



LUND UNIVERSITY
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Need for change in the audit market?

An analysis of the measures proposed to reduce audit market concentration in the European Commission's Green Paper on Audit Policy: Lessons from the Crisis

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Abstract

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Thesis title: Need for change in the audit market? - An analysis of the measures proposed to reduce audit market concentration in the European Commission's Green Paper on Audit Policy: Lessons from the Crisis

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Background and problem: In October 2010 the European Commission issued a Green Paper on Audit Policy in which they set out to draw lessons of the auditors' role in the recent financial crisis. The European Commission considers the function of the audit to be a key contributor to investor confidence and suggests a number of controversial measures with the aim of ensuring financial stability in the European financial markets. If and when the ideas mentioned in the Green Paper are transposed into new Regulations and Directives, various legal issues will arise, between auditors, within audit firms as well as between auditors and their clients. Our main research question is based on these and relates to how these measures can influence auditor independence and the audit process.

Purpose: Our purpose with this thesis is to analyse the suggested disadvantages associated with the current audit market structure, and the measures to mitigate those that are brought up for discussion in the European Commission's Green Paper on audit policy. This analysis will be done from a European as well as a national Swedish perspective.

Methodology: The thesis follows a qualitative methodology where five interviews with Swedish auditors make up the primary data. The primary data is then compared with the secondary data in an analysis leading to the thesis conclusions.

Theoretical Perspectives: In order to illuminate the different measures that are suggested in the Green Paper's fifth section, relevant academic research and other studies are used. Different perspectives are given regarding a number of topics; auditor independence and audit quality, concentration and market structure, joint audits, mandatory rotation of auditors, Big Four bias, contingency plans, consolidations, auditor designation and auditors legal liability.

Empirical Foundation: The empirical research of the thesis is built upon five interviews with Swedish auditors from different firms. Two of them are working at Big Four firms, while three of them are working at smaller firms. These interviews provide the thesis with the view on the Green Paper from the perspective of the Swedish audit profession.

Conclusions: We believe that the top-down approach that the European Commission uses in the Green Paper can be a disadvantage, and thereby making the market players react negatively to the suggested measures. Instead, the Green Paper might have been more effective by adopting a different approach, with which it could have generated more constructive responses. Furthermore, the Big Four bias that the European Commission wishes to address is something that receives diverse opinions. We believe that it is very hard, maybe impossible, to assess exactly how much of this bias that is attributable to merit and how much to perceptions. When it comes to the comparison of our empirical research and the reviewed responses to the Green Paper, the results indicate that national differences may occur. One measure can be considered appropriate in the Swedish audit market, while the same measure might be inappropriate for some other Member State's audit market. National differences in attitudes are something that the European Commission may need to address.

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Marika Hedlund

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Abbreviations

AAI	American Antitrust Institute
ACCA	Association of Chartered Certified Accountants
BCCI	Bank of Credit and Commerce International
EU	European Union
Far	Föreningen auktoriserade revisorer (The Swedish professional institute for public accountants)
FEE	Fédération des Experts Comptables Européens (European Federation of Accountants)
FRC	Financial Reporting Council in the UK
FSA	Financial Supervisory Authority in Sweden (Finansinspektionen)
G8	The Group of Eight
G20	The Group of Twenty Finance Ministers and Central Bank Governors.
IFAC	International Federation of Accountants
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISA	International Standards on Auditing
MNE	Multinational Enterprises
OECD	Organisation for Economic Co-operation and Development
SME	Small and Medium Enterprises
SPM	Small and Medium Practitioners
U.S. GAO	U.S. Government Accountability Office

Glossary

Audit consortia	An audit consortia is when two or more firms collaborate when performing the audit, in our thesis it will refer to a joint audit between two firms where one has to be firm outside of the Big Four.
Audit firm rotations	An audit firm rotation is when the client changes not only the auditor but also the audit firm after a specific period of time.
Contingency plans	A contingency plan is a plan designed to solve a specific situation that could occur in the future.
Expectations gap	An expectations gap exists when auditors and the companies audited and/or the public have different opinions in regards to the outcome of the audit and the auditor's obligations.
Joint audit	A joint audit is when two or more audit firms work together to produce a single audit report.
Living wills	Is a plan designed to mitigate the consequences of a firms sudden withdrawal from the market and involves the appointment of other firms to overtake its clients.

1 INTRODUCTION

This chapter introduces the reader to the area studied in this thesis; the European Commission's Green Paper on Audit Policy and the professions views on the measures it suggests regarding the current market concentration. The background will explain why we chose this topic for our thesis and the reasons behind the Green Paper. The problem discussion illustrates the controversy of some of the terms used, and measures suggested in this Green Paper and will lead to our research questions. Thereafter, our purpose explains what we as authors wish to attain through answering these research questions. Lastly, we introduce the reader the delimitations and outline of the thesis.

