophic risk—the likelihood that the downside scenario materialises. For example, a study by Goorbergh, Huisman and Kort (2002) found that irreversible investments are more likely to be deferred if there is a rise in uncertainty.[206] These authors also found that risk aversion reduced the frequency of large investments, which suggests that the possibility of large negative outcomes may deter potential investors.

It is also likely that the risk of liability claims may affect larger audit firms and new entrants into the market for large audits asymmetrically.

Finally, it is important to note that audit firms are unlikely to be able to overcome such problems by using capital as a buffer against potential liability claims, instead of commercial insurance. In particular, it is likely to be more expensive for audit firms to use their own capital as a buffer than pooling idiosyncratic risks through the insurance market.

6.4.2 International network and access to capital

As discussed in section 5.2, the typical international network structure of global audit firms is based on the principle of no cross-border recourse, no cross-default, no common ownership, and no significant cash-flow rights of one firm relative to another. This lesser degree of international coordination is designed to mitigate cross-border liability claims. In particular, the limited integration between member firms aims to dampen the impact of a liability claim arising against a member firm in one country on the risk of a member in a different country.

The design of the international network might have an important impact on access to capital. 'Since liability risks force audit firms not to pull their operations together internationally, the cost of capital of individual mid-tier audit firms may be higher than the corresponding cost of capital of companies of an equivalent size (in terms of global revenue) to the audit firm's global network.

6.4.3 Investments in intangible assets

According to Lent (1999), audit firm's main assets are its brand name and human capital.[207] The importance of both reputation and human capital was illustrated in Oxera (2006) and section 5 of this report. As such, an audit firm's assets are predominantly intangible. Unlike tangible assets, intangible assets cannot be easily sold in the event of bankruptcy; these assets are also not immediately transferable or tradeable. This implies that the recovery rate

[206] Goorbergh, R.W.J., Huisman, K.J.M. and Kort, P.M. (2002), 'Risk Aversion, Price Uncertainty and Irreversibility of Investments', Tilburg University, March.
[207] Lent, L.V. (1999), 'The Economics of An Audit Firm: The Benefits of Partnership Governance', *British Accounting Review*, **31**, p. 227.

for audit firms' assets may be very low, similarly to other professional services' firms, and hence imply a significant default premium required by any potential outside capital.

Moreover, since audit firms have limited collateral, this may lead to difficulties raising debt finance. A study by Qian (2003) supports this proposition by showing that firms with high levels of valuable human capital hold less debt, and the optimal debt level declines with the human capital intensity of the firm.[208]

In the audit market context, mid-tier audit firms' limited collateral may prevent debt finance being used to pay the salaries of new staff as the firm expands. This may be particularly important if a mid-tier audit were to attempt to expand into the market for larger audits, and might compound problems faced by mid-tier firms in attracting the appropriately qualified staff.

Since intangible assets may not be easily traded in the marketplace, investors may perceive firms, whose assets are predominantly intangible, to be inherently more risky. This might also be due to the problem of asymmetric information being more prominent in the case of intangible assets. These factors may lead to investors requiring higher returns as a result of their exposure to this risk.

Auditors may use costly investments in intangible assets, such as the brand name, to signal their quality to potential clients.[209] As the individual (typically, the audit committee chair or finance director) who appoints the auditor may have limited information about the potential quality of the audit product and of the audit service providers, the brand name might be used as a gauge of the potential quality of an audit.[210]

As potential clients might perceive mid-tier audit firms as not as capable as the Big Four in delivering the key components of the audit, this suggests that, in the event that a mid-tier firm were to attempt to expand into the market for larger audits, significant investment, applied to various channels, may be required in the brand. Oxera (2006) reported that companies in the FTSE 350 may perceive the Big Four as better placed than mid-tier firms in offering value-added services and insurance against catastrophes and reputational risk. This perception bias against the mid-tier firms may prevent these firms from acquiring a credible reputation with large, listed companies and their investors.

As the success of any investment in the brand name cannot easily be observed, other than on the basis of ex-post cash flows after substantial funds have already been committed, growth strategies based on investment in the brand name are likely to be perceived as inherently risky. As this may increase the overall risk of the audit firm, this could have implications for the level of returns required by either potential investors or members from investing in the audit firm.

To examine the implications of the risk associated with investment in brand on access to capital, well-documented results from empirical studies that have investigated investors' bias towards large well-known stocks can provide additional insights. Several empirical studies have reported that investors prefer to invest in stocks with easily recognised products. One such study by Frieder and Subrahmanyam (2004) suggested that individual investors were found to have a strong preference for holding stocks of companies with highly visible brands, as more high-quality information may be available about such companies.[211]

[208] Qian, Y. (2003), 'Human capital intensive firms: Incentives and capital structure', University of Iowa, June.
[209] Lent (1999), op. cit., p. 229.
[210] Ibid., p. 229.
[211] Frieder, L. and Subrahmanyam, A. (2004), 'Brand Perceptions and the Market for Common Stock', University of California, April.

Another investigation by Madden et al. (2002), based on data from NYSE, AMEX and NASDAQ between 1993 and 2002, compared the performance of firms with an emphasis on branding to a portfolio of similar firms without the same emphasis.[212] They found that risk-adjusted returns accruing to stockholders from investment in strong brands exceeded those of a diversified benchmark, and the increased returns from branding could not be attributed to stocks containing greater risk (volatility) of returns.

This suggests that potential investors may need to be remunerated in the form of substantially higher returns for committing funds to mid-tier audit firms due to the inherent risks of developing a brand and investments in other intangible assets, which would be required if the mid-tier audit firm were to attempt to expand into the market for larger audits. To this extent, this is likely to restrict such firms' access to capital independently of ownership rules.

However, this does not necessarily imply that firms with higher risk are automatically expected to have fewer investors. Indeed, investment in mid-tier audit firms may be seen by some outside investors as more attractive than investment in the Big Four, as a result of these firms having lower risk exposure in some key aspects of the business model than the Big Four. For example, as discussed in section 6.4.1, mid-tier audit firms may have a lower degree of liability exposure than the Big Four, as a result of the characteristics of their clients.

6.5 Summary of key findings

Audit firms' cost and ability to access capital are likely to depend, at least partly, on the way in which they raise financing, which, in turn, is closely related to the ownership and management structures adopted by those firms. The latter might be partly affected by the ownership and management rules and regulations faced by audit firms across the EU Member States, as discussed in the previous section.

Moreover, such rules and restrictions are likely to have a direct impact on the cost of capital of audit firms due to restrictions on the rights of the potential outside investors.

At the same time, the estimated impact of these rules and regulations needs to be considered in the context of multiple other factors that have a critical impact on audit firms' access to capital. These include the nature of the audit business as well as other regulated aspects of the industry, such as liability exposure.

In general, the evidence presented in this section suggests that several aspects of the typical employee-owned corporate form of ownership adopted by audit firms are likely to raise the cost of capital of audit firms, as well as, to some extent, restrict their ability to access capital in the first place. This, combined with the regulatory limits on the potential investment by outside shareholders and the representation of outsiders on the management board, is likely to increase the return required to undertake the investment.

However, in those Member States where the local regime does not prohibit outsiders from owning a partial stake in the audit firm (providing this does not exceed 49%), at least some aspects of the current rules and restrictions may not be binding for audit firms. For example, even though outsiders could potentially own a share of the audit firm (provided this is below 49%), audit firms with minority stakes from outside investors are not observed. This suggests that audit firms, at least to some extent, choose the current ownership and management structures *despite* the implications of such structures for the cost of raising external financing. In that sense, relaxing the rules might not lead to a change in the way that firms raise capital, despite its potentially high cost.

[212] Madden, T.J., Fehle, F. and Fournier, S.M. (2002), 'Brands Matter: An Empirical Demonstration of the Creation of Shareholder Value Through Brands', University of South Carolina.

This section has examined the implications of audit firms' corporate structures and the impact of audit firms' characteristics on their access to capital. In light of available evidence, this analysis broadly suggests that specific factors related to audit firms may further restrict these firms' access to capital. For example, as members are reliant on the performance of the audit firm for the remuneration of both their financial and human capital, this may lead to members requiring a higher return from any investment.

Furthermore, other characteristics of the audit regime pose important further restrictions on these firms' access to capital. These include the exposure of firms to liability, the fact that the audit product cannot be readily observed in the market, and the intangible nature of the majority of the audit firm's assets (such as brand) which may restrict the ease at which debt obligations can be obtained. However, it is important to distinguish these factors in terms of their differential impact on audit firms' access to capital from that of rules and regulations.

First, with regard to the implications of the employee-owned corporate structure for access to capital, this section has illustrated that there are a number of aspects of the corporate structure that may restrict audit firms' access to capital. The implications of the most relevant are discussed below, and their impact quantified.

– **Returns for exposure to risk unique to the audit firm**—as many audit members invest a large proportion of their total wealth in the audit firm, and as audit members' human capital also represents a large proportion of the members' total assets, this suggests that members may not be fully diversified. As such, the empirical evidence suggests that investors' required returns increase as exposure to the unique (idiosyncratic) risk of the firm rises.

– **Returns for risking financial investments**—as individual auditors' own personal financial contributions can directly affect the audit firm's performance, the members' situation can be compared with that of entrepreneurs. Empirical evidence indicates that individuals who risk their own financial investments require remuneration in the form of higher returns.

– **Returns for the illiquidity of ownership stakes**—additional evidence suggests that audit partners or members may require additional returns for the fact that their stakes in the audit firm are not easily transferable. As audit members' commitment might be considered illiquid, empirical evidence about the returns required by investors for investing in illiquid stocks has been examined.

To consider a potential scenario where a mid-tier audit firm attempts to raise the necessary capital to expand into the market for larger audits, it is directly relevant to consider whether members would be willing to commit capital. A major driver of the answer to this question is whether members would be able to recover their investment (and earn a return on it) within their investment horizon.

Evidence suggests that this may not be possible for older members. Results from studies about the private equity industry have been examined, and this evidence is relevant to the extent that private equity funds require returns to materialise over a relatively short time period. Analysis of such cases has suggested that returns increase when funds are able to exit their portfolio companies more quickly, which implies that the returns required may increase as the time horizon shortens.

Table 6.21 summarises findings regarding the potential impact of audit firms' employee-owned corporate forms on access to capital.

Table 6.21 Impact of ownership structures adopted by audit firms on required returns

Applicability to the audit market	Area of market research	Estimates of the range of the premium on the required rate of return (%)
Returns for exposure to risk unique to the audit firm	Returns for holding idiosyncratic risk and evidence from executive compensation	0.4–6.0
Returns for significant financial exposure by individuals	Returns required by entrepreneurs	0.4–2
Returns for the illiquidity of ownership stakes in audit firms	Liquidity premium	1–2

Source: Oxera.

Table 6.21, supported by the evidence presented in this section, suggests that the employee-owned nature of audit firms' corporate forms may lead to members requiring additional returns, around 6% above those of a diversified benchmark.[213] It is likely that members will require returns of at least this level, as they depend on the audit firm for financial remuneration for their commitment to the firm. It is possible that members of both the mid-tier and the larger audit firms may require additional returns of a similar level as a form of remuneration for the unique features of the ownership structure of these firms.

Second, the implications of other features of mid-tier audit firms for access to capital have been examined. As mid-tier audit firms tend to raise capital at the national level of the individual audit firm, rather than at the global level, the cost of capital for audit firms may be higher than that of multinational companies of similar size. Several authors have examined the magnitude of this premium to the cost of funding; the most applicable results are summarised in Table 6.22.

Table 6.22 Impact of size of audit firm on required returns

Applicability to the audit market	Area of market research	Estimates of the range of the premium on the required rate of return (%)
Return for the risks inherent in smaller firms	Small-company premium	0.13–0.90
Return for the risk unique to smaller audit firms	Premium for small-company idiosyncratic risk	0.2–1.6

Source: Oxera.

Table 6.22 broadly suggests that the cost of equity capital for the mid-tier and smaller audit firms may be up to 2.5% greater than that for larger audit firms due to size, and higher than that of similar-sized multinational companies due to the international structures of audit firm networks, as explained earlier in the section. These results might underestimate the impact of the company size; since audit firms are privately owned, the premium may be substantially higher in the case of audit firms.

Third, the impact of the ownership and management restrictions on the return required by mid-tier audit firms to undertake investment has been examined (see Table 6.23). The studies most applicable in the context of the audit market have been reviewed in this section. The empirical evidence suggests that the ownership restrictions may be costly. Higher returns may be required by investors in those firms where their ability to influence the firm's key managerial decisions will be limited (or in some cases, completely prohibited as a result

[213] This is based on the midpoint of the estimates of the band. The uplift to required returns is calculated as the premium plus the base level of required returns.

of local regimes). Since outside investors are currently not allowed to own more than 49% of the audit firm, the limited ownership that could be obtained by outside investors may imply that investors would require remuneration in the form of higher returns.

Additionally, current restrictions on management representation may restrict audit firms' access to capital because investors require higher returns in the presence of restrictions on ownership and control—ie, in situations where they cannot fully control the firm.

Table 6.23 Impact of restrictions on ownership, control and management on required returns

Applicability to the audit market	Area of market research	Estimates of the range of the premium on the required rate of return (%)
Impact of restrictions on ownership and control	Voting rights and block premium	10–20
Impact of management restrictions	Bond covenants	0.6–3.2

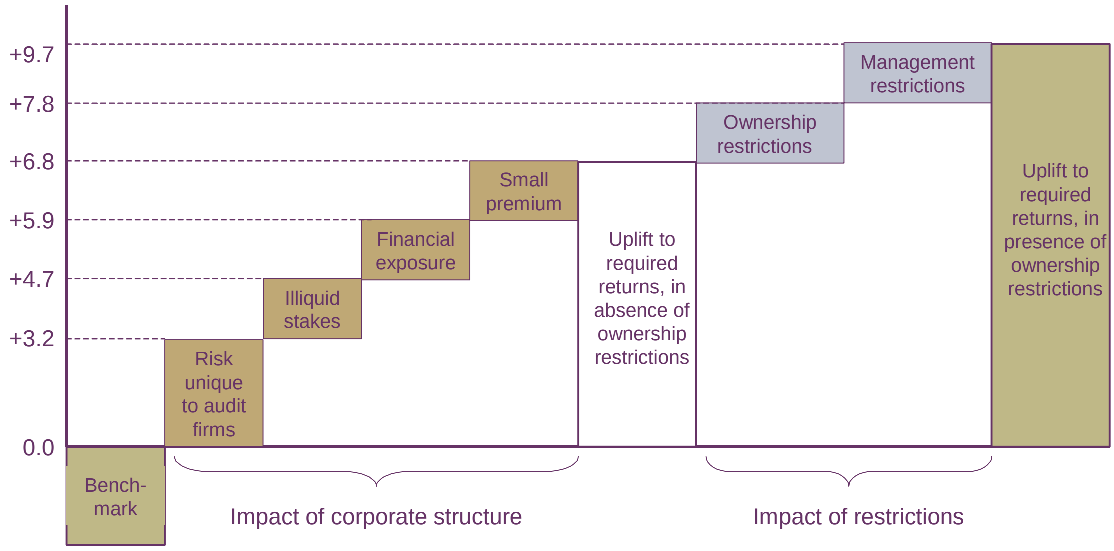
Source: Oxera.

Table 6.23 indicates that the current rules might prevent audit firms from gaining access to potentially cheaper sources of capital, and may imply that audit firms' actual cost of capital may be substantially higher than that of a diversified benchmark. The ownership restrictions may lead to an increase in the cost of equity capital of around 15% of the level of returns on a diversified benchmark, although there is substantial uncertainty associated with the size of this effect due to challenges in analysing the counterfactual scenario.[214] Additionally, the cost of debt capital may be higher as a result of the management restrictions—potentially by up to 3.2%. These restrictions may affect the smaller and mid-tier audit firms to a greater extent than the larger audit firms, which may face fewer restrictions when accessing capital.

To broadly illustrate the impact of audit firms' corporate structures and the current restrictions, the estimates of each relevant premium have been applied to indicate the hypothetical uplift that may need to be applied to a diversified benchmark, to illustrate the necessary increase in the required returns for a hypothetical mid-tier audit firm (in practice, the cost of capital for mid-tier audit firms may diverge substantially from this level). This is illustrated in Figure 6.7, and described in greater detail below.

[214] This is based on the midpoint of the estimates of the band. The uplift to required returns is calculated as the premium as a percentage of the base level of required returns.

Figure 6.7 Indicative estimates of the possible uplift to required returns above a diversified benchmark (%)



Note: This diagram is based upon the midpoint estimates of the range for each premium.
Source: Oxera.

The returns on a diversified benchmark are uplifted to reflect risk unique to audit firms, the illiquidity of members' stakes in the audit firm, the financial exposure of individual members, and the premium required by investors as remuneration for the size of the firm. These estimates are applied to derive an estimate of the hypothetical uplift to required returns for a typical audit firm, in the absence of the current ownership restrictions. Subsequently, hypothetical uplifts are applied to reflect remuneration for the current ownership and management restrictions.

As the ownership restrictions essentially remunerate investors for the lack of influence over the firm, a proportion of this premium may already be captured in the additional returns required by investors for remuneration for features of the current corporate structure. However, it is difficult to estimate the extent of this. As a consequence, uplifts have been directly applied to the required returns for an audit firm in the absence of ownership restrictions in order to estimate the hypothetical level of required returns for these firms in the presence of the restrictions.

Overall, there is evidence that both audit members and potential investors in audit firms are likely to require higher returns as a result of the current ownership and management restrictions. It is difficult to quantify the exact magnitude of this impact, but the evidence broadly suggests that required returns for small to mid-tier audit firms could be around 10% higher than that of a diversified benchmark. However, the exact magnitude of the uplift will depend on the unique features of the audit firm, as well as aspects related to markets in each Member State, among other factors.

It is important to note that even if the restrictions were to be completely removed, some barriers to raising capital are likely to remain. In particular, liability risk may restrict potential investment in audit firms. This impact may be compounded by the unique nature of the audit product under the current liability regimes across EU Member States. As potential investors may not be able to observe or monitor the effort exerted by the auditor and may view firms whose assets are predominantly intangible as more risky, this may further restrict audit firms' access to capital.

7 Implications for entry and market dynamics

This section explores the implications of the above analysis of ownership rules and access to capital for entry and market dynamics in European audit markets.

– Section 7.1 discusses possible market segmentations that are of relevance to the analysis and the assessment of policy options, in particular between the larger listed companies, where the Big Four dominate audits, and smaller listed companies, where mid-tier audit firms have a relatively greater presence.

– Section 7.2 describes the competitive dynamics in audit markets, examining the main barriers to entry and expansion into the segment of audits of larger listed companies. This sets the context for assessing the relative importance of ownership rules and access to capital as barriers to entry.

– Section 7.3 analyses the relationship between the current ownership rules and market concentration in each Member State.

– Section 7.4 presents an investment model exploring the drivers of entry or expansion by mid-tier audit firms. It deals in particular with the question of how ownership rules and access to capital affect entry and expansion decisions.

– Section 7.5 provides some tentative thoughts on how the above investment model would work for new forms of entry or expansion in the market, rather than for mid-tier firms.

7.1 Market segmentation

7.1.1 Relevance of market segmentation

Reliance on the independent audit of financial statements is important for investors in any publicly listed company, regardless of that company's size. Independent audits are also relevant for private companies, for example, for tax purposes. The Big Four have significant audit operations across both listed and private companies. The issues of concentration and choice among audit firms are therefore of relevance to all companies.

This study places greater emphasis on the larger listed companies, not only for practical reasons, but also because, from a public policy perspective, the potential systemic risks and concerns are inherently greater for the larger companies. The largest companies typically represent the bulk of the total value of the capital market in which they are invested. For example:

– in the UK, the largest 20 listed companies by market capitalisation represent approximately 55% of the market value of the FTSE All-share index;
– in Italy, the 14 largest listed companies represent 60% of the total market capitalisation of Borsa Italia;
– in Hungary, two companies represent 60% of the total market capitalisation of the Budapest Stock Exchange.[215]

If any of these large companies faced a problem due to lack of choice of auditor, investor confidence in the stock market as a whole could be significantly affected.

[215] Data from Datastream and World Federation of Exchanges, all referring to 2006.

7.1.2 Segmentation by market index and company size

In previous merger reviews, the European Commission segmented the market according to market index and company size. Its decision on the Deloitte & Touche/Arthur Andersen (UK) merger in 2002 confirmed its earlier reasoning in the Price Waterhouse/Coopers & Lybrand decision;[216] namely, that the activities of the major accounting firms can be divided into the following product markets:

– audit and accounting services to quoted and large companies;
– audit and accounting services to SMEs;
– tax advisory and compliance services;
– corporate finance advisory services;
– management consultancy services.

In the Price Waterhouse/Coopers & Lybrand decision, the Commission also referred to the 'possible existence of still narrower markets for the provision of audit and accounting services in some sectors, in particular the banking and insurance sectors.' In the Deloitte & Touche/Arthur Andersen (UK) decision, the Commission identified the main reasons why it considered that audit and accounting services to quoted and large companies form part of a separate product market:

– the necessity for such companies to have audit and accounting services provided by a firm with the required reputation in the financial markets (in the case of quoted companies);
– the geographic breadth to cover companies' needs worldwide (in the case of multinationals);
– the depth of expertise in the particular sector (large companies in general and, in particular, regulated sectors such as banking and insurance);
– significant resources (all large companies).[217]

This analysis is supported by the evidence gathered for Oxera's 2006 report.[218] The primary market segmentations used in that report were the FTSE 100, the FTSE 250, and smaller listed companies. From a demand-side perspective, the customers in each of these segments have different needs. From a supply-side perspective, there are significant differences between the Big Four and mid-tier firms in terms of their ability to compete for business in each of these segments.

In other EU Member States, a similar line can be drawn, although the number of companies in the large listed segment tends to be smaller than in the UK. Consider, for example, the main stock market indices in Germany (DAX 30), France (CAC 40), Poland (WIG 20) and Hungary (which currently has 17 constituents). See also below on geographic segmentation. London Economics (2006), which focused on the whole of the EU, also followed this segmentation by company size.[219]

Oxera (2006) confirmed that the requirements for auditing large public companies are materially different from those of smaller companies, and that at present, at least in the UK, only the Big Four are considered by the audit committee chairs and finance directors interviewed as being able to provide the services required by the larger public companies (and certainly the largest). Indeed, many audit committee chairs and finance directors consider that, for large listed companies (and certainly the FTSE 100), the Big Four are the only real choice. By contrast, several firms highlighted AIM as a segment where mid-tier

[216] European Commission (2002), 'Case No COMP/M.2810 Deloitte & Touche/Andersen (UK)', July 1st, para. 21. European Commission (1998), 'Case No IV/M.1016—Price Waterhouse/Coopers & Lybrand: Commission Decision of May 20th 1998'.

[217] European Commission (2002), 'Case No COMP/M.2810—Deloitte & Touche/Andersen (UK)', July 1st, para 23.

[218] Oxera (2006), 'Competition and Choice in the UK Audit Market', report for the DTI and FRC, April, section 4.2.

[219] London Economics (2006), 'Study on the Economic Impact of Auditors' Liability Regimes', report for DG Internal Market and Services, September, section 3.2.

firms can compete effectively with Big Four firms (more mixed views were obtained regarding FTSE Small Cap and FTSE Fledgling companies). UK audit firms themselves also seemed to broadly share this view on market segmentation. For example, at least two mid-tier firms thought that the main division in large company audit was around the FTSE 100–150 level. Another two, smaller, mid-tier firms considered that the division fell around the FTSE 350 level.

7.1.3 Geographic market segmentation

While there has been certain movement towards greater integration of international audit firm networks, and some cross-border mergers (as discussed in section 5 above), from a competition perspective, audit markets are by and large still national in nature. This is likely to be the result of a combination of factors, including the historical development of audit activities, and the fact that most legislation and regulations are determined at the national level. It is also reflected in the fact that the Big Four and other international audit firms are set up as networks of national audit firms, rather than as integrated multinationals.

This is important for any policy towards promoting competition and choice in the audit market. It means that, when considering entry or expansion, audit firms will make any investment decisions based mainly on *national* parameters, such as the size of the national market and the state of competition in that market. Audit firms are, as yet, unlikely to make an investment decision based on some notion of the size of the European market as a whole—the profitability of entry or expansion is driven by national markets.

As with segmentation by company size, Oxera does not seek to draw a specific line between large national markets—where investment would seem more likely to be attractive—and small markets. In general terms, the investment analysis presented in section 7.4 below would apply mainly to the larger markets, which have a greater number of large listed companies for which audit firms can compete.

To give an indication of national market size, Table 7.1 shows the number of constituents for each Member State in the S&P Europe 350, the index representing the 350 companies with the largest market capital across Europe; only 16 Member States are represented in this index.

Table 7.1 Country weights and number of companies in the S&P Europe 350

Country	Country weight (%)	Number of companies
Great Britain	34.91	124
France	15.06	47
Germany	10.83	32
Italy	5.48	23
Switzerland	10.49	22
Sweden	3.40	20
Netherlands	5.57	19
Spain	6.49	18
Belgium	1.91	10
Finland	1.60	6
Ireland	1.19	6
Norway	0.89	6
Portugal	0.60	6
Denmark	0.64	4
Greece	0.55	4
Austria	0.40	3

Source: S&P Europe 350, December 31st 2006, available at http://www2.standardandpoors.com/spf/pdf/index/factsheet_europe350.pdf.

7.1.4 Segmentation by sector

Some sectors have particularly complex audit requirements. Consistent with this, sector-specific expertise is an important determinant of choice of auditor. The 'complex' sector most frequently highlighted is banking and insurance. The European Commission's analysis in the merger investigations supported the view that this market segment has characteristics that differentiate it from other sectors:

> The Commission considered the possibility that there were separate markets for the provision of audit services in the case of sectors where there were indications that the particularly complex nature of the sector's activities required a significant level of specialist expertise on the part of the auditor. However, the only sectors where the Commission's market investigation confirmed this possibility were the financial sectors of banking and insurance. Indeed, both clients and competitors concurred in distinguishing these two sectors from all others, including the other regulated sectors and public companies.[220]

Other sectors that are sometimes identified as having complex audit requirements are extraction and mining, media and high-tech industries, retailing and tobacco. In fact, only a few sectors could be classified as *not* having any specific complex requirements (basic manufacturing, manufacturing of clothes and consumer goods, and property). However, as a matter of degree, there seems to be support that banking and insurance are differentiated from other sectors in terms of audit complexity.

[220] European Commission (1998), 'Case No IV/M.1016—Price Waterhouse/Coopers & Lybrand: Commission Decision of May 20th 1998', para. 34. However, the Commission finally concluded that the provision of audit and accounting services to the banking and insurance sectors does not constitute separate product markets for the purposes of 'assessing the competitive effects of the present operation' (para. 49).

From a supply-side perspective, Oxera (2006) found that the Big Four have expertise in most sectors, including the more complicated ones, which means that these are not really separate markets—in other words, there is a degree of supply-side substitution. Yet, in some sectors, including banking and insurance, UK companies perceive certain Big Four firms to be market leaders and others to be weaker, even if the latter have expertise in that sector in other countries. Thus, sector specialisation is often said to be path-dependent—even a Big Four firm would find it difficult to become established in a new sector, since prior experience is the main qualification for sector expertise.[221]

7.2 Barriers to entry and expansion in European audit markets

7.2.1 Current high concentration

It is clear that the audit market is highly concentrated, and that this is an EU-wide, and indeed global, phenomenon. Table 7.2 below reproduces the concentration figures by Member State as estimated in London Economics (2006). Concentration is measured using the Herfindahl–Hirschman Index (HHI), as often used in competition policy to express market concentration; an HHI value of above 1,800 indicates that the market is highly concentrated.[222]

Concentration is particularly high in the segment of the larger listed companies, reflecting the (near) lack of presence of the mid-tier firms there. Concentration is overall somewhat lower when considering all listed companies, although it is still high in absolute terms in several Member States. This suggests that the mid-tier firms face fewer barriers to entry and expansion into the auditing of smaller listed companies.

[221] Oxera also found that there are other sectors, such as shipping and on-line gaming, where mid-tier firms are sometimes perceived to have greater sector expertise than the Big Four.

[222] The HHI is calculated by adding up the squares of the market shares of all auditors. It ranges between 0 (numerous market participants with very low market shares) and 10,000 (monopoly with 100% market share). For example, in a market with five firms, each with 20% of the market, the HHI is 2,000. According to the US merger guidelines, an HHI above 1,800 indicates that the market is highly concentrated, and a market with an HHI between 1,000 and 1,800 is moderately concentrated. See Department of Justice and Federal Trade Commission (1992), 'Horizontal Merger Guidelines' (revised in 1997).

Table 7.2 Audit market concentration in EU Member States

Country	For companies in main index of main national stock exchange		For all public companies (2004)	
	No. of companies	HHI (by no. of mandates)	No. of companies	HHI (by no. of mandates)
Hungary	12	4876	—	—
Spain	35	4100	1805	696
Germany	30	4022	—	—
Finland	25	3984	127	2283
Cyprus	20	3800	124	1951
Latvia	5	3600	36	540
Slovakia	5	3600	—	—
Malta	14	3163	—	—
Poland	20	3150	242	622
Czech Republic	9	3000	37	284
Ireland	20	3000	57	1571
Portugal	20	3000	—	—
UK	100	2912	1850	1057
Sweden	30	2792	—	—
Austria	22	2743	—	—
Italy	40	2662	—	—
Netherlands	23	2608	183	1832
Greece	20	2550	318	2328
Lithuania	21	2340	39	1689
Luxembourg	11	2307	—	—
Estonia	10	2200	15	2444
Belgium	19	2031	140	788
Slovenia	15	2000	—	—
Denmark	19	1833	126	1611
France	40	1818	—	—

Note: For the measure of concentration for all public companies, there was incomplete information for some countries. Countries have been ranked by HHI for the companies in the main index of the main national stock exchange, from highest to lowest.
Source: London Economics (2006), op. cit., table 4, p. 20, and table 8, pp. 26–7.

Audit market concentration has increased over time, through a combination of mergers leading to a Big Five at the end of the 1990s, and the collapse of Andersen in 2002 resulting in the current Big Four. The main barriers to entry and expansion faced by the mid-tier audit firms are examined below to set the background against which the effect of the ownership rules and access to capital can be assessed. Section 7.3 then explores whether any noticeable differences across Member States in the current concentration levels in Table 7.2 are related to differences in ownership rules.

7.2.2 Factors that drive auditor selection and favour the Big Four in Europe

Oxera (2006) found that for many of the factors that drive auditor selection, the Big Four are significantly better placed than the mid-tier firms. London Economics (2006), which covered the whole of the EU, reached similar conclusions.

Technical audit capabilities

The ability to carry out the technical audit is essential for any audit firm to compete seriously in the market. Companies often take this ability for granted—there was little doubt among interviewees in the UK that the Big Four and the mid-tier firms have highly qualified staff with the required technical skills. Yet, there were some mixed views on whether the Big Four have greater technical skills than the mid-tier firms, and an almost uniform view that the Big Four have greater resources and geographic reach to carry out the technical audit for larger companies.

Technical audit capabilities required from audit firms broadly fall into the following categories:

- the accounting expertise of the audit team (ie, audit partner and supporting staff), including the technical expertise and experience;
- sector knowledge and experience;
- international coverage;
- the ability to provide value-added advice on issues such as new regulation, best practice, and internal control processes (see below).

Companies require from the audit team not only high technical accounting quality, but also experience in auditing ‘complex’ businesses. The team needs to have the capacity to provide additional advisory services while conducting the audit, and to ensure that the company has reliable financial reporting systems, and therefore provide it with some degree of insurance against any catastrophic events.

It is generally recognised that the process of audit is determined by very detailed regulation. In fact, several investors have commented that auditing has to some extent moved towards a rules-based, ‘tick-box’ exercise, with a diminishing role for the judgement of the audit partner. However, the standardisation of the audit process does not mean that it is a simple procedure. Businesses are complex and changing entities, and companies expect auditors (and particularly the audit partner) to be able to understand and infer, in a timely and efficient fashion, the impact of such complexity and transformations on the company’s financial position and reporting. Companies also consider that the auditor should be able to identify any problematic areas in the business and therefore provide a check on the state of the business. In addition, depending on the life cycle of the company, auditors are expected to provide information and value-added to some areas that are new to the company, such as new regulation, and internal control processes as the company grows larger and becomes more complex. The Big Four firms are often perceived to perform better on these aspects that the mid-tier audit firms.

Another crucial aspect of technical audit capabilities is the international coverage of the auditor network (as also discussed above in sections 5 and 6). This relates not only to the capacity to provide audit services in a number of countries, but also to the ability of the firm to provide a consistent service across different countries. Companies generally prefer to have the same audit firm across the countries where they operate, or into which they are planning to expand, for various reasons. Again, the Big Four are better placed to meet these needs of companies.

Value-added component of audit services

Many audit committee chairs and finance directors in the UK consider the real value-added to be the additional, and often informal, advice provided by auditors on top of the audit itself, in relation to issues such as new developments in accounting standards; best practice in the industry on dealing with certain standards; and how the company could improve its internal processes and controls. Many audit committee chairs have regular communications (formal and informal) with the audit partner(s) involved, discussing these issues. Audit committee chairs tend to value these communications highly because they obtain certain insights into how their company is performing (and a degree of comfort from this). At the same time, these communications allow the audit committee chairs continually to probe the quality of the involvement of the auditor.

Oxera (2006) found there to be a general view that the Big Four are better placed than the mid-tier firms to provide these value-added services. In particular, the Big Four are considered to be better informed about the latest developments in international accounting standards and about best practice across industries and countries.

Assurance component of audit services

When choosing an auditor, companies generally have limited information on the quality of the services they will receive. Some information can be gathered during the process of selecting an auditor (eg, during the tendering) and from other companies in the same sectors, but this cannot remove all uncertainty. Therefore, audit clients will seek a form of assurance from the auditor, which has two aspects.

– Company management, audit committee chairs and shareholders want some assurance that the auditor is capable of detecting irregularities and instances of fraud, thereby preventing catastrophes. Such catastrophes have a very low probability of occurring, but can result in severe damage if they do occur.

– Audit committee chairs (or equivalent individuals) seek assurance against the damage that would arise in the unlikely event of a catastrophe. This damage might be reputational as well as (or even more than) financial. Faced with such a situation, audit committee chairs (and company management) will want to point out that they had appointed the ‘right’ auditors.

Hiring a firm with a good reputation allows the agents that choose the auditor (ie, audit committee chairs/management) to prevent criticism by the shareholders and external advisers of their decision of hiring a particular audit firm in the event of a problem with the audit. This creates a form of ‘IBM effect’ in auditor selection (ie, ’no one gets fired for hiring IBM’). From a policy perspective, while the above mechanism creates desirable incentives for audit committee chairs to ensure that the auditors are of the highest quality, it also leads to an outcome in which audit firms are selected on the basis that they have a credible reputation of being the ‘right’ auditors. It is often only the Big Four who are perceived to benefit from this effect.

The above factors seem to constitute barriers to entry and expansion across EU Member States. London Economics (2006) reached similar conclusions, based on a survey among audit firms and companies from across Europe. Table 7.3 below reproduces the findings of that survey on what the main barriers for the mid-tier firms are perceived to be.

Table 7.3 The importance of various barriers to the statutory audit market of large companies

Average rating from 1 (least important) to 5 (most important)

	Replies from		
Barriers	**Big Four**	**Mid-tier firms**	**Companies**
Audit firms are too small and lack the capacity to handle audit assignments undertaken typically by large audit firms	4.0	3.2	4.3
Audit firms cannot provide services covering many countries	3.7	3	4.3
Reputation of Big Four audit firms	3.9	4	3.9
Client switching inertia	1.8	3.2	3.1
Audit liability risk	3.6	2.6	3.1
Lack of adequate audit liability insurance	3.5	2.5	2.9

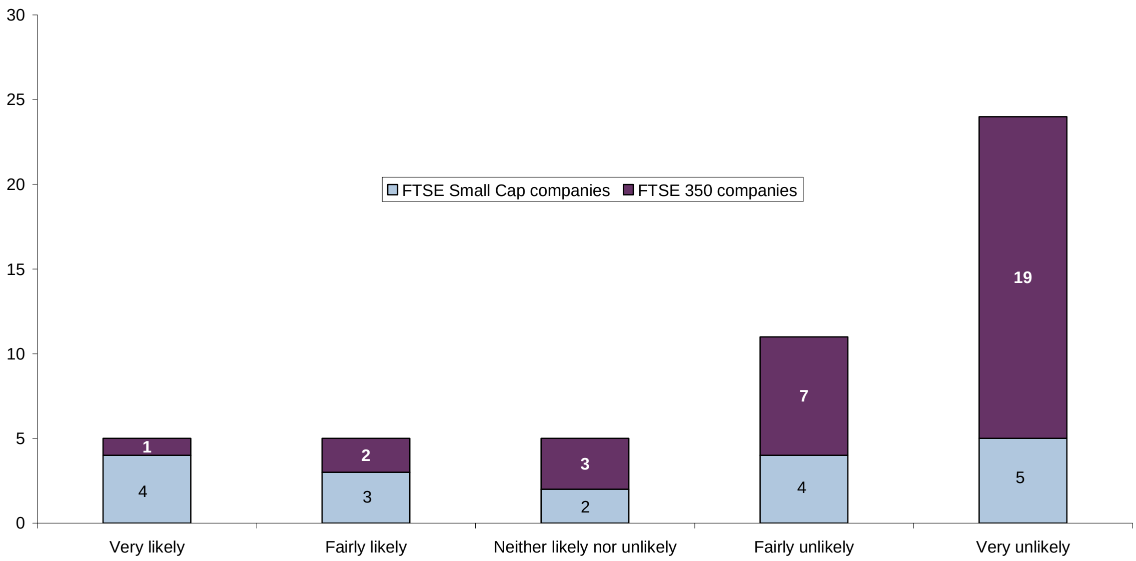
Source: London Economics (2006), op. cit., table 19, p. 41.

7.2.3 Perceptions on substitutability between the Big Four and the mid-tier firms

As discussed above, companies and investors across the EU perceive significant differences between the Big Four and the mid-tier firms in terms of quality of staff, international coverage and reputation. As a result, not many large companies would actually consider employing a mid-tier firm for the company audit, which further reflects the significant barriers to entry and expansion faced by these firms.

For example, for the Oxera (2006) study, a survey asked UK audit committee chairs to rate they likelihood of considering using a mid-tier firm (see Figure 7.1). Of the 50 respondents, 10 stated that they would be ‘very likely’ or ‘fairly likely’ to do so. In contrast, 35 audit committee chairs said that they were very or fairly unlikely to consider a mid-tier firm as their auditor. In addition, the audit committee chairs were asked about the size of a hypothetical price reduction they would require to consider a mid-tier firm as the company’s auditor. In reply, 37 of 40 audit committee chairs who answered this question agreed with the statement: ‘I would not consider a mid-tier auditor at any price’.

Figure 7.1 Likelihood of considering a mid-tier firm for the company's audit (number of companies, based on UK survey)



Base: 50 responses by UK audit committee chairs for the whole sample, 32 for FTSE 350 companies and 18 for FTSE Small Cap companies.
Source: Oxera (2006), op. cit., Figure 3.9.

A similar result emerged from the survey among EU companies carried out by London Economics, where only 33% of companies with a turnover above €100m were prepared to use a non-Big Four audit firm (for companies with a turnover in excess of €10 billion, this was 15%; while for companies with a turnover below €100m, this was 67%).[223]

7.2.4 Limited tendering and auditor switching

Another factor hindering entry and expansion by mid-tier audit firms is that companies across Europe tend to have long-term relationships with their auditors. The survey results in London Economics (2006) suggest that one-third of EU companies have had the same auditors for 11 years or longer, with another 20% having the same auditor for 7–10 years.[224] In part, this is explained by the fact that a long-term relationship can be highly beneficial to both parties, and generate efficiencies:

– the ability to deliver the audit for a *specific* company takes time to develop and requires the auditor to learn about the detailed operations of the company;
– the process of switching auditors costs both the company and the audit firm significant amounts of time (and money).

However, both the Oxera (2006) and London Economics (2006) studies found that there was also a limited degree of competitive tendering and auditor switching (even among the Big Four), and that this partly reflects a degree of inertia among companies. From a competition perspective, this has the drawback that it limits the number and frequency of competitive interactions between the Big Four, but also the number of opportunities for any expanding mid-tier firms to compete head-to-head with the Big Four and seek to gradually expand their customer base among the larger listed companies.

Evidence from Oxera (2006) suggests that tendering of audit services does not occur very often in practice. Of the 50 audit committee chairs surveyed, 36 stated that, in their company, a tender or similar process to select an auditor had not been held for at least five years.

[223] London Economics (2006), op. cit., Table 25.
[224] Ibid., Table 22.

Consistent with this, one of the Big Four firms informed Oxera that, of the FTSE 100 constituents in December 2004, it was aware of only 28 companies that had held competitive tenders in the previous 15 years.

In line with a low frequency of tendering among UK companies, there appears to be a very limited degree of switching between auditors. In 2004 only 1% of FTSE 100 and 2% of the FTSE 250 companies changed auditors, while 3.1% of FTSE Small Cap companies and 3.8% of the FTSE Fledgling companies switched. With low levels of tendering and switching, market shares are likely to be stable, and high levels of concentration, once established, are likely to persist.

7.2.5 Auditor liability as a barrier

Although auditor liability is not the subject of this study, liability risk might have an impact on audit firms' willingness to expand and attract capital. In particular, such risk might represent an important additional barrier to entry by the mid-tier firms into the market for large audits, for the following reasons:

– if a mid-tier audit firm expands (ie, it acquires large clients), its liability risk will be likely to increase (see also the assumptions in the investment model discussed in section 7);

– the impact of liability risk associated with a single, large client might be disproportionate to the size of the audit firm;

– mid-tier audit firms may not have the same ability to manage risk as the Big Four if there are significant economics of scale associated with a firm's ability to self-insure through captive insurers; and

– investors might apply a premium to the required rate of return in the presence of uncertainty about the extent of the liability risk and its potential impact on value. Industries characterised by uncertainty and asymmetric information about the true size of specific industry risks might not attract investment.

The last point is particularly important since audit services have been associated with a significant degree of asymmetric information (see discussion in section 5—in particular, section 5.4.1).

Oxera interviews have provided some evidence that mid-tier audit firms regard liability risk as an important consideration in evaluating any potential business strategies to expand. In particular, the interviewees have highlighted the costs of managing liability risk for a small group of large clients in the initial stages of hypothetical expansion, which might persist for a considerable period of time. Implicitly, this means that liability risk might represent a constraint on the commitment of internal funds to expansion. As noted above, this has been reflected in the assumptions of the investment model discussed in section 7, although quantifying the liability risk on a forward-looking basis is difficult due to various associated uncertainties.