1.1 Background to the 2010 Green Paper on Audit Policy

This thesis is about the 2010 Green Paper on audit policy (hereafter referred to as “the Green Paper”), a discussion paper about the auditors’ role in the most recent financial crisis - a crisis that started with US sub-prime home loans and resulted in collapses and nationalisations of investment banks as well as EU and IMF bailouts for entire countries. (BBC Crisis Timeline 2010, Shearing 2009) The Green Paper was published by the European Commission (hereafter referred to as “the Commission”) that believes that financial stability will come through defining the profession and increasing audit regulation. Many of the terms used and measures suggested in the Green Paper are controversial, making this an interesting topic for research. (FSB Progress 2010, Newsflash 2011)

Historically, business failures often get connected to insufficient accounting standards and auditing failures, irrespective of how the auditor has been acting. The accounting gets questioned and the auditors contributions to guarantee the accounting standards and quality gets criticised in public. (Power 1997, Hayes 2005:85) This most recent crisis is no different and in Sweden, Finansinspektionen, (FSA) revoked HQ Bank’s license after it was revealed that the bank had overvalued its trading portfolio under a long period of time, and “taken risks so large as to compromise its survival.” (FI Press Release 2010) The FSA also reported the auditor of HQ Bank to Revisorsnämnden, the Supervisory Board of Public Accountants, as some factors indicated a weak personal integrity from the auditor. (SVD HQ Bank) As a result financial crisis and large corporate collapses generally bring on changes in audit regulation in an attempt to regain some of the trust lost, e.g. Enron ,

WorldCom, and Parmalat, that resulted in the Sarbanes-Oxley Act in the USA, and the 2006 Statutory Audit Directive in the EU. (Unerman & O'Dwyer 2004)

The Green Paper presents a range of ideas on how to enhance the societal role of the auditor to mitigate the risk of future financial crisis. (Kovacheva 2011) Two major issues are identified: firstly, an expectations gap and, secondly, the fact that the consolidation of large audit firms has created a systemic risk. This means that the collapse of one such a firm could cause international markets to fall into disarray. (The Green Paper, Newsflash 2011) In this regard the Green Paper addresses the following topics:

1. The role of the auditor;
2. The application of ISAs;
3. Governance and independence of audit firms (including appointment, rotation, non-audit services and firm structure);
4. Supervision; (increasing transparency with respect to fees, non-audit services and cross-border management of audit network operations);
5. Concentration and market structure;
6. Creation of a European market for audit services enabling cross-border cooperation;
7. How to simplify rules for SMEs and SMPs.

The Green Paper's introduction chapter describes the relevance of audits and issues arising from an expectations gap between users' and the nature of an audit. One of the most controversial ideas is the one of auditor designation, meaning that the appointment, remuneration and duration of the engagement would be the responsibility of a third party and not the company. Amongst the controversial issues is that the Green Paper focuses on the structure of the audit profession and the possibility of this creating a risk to governance and independence. (ibid.)

The Green Paper invited interested individuals and organisations to contribute their views regarding these ideas. The response time for the Green Paper was short (eight weeks) as the EU considered the need to stabilise the financial system to be urgent. In all, the Commission received a total of 688 responses. These responses have come from different stakeholders, including supervisors, investors, academics, companies, government

authorities, the Big Four¹ and other bodies of the audit profession. Many of the responses are, for various reasons, critical to the ideas presented. (EC Summary 2011)

1.2 Problem Discussion

The Commission's Green Paper identifies the Big Four bias as a threat to financial stability. The reason mentioned in the Green Paper is the market concentration it brings poses a systemic risk. However, the term systemic risk is not further defined. The US GAO (2003a), OECD (2009) and Oxera (2006), a British independent consultancy, have conducted studies on market concentration suggesting that the marketplace is too concentrated. Although auditors provide information to the financial markets, many say that the concentration of the audit market is not sufficient proof that it makes them systemic and that they pose a systemic risk. This question is being raised by for instance IFAC, who also questions the view of the audit as having a systemic role. (IFAC 2010, EC summary 2011)

The suggestions made in the Green Paper on e.g. actions as mandatory rotations of audit firms and joint audits can by some groups be seen as radical ways to address the potential problem of the audit market concentration. The opinions on these matters are diverse. For instance, in the response to the Green Paper, BDO takes a positive standpoint towards joint audit and KPMG a negative.

In the first section of the Green Paper it reads that the Commission "is keen to assume leadership at the international level on this debate and will seek close co-operation from its global partners within the Financial Stability Board and the G20²". When presenting the Green Paper, Michel Barnier, the European commissioner for internal market and services stated that status quo is not an option, making it clear that he had already made up his mind that changes in the audit market were needed regardless of the responses on the Green Paper. If and when the ideas mentioned in the Green Paper are transposed into new

¹ Currently the world's largest audit firms; Ernst & Young, Deloitte, KPMG and PwC.

² A group of finance ministers and central banks governors from the 19 largest economies and the EU.

Regulations and Directives, various legal issues will arise, between auditors, within audit firms as well as between auditors and their clients. (Welch 2011, Far 2011)

1.3 Research Questions

Our choice of problem is the measures that are suggested in the Green Paper to reduce the audit market concentration, and how they can influence auditor independence and the audit process.

- What is the role of the Big Four audit firms and why can they be considered too big?
- What measures are suggested to reduce the audit market concentration and what are the positions of the official responses, research articles and the public debate on these areas?
- What is Big Four bias and how can it be addressed?

1.4 Purpose

Our purpose with this thesis is to analyse the suggested disadvantages associated with the current audit market structure, and the measures to mitigate those that are brought up for discussion in the European Commission's Green Paper on audit policy. This analysis will be carried out from a European as well as a national Swedish perspective.

1.5 Delimitations

This thesis will focus on section five of the Green Paper regarding concentration and market structure. Due to the time constraints, we have chosen the professions perspective only, which includes that of individual auditors, audit firms and professional bodies.

1.6 Outline of the thesis

The thesis is composed of eight chapters. The first chapter, introduction which was presented above, contains the background and a problem discussion which leads to three research questions and the thesis purpose, scope and limitations. This chapter is then followed the methodology explaining how the study was conducted and the reasons for decisions taken during the study. The third chapter, independence and audit quality, explains these relevant terms which the Green Paper, its responses and our analysis will be built upon. Chapter four describes the development of the concentration and market structure and chapter five the standpoints and arguments found in the responses to the Green Paper. This is followed by a chapter dedicated to the empirical data, in chapter seven this data is compared against the reviewed literature and responses to the Green Paper in an analysis. The study ends with the conclusions and suggestions for future research in chapter eight.