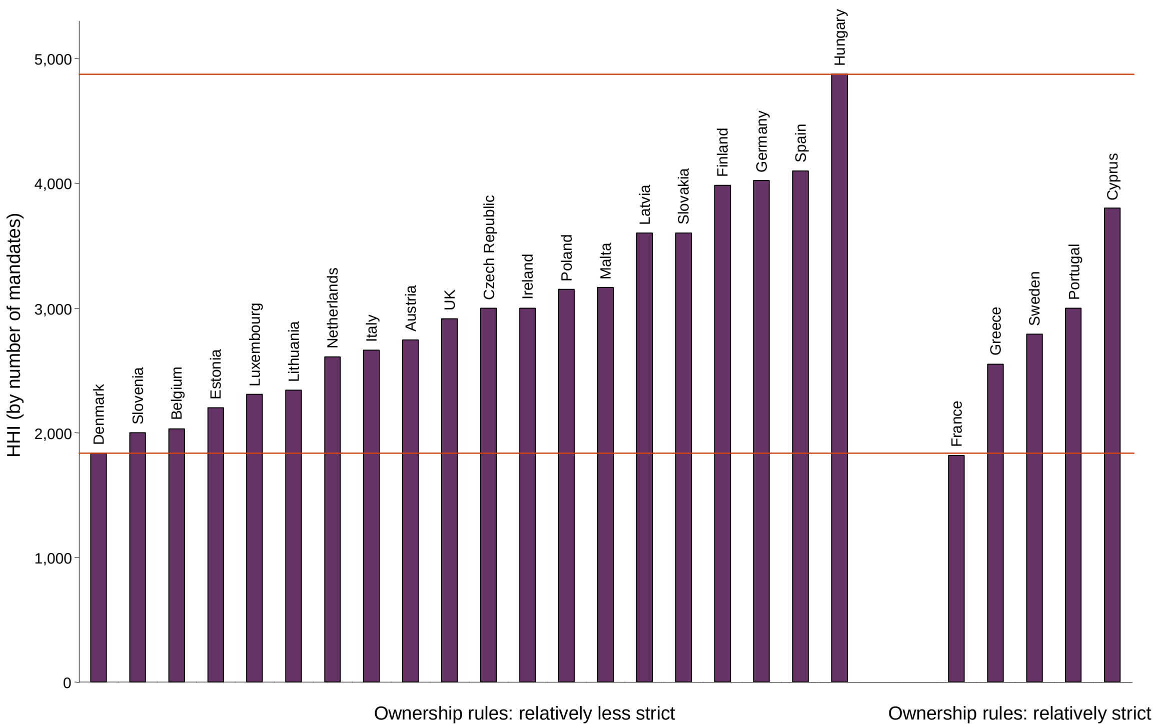
Although there is no evidence per se to support the conclusion that liability risk represents a binding constraint on external investors' willingness to commit capital at the present time and under present ownership rules, this might be partly driven by the fact that few, if any, investors appear to have carefully assessed the possibility of investing in audit firms. Any commitment of external capital might be expected to depend on the evaluation of the downside risk, where the contribution of liability risk to any potential downside business scenario evaluated in the context of the hypothetical investment is likely to be substantial.

7.3 Ownership rules and current patterns of concentration in EU Member States

A relevant question for the present study is whether any differences in the current levels of concentration between Member States can be explained by any differences in the legislative framework or in ownership structures adopted. This section seeks to address this question by combining information on market concentration by Member State from previous studies with the comparative information on ownership rules and structures presented in section 3 above. The analysis is necessarily qualitative in nature, as insufficient data, on both concentration (specifically over time) and on precise legal ownership structures, is available for a statistically more robust analysis. Nonetheless, some indicative conclusions can be drawn, as described below.

The analysis of the ownership rules across Europe in section 3 identified certain countries that imposed somewhat stricter rules than others, requiring 75% or more of the owners of audit firms to be qualified auditors. These countries were Cyprus, France, Greece, Portugal and Sweden, with Greece not allowing any outside ownership at all. In other Member States there is only a majority requirement for owners to be qualified auditors. Figure 7.2 shows that there is no distinguishable pattern when comparing the levels of market concentration (as measured by the HHI) across these two groups of countries. This indicates that any differences in the current ownership restrictions are not associated with differences in concentration.

Figure 7.2 Indicative relationship between concentration and ownership restrictions across Member States



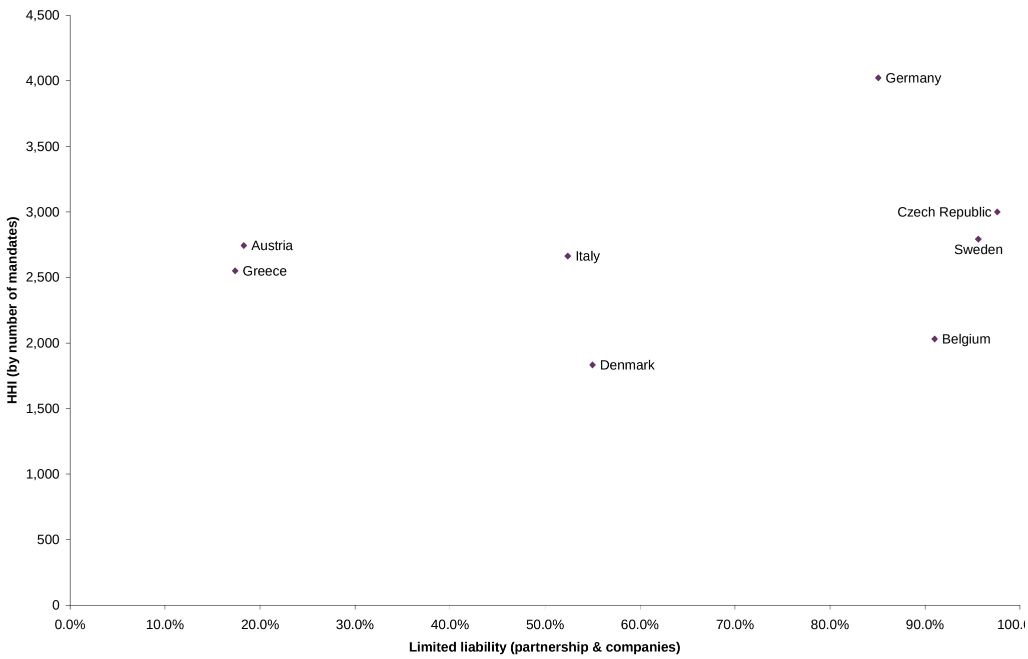
Note: The countries are split into two groups: 'relatively less strict'—those with ownership rules that require the majority of owners to be qualified auditors; and 'relatively strict'—those that require more than 51% of the owners to be qualified auditors.
Source: Oxera analysis of concentration data from London Economics (2006), table 4, p. 20.

Oxera has also reviewed whether there is any relationship between concentration and forms of ownership adopted across Member States. Some information on the legal forms of audit firms has been obtained for this study, as described in sections 3 and 5; however, comprehensive information of the legal forms of audit firms across Member States is not currently publicly available. This should change when the Eighth Directive is fully implemented because Article 40 of the Directive will require audit firms to make this information publicly available as part of their transparency report.

From the analysis of legislation concerning the audit market in Europe, all legal forms are permitted for audit firms (with some variation and exceptions), with one exception—Ireland—where audit firms are only permitted to take the form of partnership or sole trader. A qualitative assessment of the legal forms of audit firms with an international presence shows that there appears to be no consistent preference for a legal form among firms. For example, PwC is predominantly in the form of partnerships in Europe with some variations; whereas, for KPMG, for the 18 countries analysed, almost three-quarters of the member firms were in the form of companies, and Ernst & Young has mainly adopted the company form as well. Section 5.1.1 analyses the different legal forms of audit firms more generally for various Member States

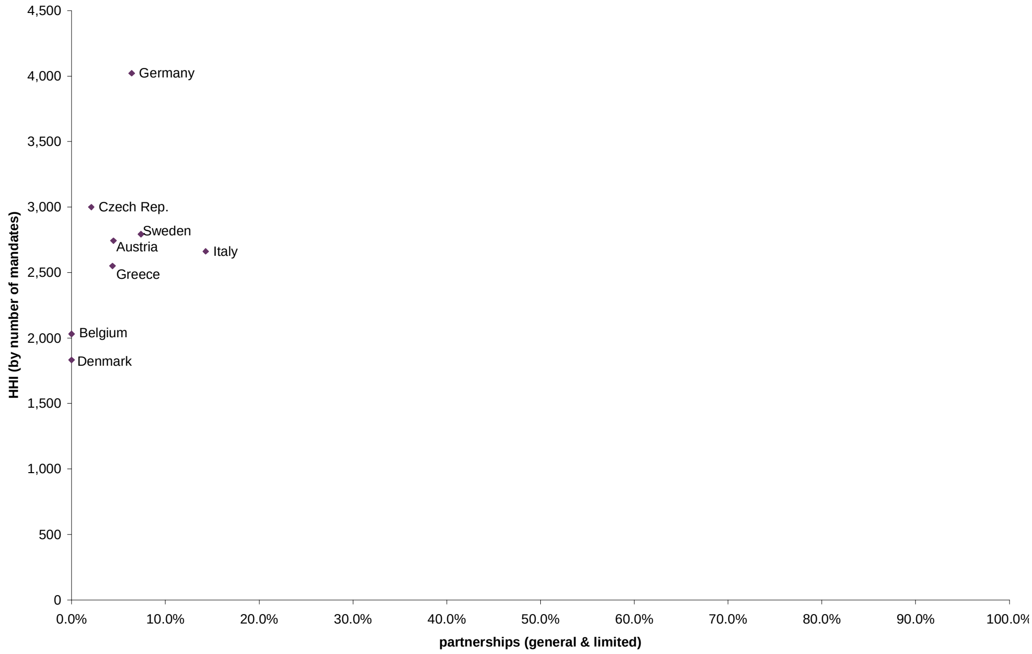
Figure 7.3 below plots, for countries where information is available, the concentration of audit firms against the percentage of audit firms that have a form of limited liability (either partnership or company form). Figure 7.4 does this for the percentage of audit firms that have adopted some variant of the partnership form. Again, from this small number of observations, there does not appear to be any clear relationship between market concentration and the prevailing forms of ownership.

Figure 7.3 Indicative relationship between market concentration and the prevalence of limited liability of audit firms



Note: HHI is measured by the number of mandates of the companies in the main index of the main national stock exchange. Limited liability is measured by the percentage of audit firms in that country with limited liability status. Source: Oxera.

Figure 7.4 Indicative relationship between market concentration and the prevalence of partnerships



Note: HHI is measured by the number of mandates of the companies in the main index of the main national stock exchange. Partnerships are measured by the percentage of audit firms with the partnership form.
Source: Oxera.

Overall, the above analysis suggests that there is no relationship between differences in current market concentration and differences in ownership rules and structures. This analysis is made more difficult not only because of the limited information available, but also because the actual differences between Member States are relatively limited in many respects—concentration is very high in all Member States, and at present the ownership rules are similar.

The two Members States that stand out for having a somewhat lower HHI are France and Denmark (see Table 7.2 above)—both have an HHI just above 1,800 for the larger listed companies, so can still be considered concentrated. (In fact, Denmark has a higher HHI, of around 1,600, for all listed companies than several other Member States.) Of these two, only France falls into the group of countries with relatively stricter ownership rules. Hence, ownership rules and structures are unlikely to explain the relatively lower concentration in Denmark and France.

A more plausible explanation seems to be that these are two Member States that have, or, in the case of Denmark have had,[225] a legal joint audit requirement in place. This enhances the possibilities for mid-tier audit firms to provide statutory audit services to larger companies alongside the Big Four—it effectively doubles the number of audit mandates. This explanation for lower concentration in France and Denmark has also been provided in, for example, London Economics (2006)[226] and in a study by Piot (2007).[227] Piot finds that 'the most common joint-auditing arrangement comprises one Big 6/4 firm and one Majors firm'. He concludes by remarking that the joint audit arrangement:

[225] The joint audit requirement for listed companies in Denmark was terminated about two years ago as the costs were perceived to be greater than the benefits.
[226] London Economics (2006), op. cit., p. 19.
[227] Piot, C. (2007), 'Auditor concentration in a joint-auditing environment: the French market 1997–2003', *Managerial Auditing Journal*, **22**:2, p. 170.

leaves an 'open door' to national auditors and indirectly mitigates the domination of the large international audit networks.[228]

7.4 Incremental and new entry into the market for the audit of larger listed enterprises

This section analyses a potential entry by a medium-sized audit firm into the market for the audit of large listed companies based on a series of incremental investments in both physical and human capital, as well as other non-intangible assets. It also explores, on the basis of this analysis, the differences that would be likely to apply to entry into the audit market by a new, non-audit, entity.

The purpose of this analysis, which is based on a stylised model, is twofold—to illustrate:

– the profitability of the potential investment, including consideration of the key economic factors faced by firms that might attempt to enter the market for large listed companies; and

– the potential use and impact of employing external capital to fund the necessary investment. This investment is based on a corporate structure instead of a partnership.

The stylised model assumes entry into the market for large audits in a single jurisdiction. Since the specific market conditions necessarily differ by country, the focus of the model is to capture the key investment dynamics associated with the hypothetical entry in general, rather than to model a specific market situation in any given country. In order to make the model realistic, real-world assumptions have been made, based on potential market conditions in a medium- to large-sized audit market in a single EU Member State.

The model presented below adopts the incremental approach of acquiring larger clients through time. The entry is modelled on the basis of three steps. This corresponds to one potential entry strategy based on a business expansion by a strong and currently profitable player in the audit market.

This analysis has two primary objectives:

– to compare the dynamics of relative profitability of potential investments at various stages of the expansion;

– to highlight the main differences between an investment made by an employee-owned firm and an investment made by an (external) investor-owned firm.

It is important to stress that the results of the analysis outlined below are presented for illustrative purposes only and might not reflect the reality of the audit market in any particular country—they have not been calibrated to a fit any specific market conditions.[229]

7.4.1 Approach to modelling entry—three incremental expansion steps

The analysis of potential entry into the market for large audits is based on modelling three distinct and incremental expansion steps. The three hypothetical steps, as set out below, do not attempt to mirror a specific expansion strategy that might be adopted by any given firm in the future. Instead, they are aimed to illuminate the general constraints that would be faced by the firm and its investors if it attempted to expand into the market for larger audits.

[228] Piot, C. (2007), op. cit., p. 170.

[229] In particular, the scale and the dynamics of the potential expansion in any particular market might be different. In that respect, the stylised model aims to highlight the key trade-offs and market dynamics associated with the potential expansion strategy rather than modelling actual investments.

Notwithstanding the above comments, these steps have been created after discussions with audit firms and represent estimates by them as to what they would need to do to achieve the various steps set out.

The three steps are as follows.

Step 1 Establishing a meaningful foothold in the lower end of the market for audits of medium-sized enterprises by gaining up to ten additional medium-sized clients (ie, an expansion beyond the current small client base). In particular, this move represents the acquisition of 10 clients that are larger than the existing client base.

Step 2 Expanding and consolidating its position in the market for medium-sized enterprises by acquiring up to 20 additional medium-sized clients. These new clients are approximately the same size as those acquired in step 1.

Step 3 Establishing a meaningful foothold in the market for the largest listed companies by gaining up to 10 large clients from the group of the largest listed companies in a given jurisdiction.[230]

These steps have been identified in the course of the interviews with audit firms as constituting a potential business strategy for entry into the market for large companies in a single jurisdiction.[231] The investment analysis assumes that each step is taken separately.[232]

7.4.2 Measuring returns on investment

A fundamental component of the investment appraisal is the estimation of mean expected cash flows. The cash flows can be discounted by the required rate of return or the cost of funding (cost of capital) in order to determine the NPV (net present value) of the investment. The required rate of return is assumed to correspond to the level of risk embedded in the project and faced by investors; it reflects the opportunity cost of assuming the same level of risk elsewhere.

The key outputs from the model are the internal rates of return (IRR) from the investments under different scenarios. In general, if the IRR of the investment is above the cost of capital, the investment has a positive NPV; where it is below the cost of capital, the NPV is negative.

As discussed in section 6, the required rate of return on external capital invested in audit firms might be lower than that on internal capital under a partnership structure. Therefore, it is of interest to compare the predicted, internal rates of return with the potential differences in the required rates of return under different ownership structures.

7.4.3 Probability of success

In order to model cash flows to investors, this analysis considers the assumptions about the returns earned by an audit firm under two scenarios: (i) if the hypothetical entry strategy is always successful (the ‘success’ scenario); and (ii) if the hypothetical entry strategy is successful with a certain probability of success that is less than 100% (the ‘base-case’ scenario). The results of the downside scenario, where the entry is never successful, are not reported.

[230] This excludes highly specialised sectors such as banking or insurance.

[231] During the programme of Oxera interviews, it was found that investors were not actively considering investments in audit firms, therefore the inputs of the model are based on information supplied by the audit firms alone.

[232] None of the investors interviewed by Oxera has considered an investment in an audit firm, so these assumptions cannot be verified as either realistic or plausible from the investors’ perspective.

The estimated returns in the success scenario are based on the assumption of a successful entry under a set of illustrative, but plausible, market conditions, which comprise the acquisition of a certain number of clients at each of the three steps.

The assumptions about the market conditions under the success scenario include the required profile of investments over time, the payback period, resulting revenues and profit margins, as well as other, general assumptions about market conditions, such as the rate of companies' tendering audit mandates and the rate of switching.

The base-case scenario is the probability-weighted combination of the success scenario and the downside scenario, where the latter assumes no new clients. That is, the downside scenario implies that the new investments bring no additional revenues. The probability of failure under the base-case scenario varies by step from 35% to 50%. This reflects significant uncertainty about the potential success of the investment strategy.[233]

On the basis of the interviews undertaken by Oxera, the stylised model assumes that the increase in the liability risk as a result of the expansion is likely to be significant. It is also conditional on the type of expansion and the size of the average new client at each step.

The liability risk is assumed to be equivalent to the likelihood of a successful liability claim against the firm, where such a claim is assumed to be large enough (in financial terms) for the audit firm to be forced into bankruptcy. In modelling terms, liability risk is modelled implicitly as a cost—this could be thought of as the cost of complete insurance against liability risk.

The mechanics of the liability risk exposure in the model are such that, irrespective of whether the expansion is successful, an attempt to expand would be associated with additional liability risk and hence with an up-front cost. The probability of a large liability claim is assumed to be 1%, 2.5% and 4.5%, respectively, for each step.

7.4.4 Ownership structure—investment by insiders or by outside investors

The hypothetical expansion has been modelled under two alternative audit firm ownership structures. Under the first, an employee-owned audit firm (eg, a partnership) undertakes the investment; while, under the second, an investor-owned audit firm (company) undertakes the investment.

The form of the investment

Audit firms are professional service firms, which invest in tangible and intangible assets to expand. The former assets include, for example, enhanced computer networks or additional buildings, while the main intangible assets are human capital and brand—a result of past performance, as well as of the additional expenditure on activities that generate higher visibility and create an enhanced reputation.

In the case of the potential investment to enter the market for large audits, these expenditures would need to occur *before* additional clients could be obtained. In addition, in attempting to enter this larger audit market, the probability of winning any particular tender would be considerably lower for the new entrant compared with the firms established in that market (and lower than for the new entrant in its existing market), while it establishes itself in the larger audit market. Thus, the direct costs of acquiring clients will be higher for the new entrant in this phase.

Most of the investments required do not constitute visible assets, but represent higher operational expenditure leading to lower profits for owners. In economics terms, therefore, the necessary investment required to enter the larger audit market manifests itself in a period

[233] In modelling terms, the probability of failure is 0% under the success scenario.

of reduced income followed by higher incomes, once the firm has established itself in the new market.

In general, at least two critical factors influence the profitability of the expansion: namely, the required investment and the additional income generated by that investment in the future. The basic dynamics of the model are simple in that respect. As the required investment falls, or the future income increases, or both, the IRR increases and the probability that the return is sufficient to cover the relevant cost of capital also increases.

If the investment were carried out by insiders (under a partnership or other form of employee-ownership), reduced income would represent investment to be recovered by higher income in the future. In the case of external investors, the same pattern of financial flows would occur, but instead of lower incomes to partners during the investment phase, the external investor would face a cash outflow followed by a cash inflow once the firm has established itself in the new market.

Under the external ownership, the 'partners', who are now assumed to be the employees, maintain their income throughout—ie, they do not make the initial investment and do not benefit from the potential future upside. Therefore, under this scenario, insiders do not directly bear the risks of the investment.

Therefore, although the basic model dynamics are the same under both ownership structures, each ownership structure implies a different profile of financial flows (implicitly as a result of different financial contracts) and different exposure to risk—this is explained in greater detail below.