2 METHODOLOGY

In this chapter we present and explain our scientific starting point and the choices we have made throughout the process of writing this thesis. The chapter also includes a discussion about the validity and reliability of the thesis.

2.1 Choice of methodology and research approach

Within the field of social science, a distinction is made between two main areas of method; quantitative methods and qualitative methods (Andersen 1998). Quantitative methods mainly focus on measurable results and statistics, while qualitative methods focus on understanding the connection between the data collected. (Backman 2008)

This thesis uses a qualitative method, mainly because it is the most suitable for our research questions and purpose as it allows the use of opinions and experiences gathered from interviews. The aim of this thesis is not to be able to generalise, but to create a more in-depth understanding of the suggested terms and measures; therefore, quantitative data are not suitable.

Our research approach is of a deductive nature. This is because we begin by formulating a research theory that is being narrowed down to specific research questions. These questions are then answered through the information we receive from our interviews with the respondents. (Saunders et al. 2007)

2.2 Data collection method

This thesis uses two different types of data; secondary data and primary data (Christiansen et al. 2001).

2.2.1 Secondary data – choice of responses

Secondary data is information that has already been collected by other people in other studies, and includes both quantitative and qualitative data. Secondary data can be divided into three main groups; documentary data, survey-based data and data compiled from multiple sources. (ibid.) The advantage of secondary data is that it is less resource demanding compared to primary data since it has already been collected (Saunders et al. 2007).

The secondary data collected for this thesis comes from relevant literature, academic journals, newspapers, EU regulations, websites, databases and an audit file from the Commission financial reporting and auditing conference about the Green Paper. The databases we have used are ScienceDirect, Emerald and Ebsco. In this study we have also collected opinions from a number of responses sent to the Commission regarding the Green Paper. As we have chosen to focus on the perspective of the profession we have selected responses from the Big Four audit firms, the four largest mid-tier audit firms in Europe that could be affected by measures taken against the current market structure, and four bodies linked to the profession. Naturally there are a number of additional interesting professional bodies but due to time restraints we have limited our study to include the responses we found to be most important. These were: IFAC, FEE, Far and ACCA.

- IFAC is the global profession's international organisation. Through its member bodies, it represents 2,5 million accountants from 125 countries. IFAC develops international standards on auditing, assurance, education and ethics.

- FEE is a regional professional organisation and works at a European level. It is independent from IFAC and represents 500 000 accountants from 33 different countries in Europe.
- Far is a national organisation for accountants in Sweden and a member of both FEE and IFAC. As our empirical study is focused on Sweden, this response is important for us to incorporate.
- ACCA is a London-based international education body and an important player in the audit industry. It is one of the world's largest and fastest-growing accountancy bodies with 147,000 members and 424,000 students in 170 countries. ACCA is a member of IFAC and FEE.

2.2.2 Primary data

Primary data is new data that is specifically collected for the research, and the data can be collected in several ways, for instance through observations, surveys or interviews. The use of interviews is a useful way of gathering valid and reliable data that is relevant for the research. (Cristiansen et al. 2001) We have chosen to collect primary data for our study as it gave us an opportunity to get answers to the questions raised in the collection of secondary data. This primary data were collected through interviews, as we think it provides a deeper insight into the professionals' opinions than a survey.

2.3 Choice of respondents

Since we have chosen the professions perspective to the issues identified, and measures suggested in the Green Paper, we needed to find respondents that were suitable to provide us with the information necessary to fulfill our purpose. In order to do so, we set some criteria for the respondents. These were that the respondent should be a chartered or approved accountant in Sweden, and familiar with the contents of the Green Paper's fifth section.

As step number two, we contacted a number of audit firms where we were likely to find respondents that met these criteria. These were mainly the Big Four and the largest mid-tier firms, but also some smaller firms where the partners were on Far's board or involved in one of their policy groups. Unfortunately, not all firms were able to participate.

When presenting the respondents' opinions on the different matters, we divided them into two groups; Big Four and smaller firms. In order for the respondents to have anonymity, we gave them random numbers (e.g. B1 for a Big Four respondent and S1 for a smaller firm respondent) so that the reader can follow the answers.

The respondents who participated in the study are as follows:

- Martin Gustafsson

Gustafsson is a chartered accountant and office manager at Mazars SET in Lund. He has been working in the audit industry since 1998 and at Mazars SET since 2003. He has been auditing smaller firms as well as subsidiaries of multinational corporations.

- Daniel de Paula

de Paula has been in the profession for 14 years and is a chartered accountant and Partner at Deloitte in Stockholm. He is responsible for risk management in the audits of several multinational corporations and also a member of Far's Auditing Standards Committee.

- Christer Cederblad

Cederblad is a chartered accountant and began his career at Öhrlings (now PwC) in Stockholm in the 1960's. In 1977 he started his own firm Cederblad & Co in Kristianstad. He is a member of DFK's European Executive Committee and has also been board member in Far from 1999-2007.

- Roger Molin

Molin started his career as an internal auditor at a large listed American corporation. In 2001 he started working as an auditor for Arthur Andersen in Sweden. He is now a senior manager at KPMG and coordinates the audits in listed and multinational corporations at group level.

- Claes Jörstam

Jörstam is an approved auditor and has been auditing non-listed firms at Grant Thornton for 10 years. He is also a Partner and Business Manager for Audit at the office in Gothenburg.

2.4 Interview Procedure

An interview may be conducted with different degrees of structure and formalisation. A high degree of structure means that you strictly adhere to the interview questions while a low degree is an informal conversation in which the questions are developed during the interview. We have chosen to use a semi-structured interview, which is a mix between these two. It gives us the opportunity to develop questions beforehand but still ask follow-up questions in order to deeper explore the questions and/or the answers from the interview. (Kvale & Brinkmann 2009) According to Saunders et al. (2007), semi-structured interviews are appropriate when it comes to obtaining a better understanding of the relationships between variables in explanatory studies.

The interviews have been conducted by personal meetings when given the opportunity, but two of the respondents were interviewed by phone. We preferred personal meetings as we think it will give us an improved understanding of the respondents' opinions regarding the topics that are up for discussion. If something is misunderstood during the interview, it will be easier to correct the error when sitting face to face with the respondent (Saunders et al. 2007). Before conducting the interviews, previous research in the field is studied in order to be able to make contributions in the discussions with the respondents. (ibid.)

In our study we have chosen to mention our respondents and which audit firm they work at, but in the chapter on empirical research we will not connect certain responses to certain respondents. The interviewees were announced to this approach which we believe led them to be able to answer our questions more freely.

2.4.1 Developing the interview questions

When developing the questions for the interviews we started from our research questions, the thesis purpose and the issues raised during the processing of secondary data. We believe that this method have allowed us to retrieve the information needed to answer our research questions and fulfill our purpose.

2.5 Reliability and validity

All collected data must, regardless of its source, be critically reviewed in order to investigate how reliable it is. By doing so, as well as identifying who the information is directed to, one can improve the study's validity and reliability. One should also pay careful attention to such material that others use as reference as well as materials that have been translated since the information has been interpreted by the author making the reference and the translator. (Bell 2006)

Reliability measures to what degree the data collection techniques or analysis procedures are receiving the same answers each time they are applied. When it comes to qualitative research which is based on opinions and experiences of respondents and various academics the degree of reliability is difficult to determine. (Bell 2006)

Validity is a measure of the extent to which a study measures what it intends to measure. It can also be explained as the absence of systematic measurement errors, whilst reliability is the absence of random ones. (Bell 2006)

To reinforce the validity of our study, we chose to do a literature review, a number of interviews and an analysis of a selection of the Green Paper responses. The data we present in this study were collected in order to answer our research questions and fulfill our purpose. We also developed a number of interview questions to help us obtain the necessary primary data. We recorded and transcribed all the interviews to make sure that we did not miss anything. The risky part of an interview is the actual respondent, since he or she will be crucial for our research. As we in most cases turned to the firms and not specific individuals when finding respondents it was also up to the audit firms to choose a respondent with sufficient knowledge on our area of research.

A personal interview can both increase and decrease the validity. Increase because you get fuller and more nuanced response than you could get through a survey but it also gives an opportunity for follow-up questions. Such an interview form can also provide a better understanding of the answers as the interviewer can see the body language and hear what opinions the respondent emphasise as being the most important. On the other hand validity might be decreased as the interviewer may affect the respondent and the answers given through deciding the turn of the conversation. The responses also have to be interpreted by

the interviewer; however, answers in a survey needs to be interpreted as well and could therefore not eliminate this threat to validity. (Christiansen et al. 2001)

There are also several issues to take into consideration when using semi-structured interviews. The interviewer may unintentionally affect the person being interviewed due to, for instance tone or non-verbal behaviour, which is called interviewer bias. There may also be a so called interviewee bias, which means that the person being interviewed do not answer the questions completely honestly, which will affect the validity and the reliability of the information received (Saunders et al. 2007). To come to terms with these problems we tried to let the respondent answer all questions before asking any follow-up questions. We also informed the respondents that their responses will not be identified to them as individuals; something we believe made them able to answer our questions more freely.

3 INDEPENDENCE AND AUDIT QUALITY

This chapter explains, in short, the terms audit quality and auditor independence which are used in the Green Paper as well as in the responses.

The first harmonising legislative Acts regarding auditing in the EU was the fourth and the seventh Company Law Directives making it compulsory for companies to have their annual, as well as group accounts, audited by a professional. (78/660/EEC Article 52, 83/349/EEC Article 37) In 1984 the 8th Company Law Directive on audit requirements was passed, setting minimum education and experience requirements. (84/253/EEC) In order to create credibility to the financial information the audit report needs to be objective and to be objective the auditor needs to be independent from their clients. The Directive never defined independence, causing countries to implement it different ways. As harmonisation and credibility of audits is necessary to create a single market, the Commission published a Green Paper on Audit Policy in 1996. This Green Paper introduced independence of the auditor as a key factor when performing the statutory audit. It was aimed, not only towards professionals, but also towards audit firms. (Europa 2011) It refers to the principles on independence developed by the European accounting profession, FEE. (European Commission Green Paper Article 4.8 1996) In 1998 and 2001 the FEE issued two policy

papers called Statutory Audit Independence and Objectivity, and the Conceptual Approach to Protecting Auditor Independence which set out common fundamental principles concerning the independence issues for auditors. (FEE 2011, FEE 2001)

A distinction can be made between independence in fact and independence in appearance making it equally important that users of financial statements have confidence in that independence. (Hayes et al. 2005) Independence in fact is also called independence in mind as it refers to the auditors ability to be unaffected by influences that might compromise the objective professional judgment, objectivity and integrity. (Pott et al. 2009, Flint 1988) Since independence in fact is hard to measure and observe it means that the mere suspicion of independence failure is enough to undermine confidence in the auditing profession. (Nieschwietz 2009) Independence in appearance is described as the avoidance of significant facts and/or circumstances that would reasonably cause a rational and informed third party to conclude that a firm's integrity, objectivity or professional scepticism have been compromised. (Pott et al. 2009) Research shows that the increased regulations effectively influence the users' perceptions of independence. But that it might not affect the auditors' independence in fact. (Nieschwietz 2009, Pott et al. 2009) According to Pott et al. (2009) the gap between the expectations and the actual behaviour of the auditor cannot be attributed directly to a failure of independence either in fact or appearance.