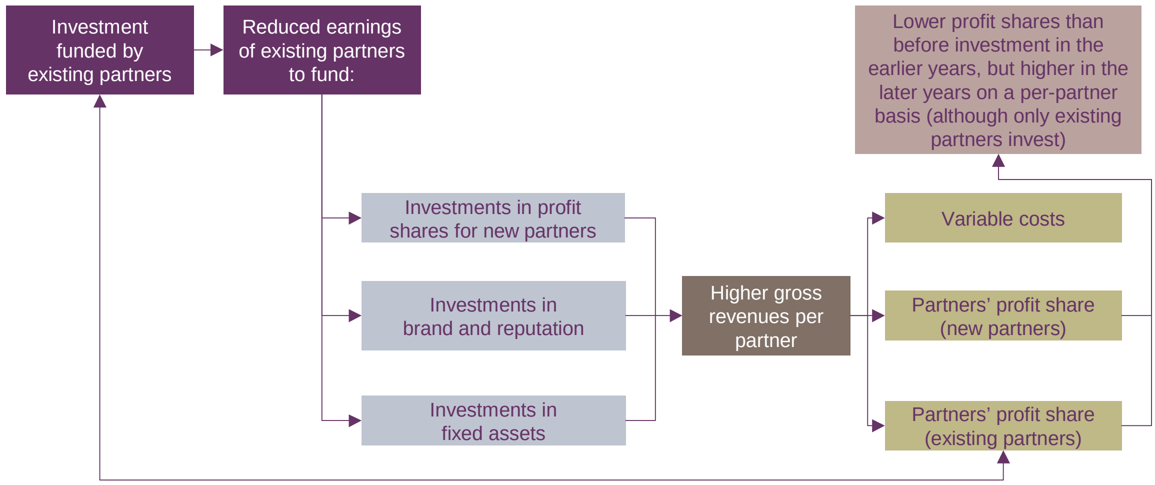
Investment by an employee-owned firm

Oxera's stylised model assumes a partnership-like structure of an employee-owned audit firm. The analysis considers the expansion of the firm as a whole. This set of assumptions has been translated into 'per-partner' decision variables in order to model individual member's risks and rewards from the hypothetical investment. This is consistent with the assumption that individual partners would have to vote collectively to make the investment decision.

The investment model also assumes that, at any point in time, profits are distributed equally among all current partners and that the profit share represents the only form of compensation. In other words, existing partners share the benefits of a successful entry with the new partners who join the firm in order to service additional clients.

The existing partners directly incur the initial investment costs via forgone earnings; new partners implicitly contribute to the initial investment through their capital contribution to the firm when they join.

Figure 7.5 Stylised illustration of the investment by an employee-owned firm



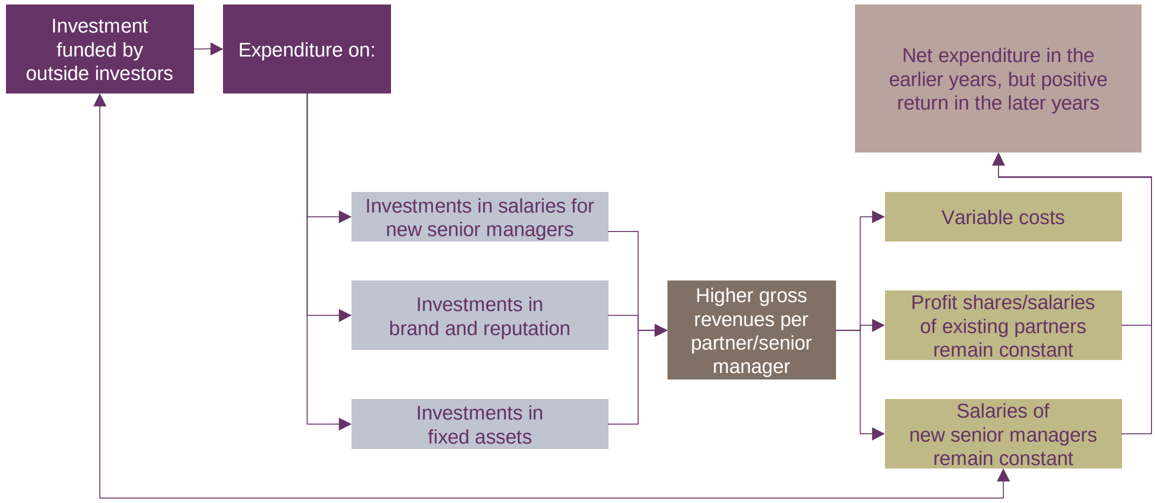
Source: Oxera.

Partners finance the necessary investment themselves, without recourse to any form of external financing. This could be attractive to partners if the remuneration from carrying out large audits, available for distribution among partners, is significantly higher than that for carrying out audits of smaller companies—ie, if the potential gains from expansion are sufficiently large.

Investment by a firm funded with outside capital

Oxera has modelled the same investment necessary for expansion as if it were carried out by an audit firm owned by outside investors. Under this structure, audit 'partners' (now employees) are assumed to be salaried with a fixed wage contract, while the potential profits and losses are distributed to the outside investors.

Figure 7.6 Stylised illustration of the investment by an investor-owned firm



Source: Oxera.

The model assumes that the outside investor makes the required investment, while keeping the compensation of the existing partners at the same level as before. The profits or losses from the investment then accrue to the outside investor, while partners' or senior managers' compensation remains unchanged.[234]

Differences between investor and employee type of ownership

There are two primary differences between the employee-owned firm and the investor-owned firm that are reflected in the stylised model:

– **the structure of the employment contract with 'partners' (senior managers)**: in the investor-owned firm, senior managers are employees and their compensation might be less affected by the performance of the firm than in the case of the employee-owned firm. In particular, they might be protected from the downside and are not required to invest their own capital. In the employee-owned firm, partners are equity holders of the business and the value of their compensation might be significantly affected by the firm's performance. The implication is that partners' compensation is more uncertain than in the investor-owner firm. In the employee-owned firm, partners expect to receive returns on their equity investments, while in the investor-owned firm the returns on equity accrue largely to the outside investor;

– **implications of the type of investor for the required rate of return**: when the employee-owned firm invests, individual partners fund the investment from retained earnings, whereas in the investor-owned firm, the initial equity investment is made by the outside investor. As discussed in section 6, the required rate of return or the cost of capital is likely to be higher for partners than for outside investors.

The differences between the two ownership structures are summarised in the table below.

[234] The lack of upside to 'partners' or senior managers in the base case under investor ownership does not constitute a major limitation on this model. The possibility that salaried 'partners' or senior managers share some limited portion of the upside only if the original investment and hence expansion is successful (along the lines of the typical incentive-based compensation) does not fundamentally alter the model dynamics.

Table 7.4 Employee and investor ownership—a comparison of modelling assumptions

	Investor ownership	Employee ownership
Who makes the investment decision?	Outside investors	Existing partners
Who makes the initial investment?	Outside investors	Existing partners New partners make capital contribution to the business upon joining
Who receives the benefits of the investment and who bears the financial risks?	Outside investors	Existing and new partners
How are the existing partners or senior managers compensated?	Existing and new 'partners' are employees of the firm—they receive a fixed salary. The fixed salary of the existing partners in the investor-owned firm equals the expected profit of the existing partners in the employee-owned firm. The salary is not affected by the firm's and investor's decision to invest in new business or business performance—it remains fixed.	Existing and new partners are the equity holders—they receive the profit share. Compensation includes the profit share less the investment to fund expansion (retained earnings net of total expenditure). In the earlier years, partners' compensation is lower than the profit share that existing partners were receiving prior to investment. In the later years, partners' compensation exceeds the profit share that existing partners were receiving prior to investment (if the investment is successful).
How are the new partners compensated?	New partners are offered an employee-type contract with a fixed salary. The fixed salary of the new partners is equal to that of existing partners and is assumed to remain constant over the lifetime of the investment.	New partners are offered an equity stake and a profit share, which is equal to the profit share of existing partners.
Who bears the risk?	The outside investors bear financial risk.	The partners bear financial risk.
What is the investment for?	To fund compensation of new partners in the earlier years when the business does not generate sufficient cash flows to cover contractual compensation. To fund other tangible and intangible assets.	To fund compensation of new partners equal to the profit share of existing partners prior to investment since the business does not generate sufficient cash flows. To fund other tangible and intangible assets.
What is the investment horizon and terminal value?	The investment horizon is 30 years under the base case. After 30 years, the investor is assumed to sell its ownership at market value (the NPV of future expected cash flows discounted at the IRR).	The investment horizon is 20 years under the base case. After 20 years, the existing partners, as they retire, are assumed to receive the nominal value of their initial equity investment in the partnership.

Note: 'Existing partners' refer to partners of the firm prior to investment; 'new partners' refer to partners that are hired to join the firm during the initial investment and expansion.
Source: Oxera.

Under employee ownership, existing partners make the original investment, which keeps the compensation of new partners equal to the compensation of existing partners in earlier years, when the investment generates low cash flows; it also funds other intangible as well as tangible assets.

Under investor ownership, outside investors make an investment, which funds tangible and intangible assets and the salaries of new partners in earlier years. In later years, when the investment starts to generate higher cash flows, the investor receives all benefits generated by the expansion.

7.4.5 Modelling assumptions

Investment horizon: the investment period

The investment analysis is based on the assumptions about two distinct periods, which characterise each investment step:

– the investment period during which new clients are gained; and
– the payback period when the returns on the investment are realised.

During the investment period, new clients are acquired incrementally. The model assumes that the new entrant would be able to secure no more than one to three new clients per year in each investment step under the success scenario. In the base case, Oxera has assumed two additional clients per year in step 1, three additional clients per year in step 2, and one additional client per year in step 3.

Investment horizon: the payback period

The investment horizon for the employee-owned firm is assumed to be 20 years, reflecting the length of time that the existing partners who make the investment could be expected to remain with the firm (until retirement) to receive benefits from their investment.

The investment horizon of the investor-owned firm is not capped, as it is assumed that perpetual cash flows accrue to investors through the market value of equity. Implicitly, this assumes that outside investors can sell the business at the end of the investment horizon at market value.

Size of required investments

The results of Oxera's interviews suggest that an investment of €10m–€30m in tangible assets (in addition to the investment in human capital) might be the amount required to support the initial expansion in a single jurisdiction. This is equivalent to an average investment of €1m–€3m per year in the course of the hypothetical investment period of ten years. This could be seen as a conservative assumption, and in some cases the investment necessary would be substantially higher.

Revenue gains and margins

The required investment might vary depending on how successful or unsuccessful the firm is assumed to be in gaining new, larger clients and on the economies of scale that exist in the audit market.

It has been assumed that the average audit fee from each new company in the first step of expansion would be €750,000; implicitly, this represents a significant increase in the maximum size of audit undertaken by the firm in the stylised model. The same assumption on size of audit has been made for companies gained in the course of the expansion and consolidation (step 2). A significantly larger company size was assumed for the third step of expansion with an audit fee of €3.5m per client.

An operating profit margin of 40% has been assumed for audits in all steps (before specific investment costs but after compensation to junior staff).

The summary of the modelling assumptions is presented in Table 7.5 below.

Table 7.5 Summary of the key modelling assumptions (base case)

	Step 1	Step 2	Step 3
Initial investment (€m per year)	2	2	3.5
Number of newly acquired clients (cumulative for each step)	10	20	10
Revenue from new clients (€m per client)	0.75	0.75	3.5
Number of new partners required	3	5	10
Investment period (years)	10	7	10
Likelihood of failure with no additional revenues (%)	50	35	50
Liability risk (probability of bankruptcy as a result of liability claim) (%)	1.0	2.5	4.5
Operating margin (%)	40	40	40

Note: The investment period represents the time from the first year when expenditure to attract new clients occurs until the new steady state is achieved and no more investments are required.
Source: Oxera's estimates and calculations based on interviews.

7.4.6 Results of the incremental entry model

The results from the Oxera stylised model of expansion, presented in Table 7.6, are shown as IRRs for each step of the analysis, by employee ownership and by investor ownership.

Two types of IRR are shown:

– under the success scenario (where the probability of failure is assumed to be zero);
– under the base-case scenario (where the probability of failure is 35–50% for each step).

A cost of capital differential of 10% between employee ownership and investor ownership of the audit firm has been assumed in order to benchmark the IRRs.

Table 7.6 Summary of results (IRR)

	Step 1	Step 2	Step 3
Employee ownership			
IRR (success scenario)	10.8%	20.6%	16.2%
IRR (base-case scenario)	–1.8%	9.0%	1.8%
Investment decision (at the cost of capital of 15%)	**No**	**No**	**No**
Investor ownership			
IRR (success scenario)	10.0%	19.3%	16.8%
IRR (base-case scenario)	1.8%	9.7%	5.5%
Investment decision (at the cost of capital of 5%)	**No**	**Yes**	**Yes**

Note: The model is calibrated in real terms.
Source: Oxera's calculations based on interviews with audit firms.

7.4.7 Conclusions from the model and further observations

The model indicates that the business expansion might be economically profitable and cover its cost of capital in all three steps if the predicted cash flows were certain. However, the ex ante expected returns are substantially lower due to low probability of success. The results for the success scenario under both employee ownership and investor ownership are similar, but differ more significantly in the base-case scenario.

In the base-case scenario and the modelling assumptions presented in Table 7.5, the expansion of the employee-owned firm into the market for large enterprise audits is not profitable since steps 1, 2 and 3 generate IRRs below the assumed cost of capital. In other words, the results of the model indicate that the partners would not support the initial investment.

At the same time, the expansion of the investor-owned firm is profitable in steps 2 and 3, but not for step 1, where the IRR is low. The first step aims to gain the initial foothold in the market for larger audits. This step is not economic due to high entry costs. However, it might constitute an acceptable step if the entire expansion strategy comprising all three steps is considered.

Some further key observations emerge from the above analysis.

– The general dynamics of the modelled expansion strategy are such that while, under the employee ownership, senior managers (partners) are required to provide capital and assume exposure to risk, under the investor ownership they are compensated with a fixed wage. In other words, under employee ownership, partners require additional compensation for assuming residual equity risk. This is reflected in the difference in the total compensation for partners between the two scenarios.

– In contrast to the employee ownership, the investor ownership might be more supportive of the decision to expand as external investors derive additional value from a longer investment horizon, whereas investment by partners is associated with returns that are likely to be capped due to a shorter investment horizon. The difference is reflected in the present value of the terminal value of the investment.

– Under the employee-owned structure the model assumes that the initial investment is shared across new and existing partners. Implicitly, partners spread the risk among the existing and new partners since new partners are required to commit capital ex ante. This results in the success scenario for steps 1 and 2 being more attractive under employee ownership, which means that the risk sharing present under employee ownership might create benefits if investments can be expected to be highly profitable and relatively certain, as in the success scenario.

– The profitability of the second and third steps of the business expansion modelled in this analysis is higher than that of step 1—ie, the capture of the initial foothold—as expected.

Finally, it is worth noting that the results of this analysis are broadly in line with the opinions expressed by market participants during Oxera interviews about the potential outcome of a hypothetical business expansion by an audit firm.

7.4.8 Sensitivity tests

The results presented above were sensitivity tested with respect to two critical assumptions:

– **return of initial equity capital to existing partners at the end of the investment period**: the results presented in Table 7.6 assume that, upon retirement (ie, at the end of their investment horizon), partners receive the book value of the equity capital they have invested in the business. This depends on whether their initial investment is recognised as equity invested in the business. Under the alternative assumption presented in Table 7.7 below, partners do not receive their initial investment back upon retirement;

– **investment horizon for existing partners (years to retirement)**: under the base-case scenario, it was assumed that partners remain with the firm for 20 years. Under the alternative scenario, partners' investment horizon is extended to 30 years. This assumption is important since it affects the total cash flows that accrue to partners and the present value of their original capital investment (if and when it is returned).

The results of the sensitivity analysis are presented in Table 7.7. Note that these results refer to employee ownership.

Table 7.7 Sensitivity tests

Employee ownership	Step 1	Step 2	Step 3
Capital is not returned			
IRR (upside scenario)	6.2%	19.6%	14.6%
IRR (base case)	–14.1%	6.6%	–3.4%
Investment period is extended			
IRR (upside scenario)	10.4%	20.7%	16.6%
IRR (base case)	–0.1%	9.8%	3.7%

Source: Oxera's calculations based on interviews with audit firms.

As expected, the expected profitability of partners' investment in the expansion (the expected rate of return) diminishes significantly if partners do not receive their original equity capital back at the end of the investment period (ie, upon retirement).

The critical observation in this context is that partners cannot realise the market value of their ownership rights whereas outside investors can, as the outside equity is assumed to be liquid.

If the period over which partners can recover their initial investment is assumed to be longer—ie, 30 instead of 20 years—the expected returns to partners increase. This is because extra cash flows accruing to partners over the period of the additional ten years (from year 20 to year 30) are worth more in NPV terms than the loss from the delayed return of their initial capital.

The critical observation in this context is that as partners become more like equity investors (ie, as their investment horizon increases and the value of their initial equity contribution diminishes), they can realise a higher market value from their initial investment.

7.5 New entry

The analysis set out above concerns the move by an existing mid-tier firm into the market for larger audits, by expanding its existing capability. Critical to that analysis is the amount of economic investment required to enable the firm to compete effectively in the new market, and estimates based on the experience of mid-tier firms have been used to dimension the model. However, in theory it would be possible for a new audit firm to be established from scratch, by bringing together the required resources and launching into the market. Such a new entry would, in theory, be possible under either partnership-type ownership or outside investor ownership.

A detailed analysis of the economics of entry under these circumstances is beyond the scope of this report. However, a number of factors make partnership-type ownership more likely to be problematic than the expansion of a mid-tier firm. These include:

– the need to have multiple clients so that no one client represents a significant proportion of the firm's total income, as is required by the independence rules applying to auditors. It would not really be possible to start with a small client base;

– to create such an entity, pre-qualified and highly experienced partners (or equivalents) would be required from the start. However, from the clients' perspective, the reputational effect of the existing firms appears to reside more with the firm than with the individual audit partners. Partner rotation, which is encouraged (or may be a regulatory requirement), is likely to reinforce this location of reputation with the firm, not individual partners. Hence, partners setting up the new firm may find it difficult to take any existing large public audit clients with them.

Under outside ownership it would be possible for the new entity to operate under the umbrella of an existing corporate structure. That structure might have the ability to transfer its own (corporate) reputation to its new audit activities. If it could, such reputational borrowing could make it easier for the new audit entity to persuade potential clients that giving them the audit contract is low risk, notwithstanding that the entity has no track record in audits (including large public interest audits).

The borrowing of reputation in this way could be more advantageous, compared with a mid-tier audit firm, if prospective clients thought that the reputation of the entity in another field is more applicable than that of a mid-tier firm in carrying out smaller audits. Given the dynamics of auditor choice, for such a reputational spillover effect to work, it would have to operate at the level of the major stakeholders in choosing the audit firm—the audit committee and chairman, CFO of the company, investors in that company, etc. This suggests that such an entity would need to be very highly regarded, with a particular reputation for independence, and a track record in successfully entering new markets. It would also be necessary for such an entity not to have any significant conflicts of interest with the activity of the supply of public interest audits.

It might also be possible to relax the requirement with respect to the maximum size of an individual client as a proportion of total fees if the audit activity is a small part of a very large company. The underlying logic being that the entity would not risk its corporate reputation as a result of pressure from a dominant client within the audit function. For this to apply, it would be necessary for any reputational damage caused by lack of independence in the audit to spill over into the rest of the business. Under these circumstances, such an audit firm could start small (ie, with very few clients).

However, given the risks attached to the performance of public interest audits, there must be some doubt about whether an entity with the right reputational profile would be willing to enter the large public interest audit market, as the potential downside could easily exceed the total value of the audit function.

Under outside ownership, new entry could also take place as a hybrid between the expansion of a mid-tier firm and the creation of a new audit entity—for example, by a company with the right kind of reputation taking over ownership of an existing mid-tier firm. The reputation of both entities could then be combined, which should make it easier for the mid-tier firm to be more successful (and reduce its investment requirements) in entering the large public audit market.

Apart from just allowing external capital to fund the investment needed for expansion, the possibility of outside ownership also creates a number of additional ways in which the transition to competing effectively for larger public interest audits could be achieved. Some of these are likely to reduce the amount of investment required to make the transition. Exactly how significant this would be is beyond the scope of this report, but it seems fairly clear that these innovative approaches could help.

8 Conclusions and policy options

8.1 Concerns about market structure

There are a number of reasons why stakeholders are concerned about the current market structure for the supply of audit services to public interest corporations. These include issues relating to the level of effective choice for companies when tendering their audit contracts and the possible impact of the market structure on the underlying price and quality of the audit product to the extent that these two factors might be influenced by the level of competition in the market. There are also significant levels of concern about the impact of the possibility of a failure of one of the Big Four on both regulation and the capital markets.

In this context, Article 29 of the Audit Directive explicitly highlights the importance of public oversight bodies in ensuring quality and monitoring the prices of audit services. The importance of the role of public oversight bodies in monitoring the audit market is also confirmed by the results of the Oxera survey of European companies, as outlined in section 4. However, pubic oversight bodies are unlikely to have a fundamental impact on the level of effective choice for companies tendering for audit services.

As a result there is some general agreement that, if possible, action should be taken that would change the current market structure such that there would be additional suppliers of audit services to the largest public interest corporations (and other entities requiring audits). The overarching objective might be to create opportunities for new as well as medium-sized, existing audit firms to enter the market for audit services to public corporations and large private enterprises. However, how this might be achieved is not generally agreed.

8.1.1 Ownership and the cost of capital

The focus of this report is on audit firms' ownership rules, and their access to, and cost of, capital. Particular emphasis is placed on examining whether the existing common employee control and ownership structures generally adopted, and the rules controlling those ownership and management structures, have a significant impact on the ability of the market to deliver a more open market structure, or market dynamics, that would reduce some or all of the concerns expressed about the current market structure.

In this context, access to, and the cost of, capital are important if one of the factors that is constraining additional firms' ability to supply audits to larger public interests companies and other large entities is the need to make economic investments in order to become a potential supplier in this market segment. In this context, the necessary investment may include the acquisition and development of certain tangible and intangible assets, as well as other expenditure (such as training and development of human capital).