Research suggests that auditor independence decreases as the length of auditor tenure increases and the auditor becomes familiar with the client (e.g. Chen et al. 2004 and Knecheland & Vanstralen 2007). This implies a greater earnings management by the company followed by lower earnings- and audit quality (ibid.). As a means to ensure audit quality through increased auditor independence the EU and other legislators have enforced mandatory auditor rotation and hence, put a limit on the length of the auditor tenures. (Lu & Sivaramakrishnan, 2009) In contrast, other studies have found short-term tenures to decrease audit quality. According to Gul et al. (2007) first-year audits are often less thorough due to the lack of client-specific knowledge and the extensive time required identifying potential risks when performing the audit. A study by Myers et al. (2003) also found that longer audit tenures can be associated with an increase in earnings quality as these auditors place more constraints on extreme management decisions regarding financial reporting. Gul et al. (2009) examined the positive correlation between audit

tenure and audit quality, and concluded that the correlation was weaker when firms were audited by industry specialists. Industry specialists being more prone to detect irregularities and misrepresentations was identified as a possible explanation. (ibid.)

4 CONCENTRATION AND MARKET STRUCTURE

This chapter starts with the history behind the current market structure and the development of the Big Four. This is followed by the Commissions standpoint and suggestions made in the Green Paper's fifth section, concentration and market structure.

4.1 The development of the Big Four

In order to explain why the current audit market configuration is shaped the way it is one must look to history and see the events and circumstances behind the transformations. It is also useful to examine the factors that influence the audit market concentration to provide a clear view of the current conditions.

When it comes to motives for one firm to take over another firm, Berkovitch & Narayanan (1993) name three; synergy, agency and hubris. The synergy motive means that there are economic benefits to gain from the merger of two firms, this because of the combining of the firms' resources. The agency motive proposes that a takeover occurs because it increases the acquirer management's wealth at the cost of the acquirer shareholders. When it comes to hubris, it means that the acquiring firm's management is making mistakes when evaluating the takeover target, and that the merger occurs when there is no synergy. (ibid.) Lee (2005) suggests that the Big Eight mergers have assisted the merging firms in gaining market power and market share in an audit market where the presence of the merging firms is little.

From the beginning of modern audit in the United Kingdom around the year 1850, it took about 150 years for the Big Four to evolve into the dominant players of the global audit market that are seen today (House of Lords Select Committee on Economic Affairs 2011). When looking at the history of the Big Four, Ernst & Young have roots back in the 19th century. In USA, Arthur Young, born in Scotland, founds Arthur Young & Company with

his brother in 1906. Alwin C. Ernst is born in USA and founds Ernst & Ernst with his brother in 1903, and the firm changes into Ernst & Whinney in 1979. Both firms are active in the global marketplace, starting partnerships with British firms as early as 1924. Alwin C. Ernst and Arthur Young never met in life, and both died in 1948. The firms merge in 1989 and become Ernst & Young. (Ernst & Young 2011)

In 1845, William Welch Deloitte opens his accountancy office in London, United Kingdom. Deloitte accepts his first partner, Thomas Greenwood, in 1857 and the firm becomes Deloitte & Greenwood. George Touche founds his firm in London in 1898, and forms a partnership with John Ballantine Niven in 1900, creating the firm Touche, Niven & Co. As a founding partner, Nobuzo Tohmatsu starts Tohmatsu Awoki & Co. in Tokyo, Japan in 1968. Following a number of mergers during the 20th century, Deloitte Touche Tohmatsu Limited is created in 1990. The name is changed to only Deloitte in 2003. (Deloitte 2011)

KPMG is established in 1987 through the merger of Peat Marwick International and Klynveld Main Goerdeler. The K stands for Klynveld. The accounting firm Klynveld Kraayenhof & Co. is founded by Piet Klijnveld in Amsterdam, the Netherlands in 1917. The P stands for Peat. The accounting firm William Barclay Peat & Co. is founded by William Barclay Peat in London, United Kingdom in 1870. The M stands for Marwick. James Marwick and Roger Mitchell found the accounting firm Marwick, Mitchell & Co. in New York City, USA in 1897. The G stands for Goerdeler. Dr. Reinhardt Goerdeler was the chairman of Deutsche Treuhand-Gesellschaft and later chairman of KPMG. (KPMG 2011)

PricewaterhouseCoopers is founded through a merger of Price Waterhouse and Coopers & Lybrand in 1998. Both firms have roots back in 19th century United Kingdom, and became multinational by moving into the USA in the 1890s. The firms were part of the development of American auditing standards, this through the involvement of the founders in professional organizations at the time. (PwC 2011, Columbia University 2002)

The audit market exists because the owners of a firm demand monitoring of managers' activities (Sullivan 2002). Watts & Zimmerman (1983) suggested that an audit performed by someone who is independent from the manager reduces the incentive problems that come when the manager does not own all of the residual claims on the firm. Furthermore,

external audits decrease the risk of managers stealing from the firm or trying to hide poor decisions. It also implies that the value of the firm is increased by the external audit because it prevents economic losses when it comes to both managerial power abuse and legal liabilities to the firm's stakeholders who depend on the financial statements. (Sullivan 2002)