In general, the higher the cost of capital, or the greater the capital rationing (ie, the inability to raise additional capital) facing the firm, the fewer the investment opportunities that are economic for the firm to pursue.[235] As a result, where the economic investments are required for a firm to enter the market for audits of larger companies, all other things being equal, the more constrained the access to capital, the higher the hurdle rate for the companies to

[235] In perfect markets, the cost of raising capital should be dependent exclusively on the nature of the assets, including embedded risks. In other words, if the cost of capital and therefore access to funding is specific to the investment opportunities, it would not be possible to change the cost of capital for a given set of investment opportunities. However, as highlighted in section 6, the rules and regulations governing the market, together with the means of accessing capital, might have an impact on the availability and the cost of capital, including human capital.

undertake a profitable business expansion. Thus, new market entry might be depressed by the constrained ability to make such investments, all other things being equal.

Factors contributing to the cost of funding

The analysis set out in sections 6 and 7 demonstrates that the current ownership structures, which have been adopted by audit firms for a variety of reasons, are likely to increase the cost of capital that audit firms face. In particular, the firm-specific costs of capital under the current ownership structures are likely to be above the levels that would be expected to prevail in efficient capital markets.

Factors that contribute to this higher cost of capital include:

– the restricted set of capital-constrained investors, whose time horizon for the required payback from the economic investment differs from that required by investors in capital markets, thereby creating an asset–liability mismatch. Within the same firm, the above-mentioned time horizons are likely to vary from the very short (2–3 years) to the medium term (10–15 years or more);

– investment in the firm is likely to carry a significant idiosyncratic risk that cannot be optimally diversified by the current investors (insiders). For investments to be attractive, these investors may need to be compensated by returns that are, at least on average, higher than would be required from optimally diversified investors.

For these and other reasons specified in the report (including liquidity of ownership stakes), there is evidence that if those who can currently make investments in audit firms are economically rational, they will, on average, require a higher return than that which might be available to the firm under alternative ownership structures—for example, under unrestricted access to capital markets.

Those who can currently invest in, and control, audit firms may require returns that are considerably in excess of those that would be required by diversified investors in capital markets more generally, as their payoffs would be truncated in time without the ability to realise the full residual value of their investment. Partners or shareholders who are about to retire, and where the market value of their stake in the firm upon retirement cannot be fully realised, will be in this position.

If these potential investors have the ability to veto any investments that are not of a direct benefit to them, the relevant internal hurdle rates (ie, the expected level of return required to achieve agreement to make the investments in the first place) may be significantly higher than those that would be available under alternative corporate structures.

As a result, there is a clear possibility that the current ownership structures lead to a higher cost of capital for firms. This, in turn, makes it less likely that market entry opportunities requiring economic investments will be taken up, all other things being equal.

However, notwithstanding European audit firms' ownership structures being consistent with, and constrained by, the current ownership and management rules, it does not necessarily follow that these rules are binding, even though the adopted structures result in higher costs of capital. There is some evidence that, for activities requiring significant investment in human capital and intangible assets, ownership by those with the human capital assets may be more beneficial than ownership by outside investors. In other words, the choice of the forms of financing might not be independent of the investment opportunities and the nature of the business per se, if, for example, the ability to obtain human capital is dependent on adopting certain forms of financing.

If this is the case, the reform or the replacement of the current ownership and/or management rules by another system might not result in a significant change in ownership structures of audit providers, at least in the short term. It would, however, create the possibility that alternative structures could be designed that combine the advantages of partnerships and similar structures with the lower cost of capital of outside and diversified investors. In other words, the opportunity could be created for firms to explore alternative structures and choose the optimal one. By contrast, under the current rules, the firms, and potential investors, are restricted in their ability to choose the optimal corporate structure and the preferred financing structure.

In the long term, firms might be able to adapt their business structures in order to take advantage of lower costs of capital available from capital markets. Under the current rules, they do not face direct opportunities to explore such possibilities.

Therefore, the ability and/or incentives to raise capital from different sources (and, potentially, at lower cost) might create additional opportunities for economic investments. However, the type and nature of the investments required for existing audit firms to enter the large public interest audit market may be such that these investment opportunities are not economic, whichever funding method is used. In such a case, enabling firms to adopt ownership structures that give them access to capital at a lower cost may not by itself be sufficient to enable new entry. At the same time, by giving firms access to cheaper capital and enabling investors to invest in and control audit firms, market entry is likely to be facilitated.

With respect to the costs of operations, the restrictions on ownership structures are either neutral (ie, they do not bind the firms), or they increase costs, particularly the costs of expanding into new markets. In the absence of additional benefits flowing from these restrictions, the option of removing the ownership restrictions (while possibly replacing them with other safeguards on independence as part of a broader reform) would appear to have limited downside and at least some potential upside.

The above considerations should also be viewed in light of the potential path dependence associated with audit firms' current choice of ownership structures and funding methods. Given the long tradition of independent ownership of audit firms and the existing rules, there may not be sufficient incentive for the firms to consider changing their ownership structures.

8.2 Relative importance of auditor independence

8.2.1 Legal rules and stakeholder views on independence

The main rationale for ownership and management restrictions appears to be related to their impact on the independence of auditors from outside and potentially negative influences, including conflicts of interest that might affect individual audit decisions.

If the investor could not be reasonably certain that the auditor's verification of the company's financial performance was being undertaken in an objective and impartial manner, most, if not all, the benefits of the auditor's monitoring function for investors would be lost. In other words, the verification must be seen to be independent of any undue influence from the management of the company whose performance is under scrutiny, or from other stakeholders.

It has therefore long been acknowledged that the independence of the auditor is essential for the efficient functioning of capital markets. In particular, it has been recognised that, under some circumstances, auditors can face conflicts of interest that might affect their ability to maintain independence. One of the mechanisms used to ensure independence have been the specific controls on the ownership and management structures of audit firms. In most Member States (although not all), these have been regulated for a long time at the national level. More recently, minimum requirements on ownership and management have been set at the EU level.

Rules on ownership and management of audit firms

There is now considerable uniformity with respect to the specific rules on ownership and composition of the management board of audit firms across Member States (and in other jurisdictions). All EU countries require a majority of voting rights in audit firms to be held by qualified auditors, as set out by the European Commission's Eighth Directive. This Directive from 1984 was amended in 2006, and several Member States are in the process of transposing its requirements into national law, or have yet to do so. Some have interpreted these specifications more strictly than others by requiring 75% or more of the owners of audit firms to be qualified auditors. These countries include Cyprus, France, Greece, Portugal and Sweden, with Greece in particular not allowing any outside ownership at all. The reasons for the adoption of such a strict requirement appear to be largely historical.

Likewise, the requirement for a majority of members of an audit firm's management board to be suitably qualified has also been adopted by all Member States. However, certain countries have adopted a stricter regime. Again, the reasons often appear to be historical, as in the case of Germany, where the requirements for management board composition were established in 1961 at the same time as those for ownership.

With regard to legal form, it appears that all Member States, with the exception of Ireland, allow audit firms to adopt any one of a wide variety of corporate forms, including public and private limited companies, as well as various forms of partnership (with unlimited liability for all partners, as well as limited liability for some and unlimited liability for others). In recent years, a number of countries, including the UK and Germany, have introduced a new corporate form—the limited liability partnership—in which all partners of the firm have limited liability.

Perceptions and opinions concerning independence of audit firms

Notwithstanding the link that has historically been cited between ownership requirements and restrictions on management structures, the Oxera survey of stakeholders in the audit market indicates that there is little consensus on exactly what drives auditors' independence and quality; nor is there much agreement on the importance of the ownership and management restrictions for ensuring the auditor's independence.

The survey highlighted that, for the companies surveyed, concentration and choice are key concerns, but that, importantly, there is only limited, if any, willingness to sacrifice any degree of auditor independence or audit quality in order to improve choice. Stakeholders in the audit market appear to agree that the relaxation of ownership and management rules could positively affect choice of audit firm and the level of fees. However, they are also concerned that this might be accompanied by a detrimental impact on independence and audit quality. At the same time, the existence of a public oversight board and other regulations addressing conflicts of interest were viewed as ways to mitigate these perceived negative effects. These conclusions appear to be shared by companies across EU Member States rather than being country-specific (see section 4 for details).

Stakeholders in the audit market appear to believe that partnerships and other employee ownership structures have a positive impact on independence and audit quality. With regard to the management board, it was also felt that the majority of the board should be made up of qualified auditors (as is currently required).

However, the results of the survey also indicate that the specific legal and corporate form that an audit firm has actually adopted (within the range of currently legally options) has no bearing on the process of selecting an audit firm. This suggests that, at this level, stakeholders are not particularly concerned with the adopted corporate form per se.

Furthermore, Oxera's interviews indicated that the importance of the independence of the ownership of audit firms—ie, audit firms being independent of other corporate entities—for auditor independence in general is perceived differently from country to country. For example, it appears that independence of ownership is considered more important in France and Germany for ensuring independence of audit decisions than in the UK or Spain.

Transparency and informational asymmetry

Finally, outsiders' understanding of the functional linkages between independence of ownership and management, on the one hand, and that of individual audit decisions, on the other, appears limited. That is, neither investors nor audited companies have a clear understanding of audit firms' internal decision-making processes and governance structures. This includes the internal processes that ensure independence and quality of individual audit decisions, as well as transparency of international networks and the functions of the international umbrella organisations in management and quality control.

This conclusion is confirmed by academic research, which describes the audit market as characterised by high levels of information asymmetry between the different stakeholders. This implies that greater transparency of audit firms, as required by the Article 40 of the Eight Directive, is likely to make an important contribution to the perception of independence of audit services in general. An important conclusion from the academic literature in this context is that partnership-like ownership structures become less important with limited information asymmetry, as discussed in section 5.

8.2.2 Potential implications of alternative ownership structures for independence

As explained above, the general perception among stakeholders is that the current ownership restrictions and management control requirements have a positive influence on independence. At the same time, the review of the decision-making process in audit firms indicates that alternative ownership and management structures, where the control over the audit firms is with external investors (non-auditors), are unlikely to significantly impair auditor independence—particularly if there other safeguards of the independence of individual audit decisions are in place, including the requirement for transparency in the audit control reports.

This is the result of two factors.

– The size and organisation of the larger audit firms (including the mid-tier firms) means that there is organisational separation of individual audit decisions from business decisions. There appears to be limited scope for potential influence of senior management on the outcomes of individual audit assignments (even if market strategy, including client acquisition and retention, is clearly influenced).

– It is unclear why, in the long term, the commercial interests of external investors would fundamentally differ from those of audit partners. In other words, external investors would face similar incentives to preserve quality and independence of individual audit assignments, especially to the extent that such decisions are independently verifiable ex post (ie, they might have financial, legal, or commercial consequences for the firm as a whole).

Opening up ownership and control to non-auditors creates the potential for additional specific conflicts of interest to arise in this context—for example, where the audit firm supplies an audit to a company owned by the same parent company. However, there appears to be no a priori reason why these could not be dealt with through specific controls on such conflicts—ie, through specific additional safeguards, rather than via general restrictions on the ownership and management of audit firms. In turn, this might mean that, for practical reasons, some types of owner would be effectively ruled out.

Identifying the mechanism that delivers any specific advantage (in terms of the incentive to produce independent audits) of limiting ownership and control to qualified auditors has been difficult. The lack of any significant market that approximates an EU national market (in terms of oversight, development of the capital market, etc) without ownership and control restrictions means that there is also no empirical evidence within auditing of the impact on audit independence and quality that might result from relaxing ownership and control restrictions. It also means that few, if any, of the stakeholders have experience of an audit market without the existing type of ownership and management controls.

In comparable sectors where there has been some analysis of the link between similar ownership restrictions/structures and independence (eg, the legal sector), the general conclusion is that these restrictions are not particularly effective, and the trend has been to remove them.

At the same time, Oxera interviews identified some concern among audit firms that their clients are likely to perceive independence of ownership as a factor influencing the independence of audit decisions. Indeed, some audit firms take the view that ownership restrictions do help them maintain independence of the audit product. Therefore, any potential reform of the current rules and regulations would have to address explicitly the perception of the importance of independent ownership and management on the independence of audit decisions on both the demand and the supply sides of the market—ie, among audited firms and/or investors, as well as among auditors themselves.

8.3 Interaction of ownership and access to capital

As discussed in section 6, the existing restrictions on ownership and control are likely to be increasing the effective cost of capital of the audit firm. At the same time, the resulting ownership and control structures are generally considered by stakeholders to improve independence, although the actual mechanisms that achieve this improvement are not entirely clear, at least for the larger audit firms. Direct and indirect customers of the audit also appear to have limited appetite to trade off an improved market dynamic if this results in any reduction in audit quality or independence.

The analysis of the reasons why the cost of capital increases under the current ownership structures, which are compatible with the existing ownership and management rules, also suggests that a lower cost of capital might only become available if the general ownership restrictions were removed completely such that audit firms could, for example, be majority-owned by highly diversified shareholders, and where the ownership resided in reasonably liquid shares. Although partial relaxation of these restrictions (eg, requiring a minimum of less than 50% of shares to be owned by qualified auditors, or simply adding a few more categories of approved owners, such as qualified accountants) might help to create some additional investment opportunities, it is unlikely to have a significant impact on ownership structures. As such, it is unlikely to create a meaningful opportunity for the audit firms to access capital more easily or at a lower cost.

As a result, if the audit market is to be offered the potential of a lower cost of capital and an increase in the probability of new entry, radical, rather than incremental, changes in the ownership rules are likely to be required. From a policy perspective, the critical piece of information is therefore whether suppliers of audits owned under more typical corporate structures, which include access to public capital markets, would deliver audits that were at least as independent and of the same high quality as are currently delivered by the existing, large audit firms.

If the other existing controls on audit quality and independence (eg, public oversight, or the potential financial, commercial and legal consequences of biased audit opinions) are what currently bind audit suppliers, the relaxation of the ownership rules could occur without compromising independence and quality. In particular, this would be the case if additional controls could be introduced that directly address quality and independence to compensate for the potential loss of the existing positive impact of the current ownership rules, or for the perception that such loss might occur.

This research has highlighted some important observations that might be helpful in answering this question more definitively, including the following:

– there is a general perception that ownership and management controls have, or had, a positive impact on independence and quality;

– at the same time, there is a lack of understanding of the internal management structures and decision-making processes within audit firms, and hence a lack of understanding of the linkages between independence of ownership and independence of individual audit decisions;

– there is a lack of agreement on whether other controls on independence and quality have fully displaced any of the benefits of ownership controls that may have existed, although the imposition of additional quality and independence controls is clearly welcome;

– there is a lack of agreement on exactly how these restrictions affect independence and quality, especially for larger audit firms;

– there is a lack of information on the detailed causality in terms of economic incentives that arise from these controls. In related sectors where research has been conducted, the relationship between ownership restrictions and independence has been shown to be weak.

Assuming that either the actual impact on independence and quality of the existing restrictions is low, or that alternative measure are available that would compensate for any change in ownership and management structures, firms could be presented with the possibility of access to cheaper capital and greater incentives to invest. However, the impact of this move on market structure would still depend on whether improved access to capital is sufficient to change the current market dynamics. Nevertheless, as noted above, it would clearly create an opportunity and the incentive for firms to explore alternative market structures.

8.4 Improved access to capital as an investment opportunity

The analysis presented in this report indicates that there are several reasons why the adopted ownership structures would be expected to increase the cost of raising capital. In that respect, the ownership structures might therefore constitute a barrier to expansion for at least some audit firms, whereas improved access to capital with fewer restrictions on corporate structure might constitute an opportunity for investment and expansion.

– Mid-level managers or members are likely to require remuneration for exposure to the idiosyncratic risk of the audit firm, particularly as these employees often risk their own financial capital through their stake in the firm, which cannot be easily transferred to other parties.

– These firms are structured such that capital tends to be raised at the national, rather than the global, level. Thus, audit firms' cost of capital may be higher than that of an equivalent-sized multinational company, implying that the commonly adopted ownership and management structures appear to create some barriers to access to capital, as well as increasing the required rates of return on the financial capital available to the firm.

– Since outside investors are not currently permitted to own more than 49% (and sometimes less) of the audit firm, this may increase the hurdle rate required by investors.

– By inhibiting the influence of outside investors on key managerial decisions, the current management restrictions may lead to an increase in audit firms' cost of capital.

This suggests that, in the context of potential market entry, there is evidence to support the conclusion that the ownership rules represent one of a number of barriers to expansion into the market for larger audits.

8.4.1 Access to capital and other barriers to entry

In general, Oxera interviews revealed that financial capital is often of limited use for the majority of audit firms, particularly given that most firms have some degree of balance-sheet buffer to access additional funding, if only on a limited scale or in the short to medium term. In particular, access to capital might be critical only for those firms seeking to expand into the market for larger audits.

This suggests that the specific barriers to raising capital created by the ownership rules may refer to types of capital that might be of secondary importance to audit firms, if they cannot be used to fund human capital. This is especially relevant given that human capital might be seen as a key value driver for audit firms.

Nevertheless, the current methods of securing the necessary human capital might be driven by the legacy of corporate structures within the industry and limited efforts made to explore alternative structures. This could be explained by current restrictions, which mean that the actual choice of corporate structure is not actually available to the firms.

The analysis in this report indicates that other barriers to entry might be also important, such as reputation, the need for international coverage, international management structures, and liability risk. This implies that the economic impact of the ownership rules on access to capital needs to be considered in conjunction with these other potential barriers. In addition to the ownership structures (and hence the ownership rules), a number of factors have been identified that are likely to affect access to capital. Examples include global structures and networks of audit firms, or the nature of firms' assets and liability risk.

Liability and access to capital

The impact of liability risk on the cost of capital could also be significant, and might lead to capital rationing to the extent that outside capital is unwilling to take on this risk. This could imply that potential expansion plans or other business projects within the industry, which might be NPV-positive, are prevented from being undertaken. To the extent that large audits are associated with substantially greater liability, potential entrants might be deterred.

Although insiders are also likely to be deterred from investment in expansion due to liability risk, they are likely to have a better understanding of their ability to manage liability exposure. Therefore, liability risk might constitute a specific barrier to raising external financing.

In general, industries characterised by a significant degree of asymmetric information and/or a small probability of a significant negative shock, which cannot easily be assessed by outside investors (eg, catastrophic shock due to a single, but very large liability claim), might face challenges to raise external funding. In particular, there is some evidence that economic agents attach a disproportionally high negative value to very large negative outcomes characterised by very small probability of occurrence. Although examples of large-scale liability risk exposure that is business-specific are not commonplace, the nuclear industry offers one potential example of the critical role of liability risk management for access to funding and willingness of investors to commit new capital.

Oxera's research suggests that liability exposure cannot typically be addressed with capital. This is because it is likely to be more expensive for audit firms to use their capital as a buffer against liability risk than to pool idiosyncratic risks through the insurance market. The importance of sharing the liability risk across jurisdictions through captive insurance firms (while limiting cross-border liability exposure via independent national practices) appears to be an important driver of the currently adopted international structures of audit firms. In that respect, existing players in the market for large audits are likely to have an advantage over potential new entrants in terms of pooling risks through captives (given the number of national firms contributing to the pool).

8.4.2 Expansion of mid-tier firms into the market for larger audits

One of the reasons why the current mid-tier audit firms do not expand their operations to include audits of companies significantly larger than their current client base is that, in order to do so, they would need to incur significant additional expenditure in the short term, the benefits of which would only be reaped after some time; moreover, the extent of these benefits is uncertain.

Although the additional expenditure required may not always be classed as investment for accounting purposes (eg, it could be reflected in additional operating costs to build up intangible assets), from an economic perspective it would be an investment by partners (or equivalent), in that it would depress the value of their share of the profits in the short run, while delivering a higher value in the longer term.

Based on information supplied by audit firms, Oxera has analysed a hypothetical investment model to explore the dynamics of the potential expansion of a mid-tier audit firm into the market for considerably larger audits in a single jurisdiction. This analysis focuses on the implications of different forms of ownership for the economics of expansion.

The analysis of the expansion of an employee-owned firm into the market for large enterprise audits under generic market conditions indicates that such an investment might not be profitable, controlling for the likelihood of the commercial success of such an expansion. For an employee-owned firm, none of the individual, incremental business steps necessary for expansion, as modelled by Oxera, generates a rate of return that could be considered sufficient for the initial investment to be undertaken (ie, sufficient to cover a plausible level of the required rate of return). In other words, in none of the steps is a sufficient rate of return generated over the time period for the partners who make the investment to be likely to reap the benefits of that investment.

More generally, under the assumption that existing partners cannot realise the market value of their investment on retirement, the results indicate that audit firms with partnership-like ownership structures are unlikely to undertake the required initial investment for this type of expansion. This is consistent with market evidence. One of the main reasons for this is that the returns on any investment would tend to be made after many of the partners have already retired. Unless they are compensated for their reduced earnings, the benefits of their investment will accrue to new partners who have not made that investment. However, the above conclusion is conditional on whether the existing partners are able to recover the initial investment.

The general dynamics of the modelled expansion strategy are such that, while under employee ownership, senior managers (partners) are required to provide capital and assume exposure to the business risk. Under investor ownership, they are compensated with a fixed wage. As a result, investor-based ownership might facilitate the decision to expand for a number of reasons.

External investors derive additional value from a longer investment horizon, while the investment by the employees (partners or members) is associated with returns that are likely to be capped due to a shorter investment horizon. The difference is the present value of the terminal value of the investment.