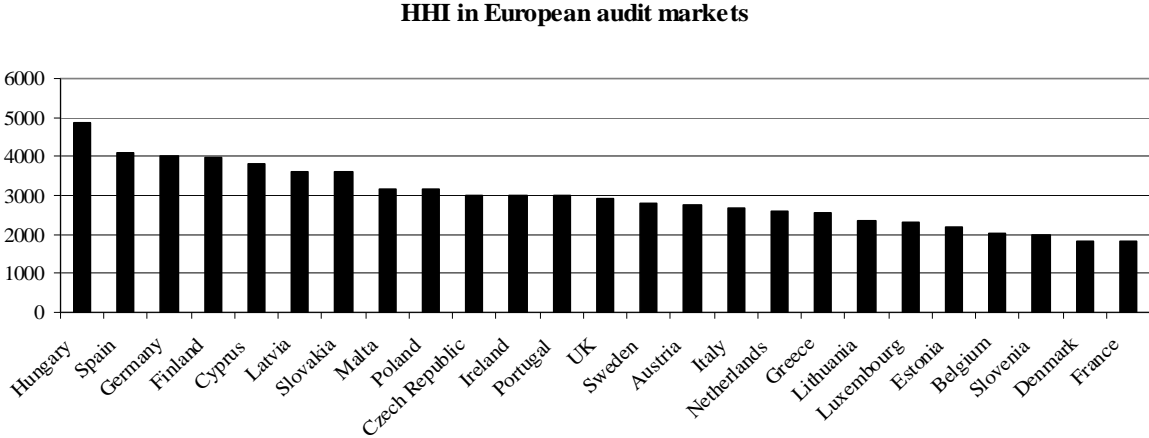
Concerns are raised when it comes to price competition as a result of high level of supplier concentration in the audit market, an issue that was given relevance by the ongoing consolidation trend of large international audit firms in the 1990s (Willekens & Achmadi 2003). In order for the audit market to have existing competition, there must be ways for the firms involved to differentiate themselves (Shockley & Holt 1983). Shockley & Holt (1983) examine the existence of differentiation between, as they were then, the Big Eight firms, and if such differentiation exists, what are its qualitative characteristics. The findings suggest that there is no absence of product differentiation in the audit market, at least not when it comes to the big eight firms. The possible characteristics of such differentiation include familiarity, industry expertise and conservatism. (ibid.) Furthermore, Dopuch & Simunic (1980) find that a relationship between a company's size and its tendency to appoint a large audit firm as independent auditor exists. This is in line with the suggestion made by Tonge & Wootton (1991) that major independent audit clients seem to favor large audit firms. Bigus & Zimmermann (2008) examine the audit market concentration in Germany, and find that there are market features that are associated with a market with few strong actors. In the market for large audit clients, which is highly concentrated in Germany, the threat of loss of reputation is less significant. In a market with a high level of competition, the loss of a firm's reputation normally results in a decreased market share. (ibid.) Furthermore, Bigus & Zimmermann (2008) raise the question if higher levels of concentration impair competition and therefore increase the audit fees or decrease the audit quality.

Doogar & Easley (1998) discuss the reasons for audit firms to merger, and conclude that in their study one factor is to increase capacity. Other reasons for audit firm mergers are to be able to defend the current market shares and to be more resistant towards price competition (ibid). Simunic (1980) states that price competition prevails in the market for public company audits, which indicates that concentration statistics alone cannot support the claim that the large audit firms are monopolizing the audit market.

4.2 Audit market concentration in Europe

A study by London Economics shows that the Big Four audit firms market shares of audit services to listed companies exceeds 90% in the EU. According to the Commission these firms have reached systemic proportions and therefore provides a systemic risk, i.e. a collapse of one of the Big Four would interrupt the services provided by the audit firms to large corporations which in turn, could lead to a collapse of an entire financial system or an entire market.

In order to display the audit market concentration in Europe, there is a report from 2007 prepared by Oxera for DG Internal Market and Services, where the Herfindahl-Hirschman Index (HHI) is used to quantify the concentration. This measure is calculated by squaring the market share of each firm that is competing in the market and then summarizing the resulting numbers (US Department of Justice 2011). The HHI Index ranges from 0, many market participants with low market shares, to 10000 which is monopoly. A HHI value that is over 1800 indicates that the market is highly concentrated. The audit market concentration has increased over time, mainly because of mergers which led to the Big Five; Ernst & Young, Deloitte, KPMG, PricewaterhouseCoopers and Arthur Andersen. After the fall of Andersen in 2002, only a Big Four remained. (Oxera 2007)



Source: Oxera (2007)

When analysing the table above, it should be noticed that it refers to the audit markets for companies in main indexes on main national stock exchanges.

4.3 The Green Paper

The Commission believes that the Big Four audit firms have grown so large that they have taken on systemic importance. Consequently, the market concentration is of systemic risk which, in turn, poses a threat towards financial stability. The Commission therefore seeks to initiate a discussion on how to avoid that any one company becomes so important that moral hazard comes into play. (The Green Paper)

One reason behind the market concentration identified in the Green Paper is "Big Four only clauses", e.g. banks have loan covenants requiring a Big Four audit in order to approve the loan or maintain a lower interest rate. Another reason identified is a general "Big Four bias" where Big Four audits are associated with higher audit quality, creating large entry barriers for mid-tier audit firms and a lack of dynamism in the market. The Commission considers several measures to reduce this concentration: (ibid.)

- Joint audits / Audit consortia; the Commission wonders if a requirement on listed companies to appoint two different audit firms, of which at least one is non-big, to perform the audit could help improve the dynamism in the market as well as reducing the risk of disruption in the audit market if one of the Big Four would collapse.
- Mandatory rotation of auditors and re-tendering; the Commission suggests that mandatory audit firm rotation could help improve market dynamism and auditor independence.
- Addressing the Big Four bias; the Commission wishes to address "Big Four only clauses" and perhaps perform studies to understand how much of the bias that relates to perceptions and/or merits.
- Contingency plans; could be used in the systemic audit firms to ensure financial stability.
- Reassessment of the drivers of previous consolidation; investigate to what extent the consolidation of the larger firms delivered the innovation in audit methodology that was expected of them. Is the broader rationale behind the consolidations still valid or should the consolidation of the past decades be reversed?

5 RESPONSES TO THE GREEN PAPER

This chapter is dedicated to responses to the measures brought up to debate in the Green Paper's fifth section, concentration and market structure. These are; audit consortia, mandatory rotation, addressing Big Four bias, contingency plans, and reassessment of previous Big Four consolidations. At the end of each subchapter is a section on the studies made regarding the pros and cons regarding these different measures.

The Commission received a total of 688 responses to the Green Paper, 87 % of these came from individual Member States (where German, UK and French responses represented more than the majority of the total number of responses), 3 per cent came from EU-wide interests. The remaining 10 per cent came from international interests and countries outside of the EU, illustrating the global nature and importance of audit services. (European Commission summary 2011, Lambe 2011) The responses represented the opinions of the profession, investors, academics, preparers and public authorities. Not surprisingly, 59 per cent of the responses came from the profession although some 200 of these responses came from small and medium sized German audit firms and were identical in content. 21 per cent came from the preparers and 8,3, 4 and 3,2 per cent came from public authorities, academics and users respectively. The Commission have prepared a summary of these responses, attempting to provide an overview of the content of the responses based on the different interest groups. (European Commission summary 2011)

5.1 Systemic risk

According to the Commission's own summary, the professional bodies and the Big Four audit firms generally disagree with the Commission regarding market concentration posing a systemic risk. Far requests a further definition of the term systemic as several of the arguments put forward in the Green Paper place great emphasis on a distinction between systemic risk firms and non-systemic risk firms. Far, ACCA and FEE all write that the concept of systemic risk in financial institutions cannot be used in regards to audit firms as these two sectors serve different purposes with a public interest dimension. (ACCA 2010, Far 2010, FEE 2010) This fact was also enlightened by La Via, CFO of the World Bank Group, at the Commission's financial reporting and auditing conference regarding the Green Paper in Brussels February 9-10, 2011. La Via (2011) stated that the fact that some

audit firms are large is not evidence that one firm's disappearance could have consequences significant enough to have a systemic impact on the market. Similarly, IFAC (2011) requires more empirical research to support the Commission's statement on systemic risk.

FEE (2010) and ACCA (2010) replies that in case of a failure, the audit market has already demonstrated its capacity to reorganise and absorb the human capital from other firms. Power (2011), professor of accounting at London School of Economics and Political Science, also expressed his scepticism over systemic risk and "too big to fail" at the Commission conference. He also stated that "there was no market failure" due to the collapse of Arthur Andersen. (Feb. 9 4.15 pm.) Entities may, as a result of a big firm withdraw, experience some delay in filing their financial statements but would not suffer collateral damage or risk their survival. Due to that there is no need for government interventions in the audit market structure. (FEE 2010) In the conference's closing speech, Faull, the Commission Director General for internal market and services, responded to this saying that "of course risk in the audit sector is not the same as in the banking sector. But is that really the point?" Faull indicated that the audit sector bares a risk nonetheless, and that this risk should be addressed. (Faull 2011)

The Big Four say that the failure of one or more big audit firms could cause a temporary disruption but that this risk could be reduced through addressing the lack of legal liability limitations. The mid-tier firms and the SMPs on the other hand do consider the current structure of the audit market to pose a risk to market stability. But even the mid-tier firms recognise legal liability issues as the main reason for the collapse of one of the Big Four. (European Commission summary 2011, Grant Thornton 2010, BDO 2010, RSM 2010, Mazars 2010, Joint Statement 2011)

Grant Thornton went on to say that the choice between the Big Four audit firms are often less than four as one or more of these firms may provide non audit services and, hence, not be eligible to perform audits. Grant Thornton also writes in their response that the Big Four are systemic and that a collapse of one of them would lead to a significant short term market disruption. The mid-tier firms also identifies long term problems which would leave the European market with reduced price competition and reduced incentives to maintain audit quality. (ibid.) BDO does not regard the Big Four audit firms as systemic in the same sense as one would with large financial institutions. But they do, however, state

that serious issues will arise with the withdrawal of one of these firms and that they believe that there are moral hazard problems associated with the perception of the Big Four as being 'too big to fail'. RSM considers the creation of a more vibrant and diversified market for audit services a key area to enhance the societal role of audit. (BDO 2010, Grant Thornton 2010, RSM 2010)

The responses also provide a general criticism about the timing of the Green Paper. Many say that the Statutory Audit Directive from 2006 brought on many changes for auditors, changes that had not yet been implemented in the Member States before the financial crisis hit. The Commission should therefore let the Directive be fully operational for a longer period of time before bringing on policy proposals in areas covered by that Directive as regulatory changes do not immediately induce behavioural change and impact market structures. (e.g. BDO 2010 and FEE 2010)

In the following sections, we will look at some of the professions responses regarding the measures against the concentration and market structure suggested by the Commission, as well as existing research on the topic.

5.2 Joint audits / audit consortia

The Commission discusses making joint audits mandatory for listed companies and then further develop the system into something referred to as audit consortia. In joint audits the audited companies are required to assign two auditors to share the audit work and jointly sign the audit report. An audit consortium would have a similar approach but require the companies to assign at least one non-systemic audit firm. The Commission sees this as an opportunity for SMPs to participate more in the large audit segment and thereby act as “a catalyst for dynamising the audit market”. The Commission also considers this concept of audit consortia to be one way of mitigating disruption in the audit market if one of the large audit networks would fail.