However, even when the external investor can take a longer-term view of the investment required to gain the initial foothold in the market for larger audits, the IRR is very low, and would not cover the cost of capital of a normal investor. Once a foothold in the market for larger audits is established, the economic outlook of expanding the output at this level (ie, getting more clients at this size) improves for both the partnership expansion and the outside investor funding the expansion. The further step of increasing the size of the audits undertaken is more economic and produces a higher positive return in both the partnership and the outside investor models.

Under the employee-owned structure, the model assumes that the initial investment is shared across new and existing partners. Implicitly, partners spread the risk among the existing and new partners since new partners are required to commit capital ex ante. This results in the success scenario for the initial steps of the expansion being more attractive under employee ownership, which means that the risk sharing present under employee ownership might create benefits if investments can be expected to be highly profitable and relatively certain, as in the success scenario.

In all three steps under the base case scenario the investment is more attractive for the outside investor because they can adopt a longer time horizon than the average of the partners. If, in addition, the required return of an outside investor is lower than that of the partners, there will be additional investments that would be made by an outside investor that would not be made by partners, even if partners nearing retirement are compensated for their initial investment through a return of their initial capital.

Although the assumptions made in the model about the required level of investment and the level of subsequent returns drive these results, the general conclusion holds, even if these assumptions are varied. The results of this analysis therefore indicate that the form of ownership might have an impact on the decision to invest, provided that human capital can be retained under the alternative ownership structures with external investors.

8.5 Drivers of ownership and governance structures adopted by audit firms

The economic analysis presented in this report has also examined why there has been a tendency for audit firms to be established as employee-owned firms, with ownership more or less evenly distributed among senior managers, akin to a partnership. In particular, it has examined whether factors other than the ownership rules might affect the choice of the ownership and management structures adopted by audit firms. This is important because if drivers other than the regulations significantly affect the choice of ownership and managed structures, any potential reforms might have a limited impact on audit firms' choices.

In general, it is difficult to obtain publicly available information on the legal forms adopted by auditors, their ownership structures and internal governance. This makes it challenging for both investors and corporate clients of audit firms to gain an accurate appreciation of how audit firms are structured in practice. This difficulty has been recognised—Article 40 of the amended Eighth Directive now requires audit firms to produce a transparency report describing legal form, ownership, network membership and effectiveness of internal quality control procedures.

The partnership-like form of ownership is typically associated with businesses such as audit where human capital is critical and where the value-added per mid-level manager or member is additive, and can be relatively clearly delineated.

Distribution of ownership and risk sharing among mid-level managers might be particularly important in businesses where the value creation process has a structure that is more horizontal than vertical. That is, where each of the final, idiosyncratic products or services can be clearly associated with the contribution of an individual in charge of one of many teams working in parallel, in contrast to businesses where all teams contribute to a single product (as in the case of an industrial product line, for example). This is particularly the case for firms offering services that are human capital-intensive, such as audit firms, law firms, consulting firms, or investment banks, with highly diversified products.

Moreover, as these firms largely rely on employees' skills that can only be acquired through on-the-job contact (ie, tacit skills), this provides a rationale for audit firms (as well as law firms) to adopt this particular form of corporate structure. Among the types of business mentioned above, investment banks have traditionally used this ownership form, but have largely moved towards the public corporate form. This could be associated with the need for financial capital to fund technological developments, and capital required to support business operations.

Critically, the analysis presented in this report suggests that there are important reasons to believe that the adopted ownership and management structures are driven by business considerations, and are not necessarily closely related to the ownership rules faced by audit firms across Member States.

The review of evidence suggests that employee ownership provides important benefits to audit firms. These perceived benefits are largely driven by the efficient management of human capital that is possible under employee ownership, and by the signals that employee ownership sends to the market regarding the high quality of the audit service.

However, recent developments in the audit market (eg, the potential for increasing outsourcing of certain elements of the audit service value chain—see section 5.4.1) indicate that, looking forward, the importance of human capital for audit services might be diminishing to some extent. In particular, to the extent that audit services are becoming more rules-based and more homogeneous, the benefits of employee ownership might become less important. At the same time, these considerations might apply primarily at the level below the audit partner, and would therefore not necessarily affect the ownership structure.

Overall, human capital represents a significant share of the overall capital of audit firms, and, unlike in the case of other industries, this is unlikely to change in the short run. Nevertheless, financially, the difference between compensating human capital by providing profit shares (employee ownership) and compensating it as a cost in the form of a salary (investor ownership) is small. For this reason, the employee ownership currently observed among audit firms might be driven by legacy, and it may be possible to manage human capital as efficiently in an investor-owned structure with appropriate incentives and alternative allocations of financial and business risks away from auditor partners.

If there are good reasons for audit firms to continue to use partner and partner-like ownership structures, where the ownership is more or less uniformly divided among senior managers, the removal of the ownership restrictions could still result in a change in the composition of the owners. This change could be based on a transfer of ownership and control from a majority of qualified auditors to a more heterogeneous mixture of partners, reflecting the skills required to run the firm in totality, rather than limiting the owners to a sub-set of that group.

8.6 Implications for the broader policy debate on ownership rules and audit market concentration

The research undertaken by Oxera for this report suggests that there is a critical policy trade-off that needs to be examined further before a robust policy conclusion can be reached on the optimal rules on ownership.

If the rules on ownership have no significant impact on the independence and quality of audit services (in particular, where alternative safeguard measures and mechanisms are in place, such as public oversight or financial as well as broader commercial incentives), there would be little or no downside from a significant relaxation of the rules that might enhance funding opportunities by stimulating consideration of alternative corporate structures.

Given the nature of the investments required for mid-tier firms to expand significantly the size of the audits they perform, access to such cheaper and longer-term capital would, all other things being equal, improve the economics of the potential investment and expansion.

However, if the impact of the current ownership structures is to significantly improve audit independence and quality, there appears to be little appetite from users of audits to remove these controls, even if this were to have some potential, positive impact on market dynamics in the longer term.

The lack of appetite to trade off independence and quality is important to the extent that there is evidence that, under the current market conditions, improved access to cheaper, longer-term capital might not in itself have a particularly rapid impact on market dynamics (even if it did represent a positive development and improve investment opportunities). In other words, it might be expected to create an opportunity for investment rather then ensure entry. This is because:

– for a relatively rapid expansion in the size of audits undertaken, the required investments may not cover the required rate of return, even with improved access to funding;

– there are reasons other than the cost of capital that may make employee-owned structures more efficient than investor-owned structures (at least at present); thus, firms may be unable or unwilling to tap into cheaper capital, even if it were a legal possibility.

Since the first point suggests that there are barriers to entry other than the differential in the cost of capital between employee- and investor-owned audit suppliers, a significant policy consideration is whether there are policies that could reduce these other barriers directly. In particular, the analysis has identified a number of areas for potential policy intervention that should be considered in parallel with the potential change in ownership rules as a means of improving access to capital:

– actions that would reduce the absolute investment costs incurred by audit firms in addressing the market for larger audits; these include the costs of acquiring the requisite reputation and the costs of creating and maintaining strong international networks;

– the provision of independent information on the actual quality and independence of audits currently supplied by existing firms (which should help in terms of reputation building);

– coordination of audit and regulatory requirements across Member States (which should reduce the costs of effective international networks);

– reform of the liability regimes so that the risks of liability do not unnecessarily affect the economics of audit firms, thereby enhancing entry and expansion into the market for audits of large companies.

The provision of independent information on the quality and independence of the audits produced would also result in better feedback to the market on the impact, if any, of changes in ownership structures, should these be permitted. Given the customers' requirements for independence and high quality, if the average standards of service were to fall as a result of changing ownership structures, the market might be expected to react by ensuring that, among different potential corporate and ownership structures, only those audit providers that continue to deliver independent and high-quality audits survive.

In this context, it is worth reiterating the importance of the transparency of audit firms. In particular, more transparency, which will be required under the Eight Company Law Directive, is likely to benefit both independence and access to capital. In that sense, improving the transparency of audit firms' corporate, management and ownership structures is not subject to the potential trade-off described above (see section 8.5 for further details of the transparency report required by the Eighth Directive).

The interaction of the independence and cost of capital issues also suggests that minor changes in the ownership rules, such as merely reducing the ownership stake that has to be held by auditors, are unlikely to be effective. Such a move would be unlikely to deliver access to cheaper capital for the types of investment needed to address larger audits.

If ownership rules are to be changed to allow access to a lower cost of capital, radical, rather than minor, changes are likely to be required, as explained above. Moreover, the effect of creating the opportunity for audit firms to access public capital markets, for example, is most likely to materialise in the longer term, as the industry explores and adapts to new potential corporate structures.

The relationship between the rules governing the composition of the management board, independence and access to capital is more tenuous. Similar to issues of ownership, the results from the survey indicate that audited entities consider management structure to be an important factor in ensuring auditor independence. Having a majority of qualified auditors on the management board is seen as helping to ensure the quality of the audit. However, the precise mechanism by which this be achieved (at least within the larger audit firms) is not clear-cut, and the audit firms themselves seem less convinced that the link between the management board structure and the independence (or quality) of the audit is strong.

Indeed, some arguments have been put forward that more non-auditors on the management board could improve the audit quality. On its own, changing the management board structure would not alter firms' access to capital. From this perspective, the composition of the management board would only become an issue after the ownership restrictions were relaxed and it became apparent that the current restrictions were somehow inhibiting the provision of capital by outside shareholders.

The indications from the research are that the role of the management board in ensuring the quality of the audit may be less than is perceived, and that other bodies within the audit firm's management structure, such as a technical committee, may be more important in ensuring audit quality and independence. Indeed, the role of the management board, within the overall governance structure of an audit firm, may be more similar to that of a corporation, whereby the board delegates to senior managers, such as the head of audit, the responsibility for day-to-day decision-making on matters such as audit quality.

APPENDICES

A1 Oxera legal template

A1.1 Prepared for the members of the TELFA network of law firms

The aim of this questionnaire is to identify current regulations on voting rights, ownership and the composition of management bodies as they apply to audit firms across Member States in the EU.

Information obtained from this will be the key element in enabling Oxera to undertake its analysis of the implications of these regulations in terms of their potential impact on the independence of auditors and market structure within which audit firms operate.

Please answer the questions, in English, as comprehensively as you can, giving full references to any specific legislation you mention.

Completed questionnaires should be returned to [TELFA contact details] by **Monday January 15th 2007**.

We thank you for your cooperation in this project.

Research template

Part 1—Requirements for companies to obtain audited accounts

1.1 Is audit defined in law, executive enactments or decisions? Please supply a copy/translation of the definition(s).

1.2 Is there a non-legal definition(s) of audit? (For example, has audit been defined by the professional body(s) representing accountants?) Please supply a translation of the definition(s).

1.3 Please describe the types of business/corporate entities that are required to have audited accounts. If there is more than one type of audit, please describe which entities require which type of audit.

Part 2—Auditors' duties and obligations

2.1 Please describe, and provide a reference for, any legal obligations[236] or duties that are automatically imposed on auditors with respect to their audit clients.

2.2 Please describe any legal obligations that are placed on auditors, when carrying out audits, with respect to any body other than the client (eg, shareholders, regulator or the government). Please reference the legal or other instrument that imposes this obligation.

2.3 Are any of these obligations or duties enforceable by actions for damages? If 'Yes', please describe which obligations this applies to and who can enforce this obligation through actions for damages.

2.5 If obligations are enforceable by actions for damages, does this happen in practice, and is the threat of such action credible? (If available, please indicate approximately how many such actions have taken place in the last 12 months, and the extent—in money terms—of the damages sought and awarded.)

2.6 Are the obligations or duties referred to in 2.1 and 2.2 enforceable in ways other than through actions for damages? If 'Yes', please describe how these obligations or duties can be enforced and who can take enforcement action.

2.7 Is it usual for the contract between the auditor and the client to contain clauses that seek to limit the capability of parties other than the client to take action for damages? If 'Yes', please describe what these contract conditions would usually contain.

2.9 Are any of the obligations or duties referred to in 2.1 and 2.2 specifically linked to the requirement for auditors to be independent of their clients? If 'Yes', please describe which obligations or duties are included in this category.

Part 3—Corporate governance and ownership rules of audit firms

3.1 Are there legally imposed minimum professional standards for those who are allowed to carry out audits? (If 'Yes', what are they? If 'No', are there de facto standards for auditors imposed by other means?)

3.2 Are there obligations that restrict the legal form of entities that can provide audit services—ie, restrictions on the legal form of audit firms)? (If 'Yes', please supply a description.)

[236] Legal obligation refers to a requirement that is contained in legislation, an order promulgated by the government, or an order or licence condition promulgated by a body that is itself set up by legislation, which is enforceable.

3.3 Are there legal rules and/or obligations that specify or restrict who can ***own*** audit firms? (If 'Yes', please supply a description.)

3.4 Are there legal rules and/or obligations that specify or restrict who can ***control*** audit firms? (If 'Yes', please supply a description.)

3.5 Are there legal rules and/or obligations that specify or restrict the membership and/or composition of the management body of audit firms? (If 'Yes', please supply a complete description.)

3.6 Are there any typical market practices determining ownership, control and management of audit firms, over and above any of the restrictions described in 3.2–3.5 above (eg, a partnership structure)? If 'Yes', please describe the typical practices.

3.7 Do the corporate forms[237] used by audit firms vary significantly by the type of audit services provided (eg, size, industrial sector of company being audited, and/or the participation in international markets of the audit clients)?

3.8 In addition to legal restrictions on corporate forms, ownership and control, audit firms may adopt firm-specific 'bylaws' or 'articles of association' concerning the corporate governance of a given firm. Do audit firms adopt such articles, and, if so, what do they typically contain?

3.9 Are any of the ownership, management and control restrictions that arise in 3.2–3.5 specifically linked to the requirement for auditors to be independent of their clients? If 'Yes', please describe which of the restrictions are included in this category.

3.10 Have any of the ownership, management and control restrictions described in 3.2–3.5 been introduced in the last 10 years? If 'Yes', please describe what rules were in place before this.

3.11 Please describe any rights and/or obligations (legal or otherwise) that partners or directors of audit firms have towards other partners or directors in the firm.

3.12 Please describe the general duties of directors of (i) public and (ii) private companies with respect to their shareholders.

Part 4—Auditor oversight

4.1 Does an organisation or public agency exist to oversee and/or regulate the activities of the auditing profession? If so, when was it established?

4.2 Under current regulations, who has the legal authority to appoint the directors of the oversight body?

4.3 Does the oversight body have the authority to set rules or standards for the audit process?

4.4 Does the oversight body currently have the authority to determine who is allowed to conduct statutory audits?

4.5 Does the oversight body have the power to impose sanctions on auditors who have breached the rules or standards?

[237] Corporate form refers to the form of incorporation, or the legal form under which the entity/firm operates.

A2 Oxera survey

A2.1 Survey template—companies

Introduction

This short survey is being conducted by Oxera as part of a European Commission research project to assess the impact of ownership rules on the structure of the European audit market and the independence of audit firms within this market.

For this survey *independence* is defined in terms of the auditor exercising objective and impartial judgement on all issues brought to their attention, and effectively communicating this to the users of the audit.

Background details

1) What position/job title do you hold within your company?

Importance of auditor independence

2) On a scale of 1 to 5, where 5 is essential and 1 is irrelevant, how do you rate the following factors when choosing an audit firm to carry out the statutory audit of your company?

   Factor: 1(irrelevant), 2, 3, 4, 5(essential), don't know

   – Technical accounting skill
   – Sector-specific expertise
   – International coverage
   – Audit firm has a good reputation for independence
   – Audit firm is one of the Big Four
   – Level of audit fee

3) Given the current state of the audit market in Europe and the development of new policy initiatives, how concerned are you about each of the following issues? Are you:

   Very concerned/Somewhat concerned/Not concerned/Don't know

   – Number of audit firms available to choose from
   – Level of audit fees
   – Quality of audits
   – Auditor independence

4) With respect to the independence of the audit firm, on a scale of 1 to 5 where 5 is essential and 1 is irrelevant, please rate the importance of each of the following factors in ensuring that an audit is independent.

   Factor: 1(irrelevant), 2, 3, 4, 5(essential), don't know

   – The auditors involved are suitably qualified
   – The audit partner has no financial interests in the audited company
   – The audit firm has no financial interest in the audited company
   – The audit partner has no other involvement with the audited company other than the supply of the audit and services directly related to the audit

– The audit firm has no commercial relationship with the audited company other than for audit (and audit-related) services
– The audit firm has no corporate linkages with the audited company
– The audit firm is majority owned by suitably qualified auditors
– The audit firm's management board consists of a majority of suitably qualified auditors
– Regular change of the audit firm (eg, every five years or so)
– Regular change of the audit partner within the same audit firm (eg, every five years or so)
– There is an independent public oversight body regulating the audit market
– The international structure of the audit firm is that of a single, integrated company, rather than a network of independent practices in different countries

Ownership rules for audit firms

1) Are you aware of any rules that restrict the level of outside ownership of audit firms in your country?

Yes/No/Don't know

2) If YES, do you think that these rules were put in place to ensure independence of the audit firm?

Yes/No/Don't know

3) If it were possible to increase the number of suitably qualified audit firms for your company to choose from, would you be willing to sacrifice any of the following to achieve this? On a scale of 1 to 5, where 1 is very willing and 5 is very unwilling.

Factor: 1(very willing), 2, 3, 4, 5(very unwilling), don't know

– Thoroughness and technical quality of the audit
– Restrictions on who can own audit firms
– Restrictions on who can manage audit firms
– Independence of the audit firm

Ownership structures and their impact

1) If ownership rules were relaxed, so that non-auditors were allowed to own the majority of voting rights in an audit firm, what impact do you think this would have on the following? Please highlight one response.

Number of audit firms available to choose from	*Positive/Negative/No impact/Don't know*
Auditor independence	*Positive/Negative/No impact/Don't know*
Audit quality	*Positive/Negative/No impact/Don't know*
Level of audit fees (fee increase is negative; fee decrease is positive)	*Positive/Negative/No impact/Don't know*

2) If ownership rules are relaxed so that non-auditors can own the majority of voting rights in an audit firm, to what extent would the existence of an independent public oversight body regulating the audit market help mitigate the potential negative impact of such a change on auditors' independence?

Independence is not affected by changing ownership rules/Fully mitigate/Partially mitigate/Not mitigate at all/Don't know

3) If ownership rules were relaxed, so that non-auditors were allowed to own the majority of voting rights in an audit firm, do you think that audit firms would come under increased pressure to sacrifice audit quality for commercial gain?

Yes/No/Don't know

Legal form and its impact

1) Would the legal form taken by an audit firm (partnership, limited liability company, other) influence you in your choice of auditor?

   Yes/No/Don't know

2) What legal form do you think provides the highest level of auditor independence? Please highlight one.

   – Partnership
   – Limited liability company
   – Other (please specify)
   – Don't know

3) What legal form do you think provides the highest level of audit quality? Please highlight one.

   – Partnership
   – Limited liability company
   – Other (please specify)
   – Don't know

Composition of the management body and its effects

1) Do you believe it is necessary for the majority of the members of the management of audit firms to be qualified auditors?

   Yes/No/Don't know

2) If YES, please indicate if you think that having the majority of members of the management body as auditors:

Makes the audit more independent	*Yes/No/Don't know*
Makes the audit partner more professional	*Yes/No/Don't know*
Means that quality takes preference over commercial pressures	*Yes/No/Don't know*
Any other factors (please add details)	

3) If YES to any of the above, what do you think the ideal proportion of auditors in the management body should be? Please highlight one response.

   – 51–60%
   – 61–75%
   – Above 75%

Other factors affecting the independence of auditors

1) What is the most important factor in the current market for audits that ensures that the statutory audit is independent? Please add details.

2) What is the most important change that could be made to make statutory audits more independent? Please add details.

A2.2 Survey template—investors

Introduction

This short survey is being undertaken by Oxera as part of a European Commission research project to assess the impact of ownership rules on the structure of the European audit market and the independence of audit firms in this market.

For this survey, *independence* is defined in terms of the auditor exercising objective and impartial judgement on all issues brought to their attention, and effectively communicating this to the users of the audit.

Background details

1) In which country is your company's head office?

2) What was the total value of your assets under management as most recently reported?

3) What position do you hold within your company?

Importance of auditor independence

1) On a scale of 1 to 5, where 5 is essential and 1 is irrelevant, how do you think companies rate the following factors when they select an audit firm to carry out their statutory audit?

   Factor: 1(irrelevant), 2, 3, 4, 5(essential), don't know

   – Technical accounting skill
   – Sector-specific expertise
   – International coverage
   – Audit firm has a good reputation for independence
   – Auditor is one of the Big Four
   – Level of audit fee

2) On a scale of 1 to 5, where 5 is essential and 1 is irrelevant, how important are the following factors in deciding whether to invest in a company?

   Factor: 1(irrelevant), 2, 3, 4, 5(essential), don't know

   – The company's auditor is one of the Big Four
   – The company's auditor has a good reputation for independence
   – The company's auditor has been with the company for at least two years

3) Given the current state of the audit market in Europe and the development of new policy initiatives, how concerned are you about each of the following policy issues? Are you:

   Very concerned/Somewhat concerned/Not concerned/Don't know

   – Number of firms available to choose from
   – Level of audit fees
   – Quality of audits
   – Auditor independence

4) With respect to the independence of the auditor, on a scale of 1 to 5, where 5 is essential and 1 is irrelevant, please rate the importance of each of the following factors in ensuring that an audit is independent.

Factor: 1(irrelevant), 2, 3, 4, 5(essential), don't know

- The auditors involved are suitably qualified
- The audit partner has no financial interests in the audited company
- The audit firm has no financial interests in the audited company
- The audit partner has no involvement with the audited company other than the supply of the audit and services directly related to the audit
- The audit firm has no commercial relationship with the audited company other than for audit (and audit-related) services
- The audit firm has no corporate linkages with the audited company
- The audit firm is majority-owned by suitably qualified auditors
- The audit firm's management board consists of a majority of suitably qualified auditors
- Regular change of the audit firm (eg, every five years or so)
- Regular change of the audit partner within the same audit firm (eg, every five years or so)
- There is an independent public oversight body regulating the audit market
- The international structure of the audit firm is that of a single, integrated company, rather than a network of independent practices in different countries

Ownership rules for audit firms

1) Are you aware of any rules which restrict the level of outside ownership of audit firms in your country?

   Yes/No/Don't know

2) If YES, do you think that these rules were put in place to ensure independence of the audit firms?

   Yes/No/Don't know

Ownership structures and their impact

1) If ownership rules were relaxed so that non-auditors were allowed to own the majority of voting rights in an audit firm, what impact do you think this would have on each of the following? Please highlight one response.

Number of audit firms available to choose from	*Positive/Negative/No impact/Don't know*
Auditor independence	*Positive/Negative/No impact/Don't know*
Audit quality	*Positive/Negative/No impact/Don't know*
Level of audit fees (fee increase is negative; fee decrease is positive)	*Positive/Negative/No impact/Don't know*

2) If ownership rules are relaxed so that non-auditors can own the majority of voting rights in an audit firm, to what extent would the existence of an independent public oversight body regulating the audit market help mitigate the potential negative impact of such a change on auditors' independence?

   Independence is not affected by changing ownership rules/Fully mitigate/Partially mitigate/Not mitigate at all/Don't know

3) If ownership rules were relaxed, so that non-auditors were allowed to own the majority of voting rights in an audit firm, do you think that audit firms would come under increased pressure to sacrifice audit quality for commercial gain?

   Yes/No/Don't know

Legal form and its impact

1) Do you think that the legal form taken by an audit firm (eg, partnership, limited liability company) influences a company's choice of auditor?

   Yes/No/Don't know

2) What legal form do you think provides the highest level of auditor independence? Please highlight one.

   – Partnership
   – Limited liability company
   – Other (please specify)
   – Don't know

3) What legal form, do you think, provides the highest level of audit quality? Please highlight one.

   – Partnership
   – Limited liability company
   – Other (please specify)
   – Don't know

Composition of the management body and its effects

1) Do you believe it is necessary for the majority of the members of the management body of audit firms to be qualified auditors?

   Yes/No/Don't know

2) If YES, please indicate if you think that having the majority of members of the management body as qualified auditors:

Makes the audit more independent	*Yes/No/Don't know*
Makes the audit partner more professional	*Yes/No/Don't know*
Means that audit quality takes preference over commercial pressure	*Yes/No/Don't know*

   Any other factors (please add details)

3) If YES to any of the above, what do you think the ideal proportion of auditors in the management body should be (please highlight one response)?

   – 51–60%
   – 61–75%
   – Above 75%

Potential investment in mid-size audit firms

1) On a scale of 1 to 5, where 5 is essential and 1 is irrelevant, if you were asked to consider a potential financial investment in a mid-size audit firm aiming to enter the market for large companies' audits, which of the factors listed below would influence your decision:

   Factor: 1(irrelevant), 2, 3, 4, 5(essential), don't know

– The rules on ownership that require majority ownership by qualified auditors
– Liability exposure of the audit firm towards third parties (ie, potential lawsuits against the audit firm)
– Degree of control that the external shareholders would have over the management of the audit firm (vis-à-vis auditors)

– Expected length of time before your investment might pay off given the nature of the audit market
– Audit firm’s ability to raise further capital, in addition to your investment, to fund future growth
– Competition from Big Four audit firms

Other factors affecting the independence of auditors

1) What is the most important factor in the current market for audits that ensures that the statutory audit is independent? Please add details

2) What is the most important change that could be made to make statutory audits more independent? Please add details

A2.3 Survey respondents

Table A1.1 Survey respondents—companies and investors

Country	Company name	Industry/sector	Person contacted	Position
Austria	[✂]	Financial	[✂]	Chairman
Austria	[✂]	Financial	[✂]	CEO
Austria	[✂]	Asset manager	[✂]	CEO
Belgium	[✂]	Consumer, non-cyclical	[✂]	CEO
Belgium	[✂]	Diversified	[✂]	Chairman
Belgium	[✂]	Communications	[✂]	Chairman
Belgium	[✂]	Utilities	[✂]	Chairman
Cyprus	[✂]	Financial	[✂]	Chairman
Cyprus	[✂]	Consumer, non-cyclical	[✂]	Chairman
Czech Rep	[✂]	Oil & Gas	[✂]	Chairman
Denmark	[✂]	Pharmaceuticals	[✂]	Chairman
Denmark	[✂]	Food	[✂]	Chairman
Estonia	[✂]	Communications	[✂]	CEO
Europe	[✂]	Asset manager	[✂]	
Finland	[✂]	Consumer, non-cyclical	[✂]	CEO
France	[✂]	Financial	[✂]	Chairman
France	[✂]	Utilities	[✂]	Chairman
Germany	[✂]	Asset manager	[✂]	Head of Market Research & Analysis
Germany	[✂]	Industrial	[✂]	President
Germany	[✂]	Financial	[✂]	Chairman
Germany	[✂]	Communications	[✂]	CEO
Germany	[✂]	Utilities	[✂]	Chairman
Germany	[✂]	Financial	[✂]	Chairman
Germany	[✂]	Consumer, non-cyclical	[✂]	Chairman
Greece	[✂]	Communications	[✂]	Chairman
Hungary	[✂]	Industrial	[✂]	Chairman
Ireland	[✂]	Financial	[✂]	Governor
Italy	[✂]	Financial	[✂]	Chairman
Italy	[✂]	Financial	[✂]	Chairman

Country	Company name	Industry/sector	Person contacted	Position
Italy	[✂]	Industrial	[✂]	Chairman
Italy	[✂]	Asset manager	[✂]	CEO
Lithuania	[✂]	Financial	[✂]	Chairman
Luxembourg	[✂]	Diversified	[✂]	Chairman
Malta	[✂]	Consumer, non-cyclical	[✂]	Chairman
Netherlands	[✂]	Asset manager	[✂]	CEO
Netherlands	[✂]	Consumer, non-cyclical	[✂]	Chairman
Netherlands	[✂]	Consumer, non-cyclical	[✂]	Chairman
Portugal	[✂]	Communications	[✂]	Chairman
Portugal	[✂]	Consumer, cyclical	[✂]	Chairman
Portugal	[✂]	Communications	[✂]	Chairman
Slovenia	[✂]	Energy	[✂]	President
Slovenia	[✂]	Consumer, cyclical	[✂]	President
Slovenia	[✂]	Basic materials	[✂]	General Director
Spain	[✂]	Asset manager	[✂]	CEO
Spain	[✂]	Gas	[✂]	Chairman
Sweden	[✂]	Industrial	[✂]	President
UK	[✂]	Banks	[✂]	CEO
UK	[✂]	Mining	[✂]	Chairman
UK	[✂]	Mining	[✂]	Chairman
UK	[✂]	Banks	[✂]	Chairman

Source: Oxera.

Table A1.2 Summary of respondents by country

Country	Number of respondents	Country	Number of respondents
Austria	3	Lithuania	1
Belgium	4	Latvia	0
Cyprus	2	Luxembourg	1
Czech Republic	1	Malta	1
Denmark	2	Netherlands	3
Estonia	1	Poland	0
Europe	1	Portugal	3
Finland	1	Slovakia	0
France	2	Slovenia	3
Germany	6	Spain	2
Greece	1	Sweden	1
Hungary	1	UK	4
Ireland	1	Anonymous	7
Italy	4		

Source: Oxera.

A2.4 Survey results

Importance of auditor independence

Table A1.3 Choosing an audit firm to carry out the statutory audit of your company

	1 (irrelevant)	2	3	4	5 (essential)	Don't Know
Technical accounting skill	0	1	1	8	40	0
Sector-specific expertise	0	1	7	20	22	0
International coverage	0	1	7	16	25	0
Audit firm has a good reputation for independence	0	2	4	12	32	0
Audit firm is one of the Big Four	2	3	7	15	20	1
Level of audit fee	0	0	15	28	7	0

Note: Responses to Q3.1: On a scale of 1 to 5, where 5 is essential and 1 is irrelevant, how do you rate the following factors when choosing an audit firm to carry out the statutory audit of your company?
Source: Oxera survey.

Table A1.4 Level of concern about each of the following policy issues

	Very concerned	Somewhat concerned	Not concerned	Don't know
Number of audit firms available to choose from	17	27	5	1
Level of audit fees	12	36	2	0
Quality of audits	17	22	11	0
Auditor independence	15	18	17	0

Note: Responses to Q3.2: Given the current state of the audit market in Europe and the development of new policy initiatives, how concerned are you about each of the following policy issues?
Source: Oxera survey.

Table A1.5 Rating the importance of the following factors in ensuring that an audit is independent

	1 (irrelevant)	2	3	4	5 (essential)	Don't know
The auditors involved are suitably qualified	3	0	4	9	34	0
The audit partner has no financial interests in the audited company	0	0	2	6	42	0
The audit firm has no financial interest in the audited company	0	1	2	4	43	0
The audit partner has no other involvement with the audited company other than the supply of the audit and services directly related to the audit	1	0	9	18	22	0
The audit firm has no commercial relationship with the audited company other than for audit (and audit-related) services	1	1	12	22	14	0
The audit firm has no corporate linkages with the audited company	1	0	4	14	30	1
The audit firm is majority owned by suitably qualified auditors	4	4	7	20	13	2
Regular change of the audit firm (eg, every 5 years or so)	8	11	15	8	8	0
Regular change of the partner within the same audit firm (eg, every 5 years or so)	0	5	16	19	9	1
There is an independent public oversight body regulating the audit market	4	1	12	12	20	0
The international structure of the audit firm is that of a single, integrated company rather than a network of independent practices in different countries	2	7	9	18	13	1

Note: Responses to Q3.3: With respect to the independence of the audit firm, on a scale of 1 to 5 where 5 is essential and 1 is irrelevant, please rate the importance of each of the following factors in ensuring that an audit is independent.
Source: Oxera survey.

Ownership rules for audit firms

Table A1.6 Rules restricting outside ownership of audit firms

	Yes	No	Don't know
Are you aware of any rules that restrict the level of outside ownership of audit firms in your country?	32	10	8

Note: Responses to Q4.1: Are you aware of any rules that restrict the level of outside ownership of audit firms in your country?
Source: Oxera survey.

Table A1.7 Ensuring independence of audit firms

	Yes	No	Don't know
If YES, do you think that these rules were put in place to ensure independence of the audit firm?	24	5	7

Note: Responses to Q4.2: If YES, do you think that these rules were put in place to ensure independence of the audit firm?
Source: Oxera survey.

Table A1.8 Sacrifices to increase the number of suitably qualified audit firms

	1 (very willing)	2	3	4	5 (very unwilling)	Don't know
Thoroughness and technical quality of the audit	3	1	0	5	41	0
Restrictions on who can own audit firms	6	11	12	16	4	1
Restrictions on who can manage audit firms	6	7	10	17	9	1
Independence of the audit firm	2	2	6	4	36	0

Note: Responses to Q4.3: If it were possible to increase the number of suitably qualified audit firms for your company to choose from, would you be willing to sacrifice any of the following to achieve this? On a scale of 1 to 5, where 1 is very willing and 5 is very unwilling.
Source: Oxera survey.

Ownership structures and their impact

Table A1.9 Relaxation of ownership rules

	Positive	Negative	No impact	Don't know
Number of audit firms available to choose from	37	2	5	6
Auditor independence	4	30	13	3
Audit quality	4	24	17	5
Level of audit fees	27	9	7	7

Note: Responses to Q5.1: If ownership rules were relaxed, so that non-auditors were allowed to own the majority of voting rights in an audit firm, what impact do you think this would have on the following.
Source: Oxera survey.

Table A1.10 Relaxation of ownership rules

	Independence is not affected by changing ownership rules	Fully mitigate	Partly mitigate	Not mitigate at all	Don't know
If ownership rules are relaxed so that non-auditors can own the majority of voting rights in an audit firm, to what extent would the existence of an independent public oversight body regulating the audit market help mitigate the potential negative impact of such a change on auditors' independence?	6	4	32	5	2

Note: Responses to Q5.2: If ownership rules are relaxed so that non-auditors can own the majority of voting rights in an audit firm, to what extent would the existence of an independent public oversight body regulating the audit market help mitigate the potential negative impact of such a change on auditors' independence?
Source: Oxera survey.

Table A1.11 Relaxation of ownership rules

	Yes	No	Don't know
If ownership rules were relaxed, so that non-auditors were allowed to own the majority of voting rights in an audit firm, do you think that audit firms would come under pressure to sacrifice audit quality for commercial gain?	30	16	4

Note: Responses to Q5.3: If ownership rules were relaxed, so that non-auditors were allowed to own the majority of voting rights in an audit firm, do you think that audit firms would come under pressure to sacrifice audit quality for commercial gain?
Source: Oxera survey.

Legal form and its impact

Table A1.12 Influence on legal form on choice of auditor

	Yes	No	Don't know
Would the legal form taken by an audit firm (partnership, limited liability company, other) influence you in your choice of auditor?	12	32	5

Note: Responses to Q6.1: Would the legal form taken by an audit firm (partnership, limited liability company, other) influence you in your choice of auditor?
Source: Oxera survey.

Table A1.13 Legal form and level of independence

	Partnership	Limited liability company	Other (please specify)	Don't know
What legal form do you think provides the highest level of auditor independence?	24	11	0	13

Note: Responses to Q6.2: What legal form do you think provides the highest level of auditor independence?
Source: Oxera survey.

Table A1.14 Legal form and level of quality

	Partnership	Limited liability company	Other	Don't know
What legal form, do you think, provides the highest level of audit quality?	25	8	0	15

Note: Responses to Q6.3: What legal form, do you think, provides the highest level of audit quality?
Source: Oxera survey.

Composition of the management body and its effects

Table A1.15 Qualifications of management body

	Yes	No	Don't know
Do you believe it is necessary for the majority of the members of the management body of audit firms to be qualified auditors?	38	11	1

Note: Responses to Q7.1: Do you believe it is necessary for the majority of the members of the management body of audit firms to be qualified auditors?
Source: Oxera survey.

Table A1.16 Management body as qualified auditors

	Yes	No	Don't know
Makes the audit more independent	26	11	3
Makes the audit partner more professional	35	4	0
Means that quality takes preference over commercial pressures	31	4	4

Note: Responses to Q7.2: If YES, please indicate if you think that having the majority of members of the management body as auditors. Some of the respondents to Q7.1 (Table A1.15) who replied 'no' or 'don't know' also completed Q7.2.
Source: Oxera survey.

Table A1.17 Qualifications of management body

	51–60%	61–75%	75%+
If YES to any of the above, what do you think the ideal proportion of auditors on the management body should be?	8	13	18

Note: Responses to Q7.3: If YES to any of the above, what do you think the ideal proportion of auditors on the management body should be?
Source: Oxera survey.

A3 Structured interviews

A3.1 Interview template

Company:
Name:
Job title:
Contact details:
Oxera staff present:
Date:

Introduction
Oxera has been commissioned by the European Commission DG Internal Market and Services to undertake an analysis of the ownership rules and management structures of audit firms across the EU. As an important part of this study, Oxera is conducting interviews with key stakeholders in the audit market.

The objective of the interview is to solicit your views about the extent to which ownership rules and management structures of audit firms influence firms' ability to raise capital, and thereby represent a barrier to entry to the audit market for public interest entities and larger unlisted entities.

We are also keen to hear your views on the relationship between the independence of the audit and the ownership rules and management structures of audit firms, as well as to understand your perspective on more general issues on audit firms' access to capital.

Structure of the interview

Your firm

– Key activities of your firm.
– Legal form, ownership structure, and structure of administrative and management bodies.
– Ownership and control: ability of existing owners to transfer ownership and control; compensation to owners upon retirement; contributions from new owners.

Drivers of the adopted ownership and management structure in light of the current regulatory framework

– Alternative forms and structures of ownership compliant with current regulatory rules: available options.
– Advantages and disadvantages of changing your firm's ownership structure.
– Features of your firm's current ownership structure that might make it attractive for an audit firm.

Raising capital

– Types of capital available for your firm: internal and external sources.
– Illustrative costs of financing (eg, if debt, an average interest rate).
– Challenges when raising capital and the degree to which you may be capital-constrained.

Market positioning and commercial strategy

- Description of the audit market in your country: concentration, gap between Big Four and mid-tier.
- Your firm's market position in terms of size compared with your competitors (eg, one of the largest after the Big Four, in the first ten after the Big Four, etc).
- Your firm's market position in terms of types of audit client (eg, all companies except multinationals, all companies except multinationals and large domestic companies, medium-sized domestic companies, etc).

Entry into the market for larger audits

- Experience in bidding for companies that are significantly larger than your current clients.
- Amounts of capital required to finance additional expenditure when auditing larger clients (working capital, capital investments): relative magnitude, investment horizon;
- Challenges for expansion: barriers for obtaining clients that are significantly larger than your current clients—how would you need to change in order to obtain larger clients.

Auditor independence

- The importance of the perception of independence for winning new clients and retaining existing clients.
- The role of ownership and management restrictions in ensuring auditor independence.
- The role of public oversight bodies in ensuring auditor independence.
- The ownership and management structure of the audit firm and independence.

About Oxera

Oxera is an independent economics consultancy—one of the largest in Europe—with an international reputation for integrity, intellectual rigour and work of the highest quality. We are driven to preserve our objectivity and integrity. Oxera is completely independent in both ownership and delivery of our analysis. As we are not tied to any one client, investor or sector, we offer unbiased, credible results, and often act as an intermediary/facilitator to two or more points of view.

A3.2 Interviews held

Table A3.1 List of interviewees

Organisation name	Organisation type	Name of interviewee	Position	Other responsibilities	Geographical coverage
[✂]	Investor	[✂]	Head of Business Control	[✂]	Germany
[✂]	Audit firm	[✂]	Partner		Netherlands
[✂]	Audit firm	[✂]	Partner		Luxembourg
[✂]	Audit firm	[✂]	Partner		Malta
[✂]	Investor	[✂]	Director of Investment Affairs		UK
[✂]	Audit firm	[✂]	National Managing Partner		UK
[✂]	Audit firm	[✂]	Chairman	[✂]	International
[✂]	Audit firm	[✂]	Partner (audit and assurance)		UK
[✂]	Audit firm	[✂]	Manager (audit department)		Spain
[✂]	Audit firm	[✂]	Partner		Hungary
[✂]	Audit firm	[✂]	Managing Partner	[✂]	Belgium
[✂]	Audit firm	[✂]	Partner (clients & markets and communication)	[✂]	France
[✂]	Audit firm	[✂]	Director of communications		France
[✂]	Audit firm	[✂]	Partner	[✂]	Belgium and Europe
[✂]	Other	[✂]	Chief Executive		Europe
[✂]	Other	[✂]	Chief executive		UK
[✂]	Other	[✂]	Staff member of the Professional Oversight Board		UK
[✂]	Audit firm	[✂]	National Managing Partner		UK
[✂]	Audit firm	[✂]	Partner (head of assurance)		UK
[✂]	Audit firm	[✂]	Chairman of European Region		Europe
[✂]	Other	[✂]	Secretary general	[✂]	Belgium
[✂]	Other	[✂]	Legal advisor		Belgium
[✂]	Other	[✂]	Director of European Affairs		Germany and Europe
[✂]	Audit firm	[✂]	Partner (professional practice audit department)		Germany
[✂]	Audit firm	[✂]	Partner (risk management)		Germany
[✂]	Investor	[✂]			Europe
[✂]	Investor	[✂]			Europe
[✂]	Investor	[✂]			Europe
[✂]	Audit firm	[✂]	Partner (risk management)		UK and France
[✂]	Audit firm	[✂]	Partner (corporate & public interest market)		
[✂]	Audit firm	[✂]	Senior Partner		UK
[✂]	Audit firm	[✂]	Former CEO		UK

Organisation name	Organisation type	Name of interviewee	Position	Other responsibilities	Geographical coverage
[✂]	Audit firm	[✂]	Partner	[✂]	Denmark and Europe
[✂]	Audit firm	[✂]	Partner (head of professional affairs)		UK
[✂]	Audit firm	[✂]	Partner		Slovenia
[✂]	Audit firm	[✂]	National Managing Partner		UK
[✂]	Audit firm	[✂]	Chair of Audit		UK
[✂]	Audit firm	[✂]	Partner	[✂]	Germany
[✂]	Other	[✂]	Associate Professor (Business and Public Policy)		USA
[✂]	Other	[✂]	Professor	[✂]	UK
[✂]	Audit firm	[✂]	Partner	[✂]	Germany
[✂]	Audit firm	[✂]	Partner	[✂]	Germany
[✂]	Investor	[✂]	Investment Director	[✂]	UK
[✂]	Investor	[✂]	Head of Legal Affairs		Finland

Source: Oxera.

A4 Case studies

This section discusses a number of cases where audit firms have adopted less typical legal forms, In particular, the focus is on audit firms which are de facto a part of a larger corporate group—for example, where the parent company is public corporation.

On the one hand, these examples provide an illustration of alternative ways of raising capital by audit firms (alternative to partners' contributions). On the other hand, they highlight the circumstances, where, although the ownership restrictions are not breached, the adopted legal structures allow for implicit or explicit links to other firms that together form a larger corporate entity.

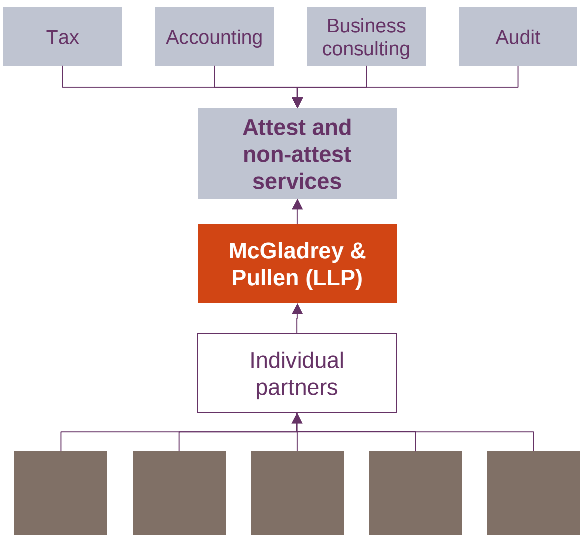
The case studies presented below focus on the following issues:

– ownership structures adopted to combine a listed non-audit business and a privately held audit partnership;
– economic relationships between an independently owned audit business and a listed non-audit business;
– relationships, including management structures, that define the interaction between partners of the audit business on one side and the managers and owners of the non-audit business on the other.

A4.1 H&R Block and McGladrey & Pullen LLP[238]

In the late 1990s, publicly listed company, H&R Block, which was active in the market for professional services, but at the time not present in the audit market, acquired a US accountancy and audit firm, McGladrey & Pullen LLP. A particular ownership structure was adopted post-acquisition (see Figure A4.1) to mitigate the potential threats to independence of the acquired audit business and to comply with regulatory requirements.

Figure A4.1 Ownership structure of McGladrey & Pullen prior to acquisition



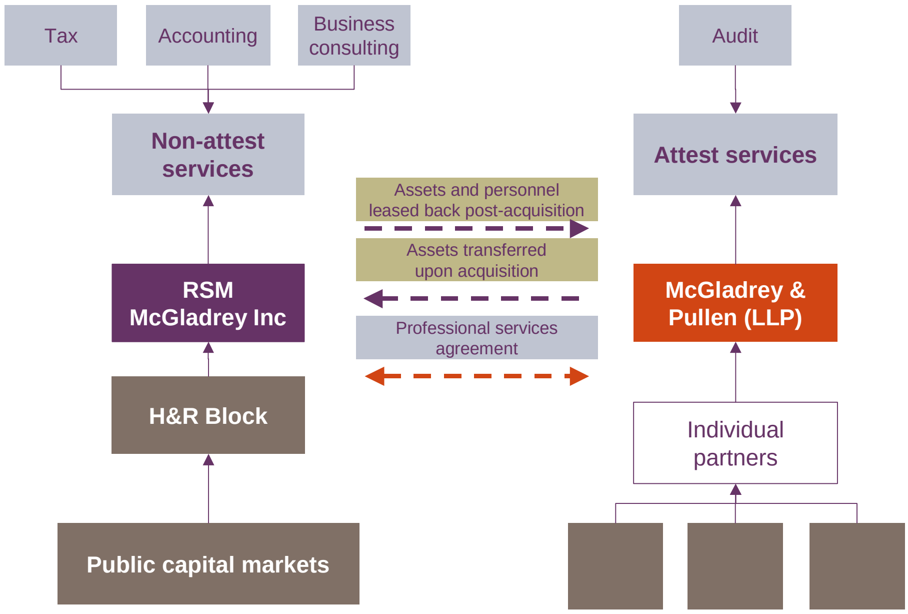
238 The description of the H&R Block and McGladrey & Pullen LLP case is based on publicly available information from third parties.

Note: Attest services are services that must be carried out by a qualified professional.
Source: Oxera analysis of public information available at www.mcgladrey.com and www.rsmmcgladrey.com

H&R Block established a wholly owned subsidiary, RSM McGladrey Inc, which acquired the non-attest assets and businesses (ie, the assets and businesses that did not require the same degree of independence in their client engagements) of McGladrey & Pullen LLP. To ensure independence, McGladrey & Pullen LLP was kept as a separate entity offering audit and other attest (services that must be carried out by a qualified professional) services. Post-acquisition McGladrey & Pullen LLP was owned and managed independently of RSM McGladrey Ltd, by audit partners as prior to the acquisition.

As a part of the acquisition, the tangible assets of McGladrey & Pullen LLP were transferred to the newly established RSM McGladrey Inc. In the post-acquisition structure, the independently owned and controlled LLP, rendering audit services, leased assets and personnel from the Inc, which was ultimately owned and controlled by the publicly listed entity.[239] Moreover, a professional services agreement between the two firms was signed, which outlined the working practices when serving clients. Both McGladrey & Pullen LLP and RSM McGladrey Inc have also become members of RSM International, an international consortium of audit firms. The post-acquisition structure is shown in Figure A4.2 below.

Figure A4.2 Ownership structure of McGladrey & Pullen post-acquisition



Source: Oxera analysis of public information available at www.mcgladrey.com and www.rsmmcgladrey.com.

This dual structure was later used for further acquisitions. In October 2005 RSM McGladrey Inc acquired the non-audit operation of American Express TBS, while McGladrey & Pullen LLP acquired the audit operations of American Express TBS.[240]

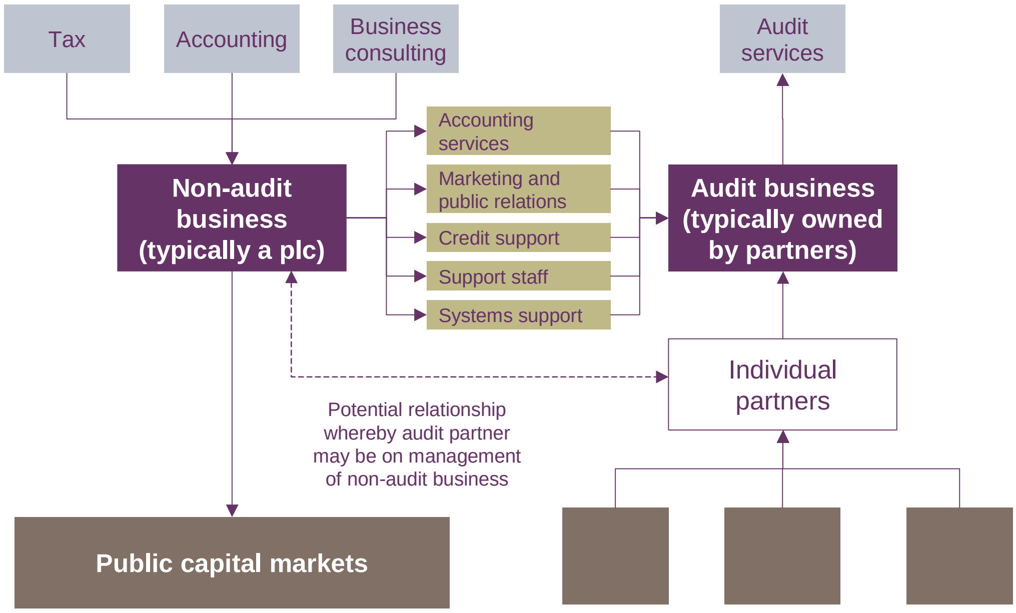
The ownership structure described for H&R Block's acquisition of McGladrey & Pullen LLP could be generalised to describe the structure that might be adopted to integrate an audit business into a publicly listed corporate group. Figure 5.5 below presents a hypothetical model structure of this form.

This model can be seen as designed to ensure that the audit business was legally separated from the non-audit business. Similar, in the H&R Block case, it might be argued that the audit

[239] According to the description by O'Connor (2002) 'H&R Block purchased the assets of everything but the core audit practice of McGladrey & Pullen LLP, leaving a *skeleton* audit firm owned by the original CPA partners of that firm'.
[240] http://www10.americanexpress.com/sif/cda/page/0%2C1641%2C24916%2C00.asp

firm was run as a 'skeleton' firm, with independent owners and managers, which leased most of its services from the non-audit business.

Figure A4.3 Audit business as part of listed Group: generic ownership structure



Note: In the UK, audit practices that have adopted an alternative business structure are Tenon Audit Ltd, Nexia Smith & Williamson Audit Ltd, and HLB Vantis Audit plc.
Source: Oxera analysis of Tenon Group plc, Tenon Audit Ltd and Numerica Group plc annual reports and other publicly available information, and Oxera interviews.

Examples from the UK provide evidence on similar arrangements relationship. These include, for example, Tenon, Vantis, and Numerica. Examples of such structures in the UK context are discussed below.

A4.2 Tenon Group plc and Tenon Audit Ltd (formerly Blueprint Audit Ltd)[241]

In 2005 Tenon Group plc had a turnover of £99.4m, whereas Tenon Audit Ltd (formerly Blueprint Audit Ltd) had a turnover of £10.7m for the same period.[242] In AccountancyAge's list of Top 50 accountancy firms for 2006, Tenon Group plc was ranked tenth.[243] The strategy for both Tenon Group plc and Tenon Audit Ltd is to target entrepreneurs for both advisory and audit services, rather than specific types of company. As a result, Tenon Audit Ltd does not see itself competing for the audit engagements of any FTSE 100 companies, although it would possibly look to auditing FTSE 250 companies. By contrast, Tenon Group plc does work for FTSE 100 companies, as an outsourcer only.

A brief history of Tenon

Tenon Group plc was incorporated in February 2000 with the intention of acquiring and consolidating several of the largest regional accountancy practices in the UK (with turnover below the level of the five largest firms) and establishing a broad-based business services group. It was then listed on the Alternative Investment Market (AIM) in the following month and raised approximately £50m during the IPO. In the 12 months after its incorporation, 14

[241] The description of the Tenon case is based on publicly available information obtained from third parties, Tenon Group plc and Tenon Audit Ltd annual reports, as well as an interview with Tenon Audit Ltd.
[242] Tenon Group plc (2005), 'Report and financial statements for the 12 months ended June 30th 2005', and Tenon Audit Ltd (2005), 'Report and financial statements for the 12 months ended June 30th 2005'.
[243] http://www.accountancyage.com/resource/top50

audit practices were purchased, nearly all of which were a leading accountancy firm for their region. Examples of Tenon Group plc's early acquisitions were Morison Stoneham in October 2000, the Williams Allan Group on December 4th 2000, and BKL Weeks Green Group and the Berkeley Jackson Group on December 29th 2000.

Following these acquisitions, the audit practice named Blueprint Audit Ltd,[244] initially became the tenth-largest audit firm in the UK. The process involved Tenon Group plc acquiring the non-audit activities of accountancy firms, while in parallel Blueprint Audit Ltd acquired the audit services of these firms. The audit partners of the acquired audit business joined as directors at Blueprint Audit Ltd; thus, the post-acquisition entity was owned by former partners and newly joined partners. Figure A4.4 shows how the target businesses were split into audit and non-audit elements before being individually acquired. When an audit firm was acquired, any equity partners of the acquisition had a choice of converting their equity stake into either cash or equity in Tenon Group plc, or a combination of both.

To combine the accountancy and related services effectively with audit services, a dual legal structure was adopted, similar to the generic model structure described in Figure A4.3 above.

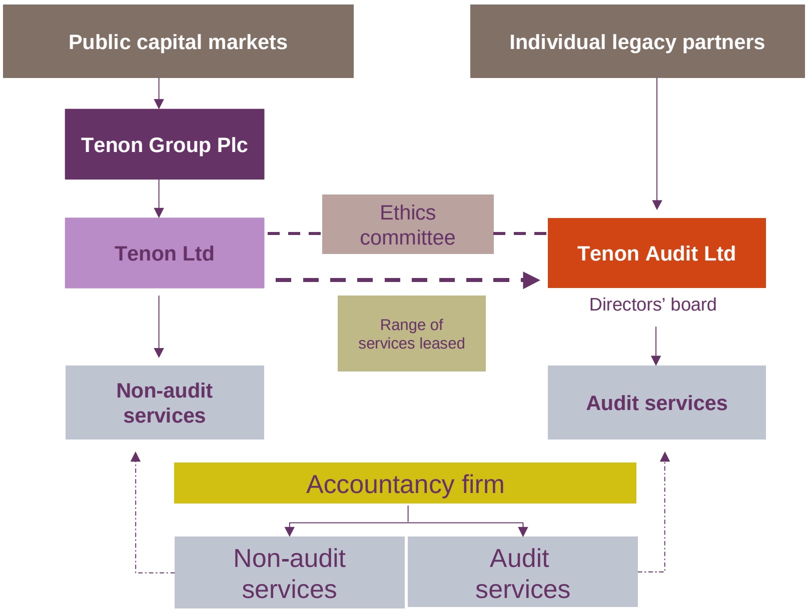
The dual legal structure

Tenon Ltd, which is a wholly owned subsidiary of Tenon Group plc, provides non-audit services, while Tenon Audit Ltd provides audit services only. Tenon Audit Ltd is owned separately from the Tenon Group plc by former partners of the acquired accountancy firms (also known as legacy partners), in order to comply with ownership restrictions in place. The legacy partners who are the shareholders have no rights to income and are not involved in the day-to-day running of the audit firm—ie, they have no voting or management rights; in addition, they are non-profit-earning shareholders.

There are four members of the Tenon Audit Ltd directors' board, led by the Chair of Tenon Audit Ltd. Not all of the present directors are shareholders in Tenon Audit Ltd, although it is possible for them to own shares in this firm. The directors alone take the management decisions for the audit firm. In addition, an individual from Tenon Group plc sits as a non-voting member on the directors' board.

[244] To prevent confusion, Blueprint Audit Ltd is referred to as Tenon Audit Ltd for the rest of this case study, the only exception being in the section that examines the issue regarding the name for the audit firm.

Figure A4.4 Structure of Tenon's acquisition transactions: acquisition of audit compared with non-audit business



Source: Oxera analysis of Tenon Group plc and Tenon Audit Ltd annual reports, and Oxera interviews.

Although Tenon Group plc and Tenon Audit Ltd are separately owned, Tenon Ltd provides Tenon Audit Ltd with a comprehensive range of services, including the provision of premises, support staff, accounting and bookkeeping services, systems support, marketing and public relations in return for a fee payable to Tenon Ltd.[245] Tenon Group plc also guaranteed £1,952,000 of banking arrangements for Tenon Audit for a fee of £80,000.[246] These fees represented a substantial proportion of the audit services revenue—over 90% of turnover.[247]

The members of staff employed by Tenon Audit Ltd, all of whom are qualified auditors, comprise the directors' board, who are also employed by Tenon Ltd, through which they are remunerated as well. From Tenon Audit Ltd, these staff earn only a salary; whereas from Tenon Ltd, in addition to their salary, they may be remunerated by a bonus scheme and/or shares in Tenon Group plc. Therefore the directors of the audit firm may be, but are not necessarily shareholders of Tenon Group plc. The different means by which the audit firm directors can be remunerated are:

– salary;
– share options—audit firm directors become equity holders in Tenon Group plc;
– bonus scheme—staff are paid a performance-related bonus.

In order to mitigate any conflicts of interest or loss of independence from the auditors being paid by Tenon Ltd and also potentially owning shares in Tenon Group plc which offers other non-audit services, an ethics committee has been set up between Tenon Ltd and Tenon Audit Ltd. To date, this committee has not had to meet in relation to potential conflicts of interest or loss of independence issues. In addition, the shareholders of Tenon Group plc are monitored in order to ensure that Tenon Audit Ltd is not engaged in any audit activities where

[245] This fee was £9,911,000 at year ending June 30th 2005.Tenon Group plc (2006), 'Report and financial statements for the 12 months ended June 30th 2006'. The Tenon Audit Ltd accounts for the year ending June 30th 2005 state that, on average, there were 391 employees in dual employment contracts with Tenon Group plc.
[246] Guarantee and fee at year ending June 30th 2005. Tenon Group plc (2006), 'Report and financial statements for the 12 months ended June 30th 2006'.
[247] For the 12 months ending June 30th 2005, turnover was £10.7m, the fee for services was £9.9m, and the fee for guarantee was £0.08m. Tenon Group plc (2006), 'Report and financial statements for the 12 months ended June 30th 2006'.

the shareholders may have an interest; in the event of any potential conflict of interest, the audit firm would resign its engagement.

One reason proposed for adopting this dual legal structure is concerns about liability. Shareholders in Tenon Group plc are liable only for their equity stake, whereas a partner's personal assets can still be exposed, even in a LLP. Thus, there is less risk for equity owners in a company structure than in a partnership.

Brand issues and name change

In 2001 Blueprint Audit Ltd began discussion with the ICAEW with a view to changing the Blueprint brand name and in 2005 the audit firm became Tenon Audit Ltd. The regulators have expressed certain concerns about auditor objectivity when the audit firm took the name of the non-audit company. It was ruled that any written material produced by Tenon that mentioned both the audit and non-audit businesses must include footnotes to explain the distinction between the two companies, highlighting their legal independence. However, it was suggested that although clients of the audit firm understand that the audit firm is legally separate from the wider group—for example, they receive two engagement letters—they perceive Tenon (sic) as a single entity.

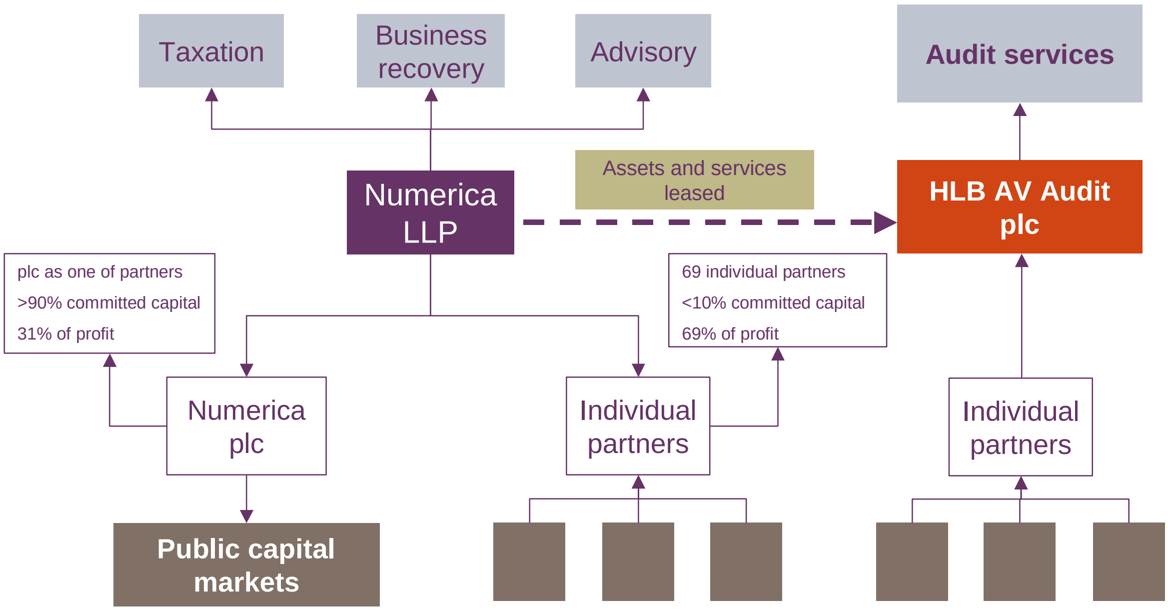
A4.3 Numerica plc and Numerica LLP

Numerica might be seen as another example of a similar corporate model, where audit business effectively forms a part of a listed entity.[248] In 2001 the Levy Gee partnership adopted the plc form and was listed on AIM as Numerica plc raising £30m. The Group also included separately owned audit business—HLB AV Audit plc, shares of which were not listed. The general ownership model described above could be applicable to the relationship between Numerica plc (listed) and HLB AV Audit plc.

In 2004 Numerica plc re-introduced the partnership form into its legal structure.[249] The post-2004 structure is illustrated in Figure A3.5.

[248] The description of the Numerica case is based on Numerica Group plc (2004), 'Annual Report and Accounts for year ended 31 March 2004' and Oxera interview.
[249] In 2004, Numerica plc made a pre-tax loss of £2.6m (March–November 2004) and its CEO and founder resigned.

Figure A4.5 Ownership structure of Numerica LLP (and audit business of Numerica Group)



Source: Oxera analysis of Numerica Group plc (2004), 'Annual Report and Accounts for year ended 31 March 2004' and Oxera interview.

Senior employees at Numerica plc were given partnership stakes in the newly created Numerica LLP. Numerica plc, which became one of the 70 partners of Numerica LLP, provided over 90% of the Numerica LLP's capital. In terms of profits, 69 individual partners received 68.7% of profits and 31.3% of profits went to Numerica plc. Numerica LLP also begun offering non-audit services. Importantly, the audit business, HLB AV Audit plc, remained separately owned from both the newly formed Numerica LLP and Numerica plc; neither Numerica LLP nor Numerica plc were engaged in audit activities. The reintroduction of the partnership element in Numerica was primarily aimed at incentivising the former partners who had previously been owners and were now currently employees. Information from interviews suggested that the next 'generation' of employees who were remunerated as employees (by a combination of salary, share options and bonus scheme) would be suitably incentivised, as they had never been partners of an owner-managed firm.

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