In the Green Paper a reference is made to France, which is the only country in the EU with enforced joint audits. According to a market survey regarding the audit market

concentration in the G8³ countries, the Big Four performed an average of 91 per cent of the public company audits. In France the concentration was 61 per cent and the joint audit requirements appeared to be the explanation. (Hanney 2007) This means that the Big Four dominance is smaller in France but it remains nonetheless, and in many cases the audit firms involved are both large global networks. However, the French mandatory joint audit only applies to audits on group accounts and there are no requirements regarding audit firm size. (Francis et al. 2006)

5.2.1 Professional bodies

The majority of the professional bodies require a description of the concept of audit firm consortium as the Green Paper is unclear about how such a regulation could function. (European Commission summary 2011) ACCA (2010) believes that the introduction of joint audits or audit firm consortia could help dynamise the audit market, but emphasize that both firms has to take full responsibility for the audit opinion. However, they question that such a change would improve audit quality and whether the audit market would benefit from increased presence from SMPs as it could cause tension between rival firms, and, in turn, increase cost and bureaucracy. (ibid.) It is also questioned whether it benefits the SMPs as the mid-tier firms to be allocated auditors on the basis of the quotas, or if it would benefit them more to qualify on their own merits. It might also be a practical problem to find smaller firms with the necessary experience in some of the Member States. (Far 2010) Due to this the professional bodies want the Commission to further explain how a possible consortium could function. They also require the Commission to undertake tests regarding consortiums impact on several accounts before enforcing such a demand. These tests should assess how such consortiums would affect audit quality, liabilities, the balance of costs and benefits, whether it is compatible with existing the legal, regulatory and economic systems in the Member States, and other potential negative consequences. It is pointed out that current evidence points to a mixed record of effectiveness in different jurisdictions. (ACCA 2010, Far 2010, FEE 2010, IFAC 2010)

Overall the professional bodies thinks that the decision to use joint audits and audit firm consortia should be left to market as the companies themselves and/or national regulators are closer to market circumstances and local cultures. It is suggested that it might be a

³ A forum for eighth of the world's largest economies; Canada, France, Germany, Italy, Japan, Russia, United Kingdom, USA. The EU is also represented but cannot host the meetings.

better alternative to create more incentives for smaller firms to expose themselves to the potential liability a consortium or joint audit can bring, and with that also overlook the legal liability systems that exists in some Member States. The responses also point out that having more than one statutory auditor is currently an option in EU Member States according to the Directive on Statutory Audit. The Directive demands the different audit firms involved to retain sole responsibility for the audit. However, no EU Member State regulator has decided to make audit firm consortiums mandatory, nor have any companies within the EU chosen to use it. Regarding joint audits, there has been little use of this option outside of France and FEE recognises the practical, organisational and legal issues it creates as the reason. (ACCA 2010, Far 2010, FEE 2010, IFAC 2010)

5.2.2 The Big Four

As the Big Four do not consider themselves as systemic they see no justification for regulatory intervention to artificially change the market, and all oppose the idea of joint audits and audit consortia. Deloitte and KPMG also reply that the concept of consortium and the impact it will have is not clear and requires further explanation on what is envisaged by audit consortia. The efficiency of the French joint audits was also discussed in the responses. The market concentration has found to be significantly lower in some studies (e.g. Hanney 2007) but KPMG refers to an analysis of audit firms of the large listed firms in France called the French CAC 40 which shows that it has enabled a fifth firm to develop as the “other” firm in a joint audit arrangement, but that market concentration remains high. KPMG therefore believes that, absent the requirement to include such a “non-systemic” firm, joint audits *per se* would not achieve the Commission’s objective. PwC on the other hand, believes that even a mandatory formation involving the use of small and medium sized audit firms for part of the audit of listed companies will not provide a solution to market concentration. (Deloitte 2010, Ernst & Young 2010, KPMG 2010, PwC 2010)

As the concept of audit consortia is so vaguely defined, KPMG has presumed that it goes beyond purely joint audits, possibly at a divisional or subsidiary level, something that would raise concerns about audit quality. The other Big Four firms also question how consortiums would affect audit quality and the ability for smaller firms to serve as the principal auditor for the largest global companies. Most importantly, the Big Four thinks that mandating joint audits would mean that the shareholder, the board or the audit

committee, will not remain free to appoint the auditor that is appropriate for the needs of their enterprise. (ibid.)

Like the professional bodies, the Big Four also believe that the choice appointing a joint audit should be left up to the shareholders as it might otherwise reduce stakeholder confidence in the audit. PwC expresses it as “mandatory arrangements of any sort are not right in principle because they interfere with good corporate governance.” The Big Four also point out that current regulation allows shareholders to appoint joint auditors if they wish, and the fact that they choose not to do so demonstrates that there are significant disadvantages and a general disbelief that such arrangements provide shareholders with either improved audit quality or value. Ernst & Young points out that it is even rarer that a company appoints one large and one small firm to jointly perform the audit as smaller firms would have to make a substantial investment in resources and expertise to be able to audit the largest global companies. According to the experiences of KPMG most joint audits are used temporary after a merger, until the shareholders have decided on a single audit firm. (ibid.)

KPMG and PwC also refers to the companies Deutsche Telekom, BHP Billiton, Ericsson and Shell where the shareholders have chosen to move from a joint audit arrangement to a sole audit relationship fairly recent, to Denmark that abolished it a few years ago and to the failure of BCCI and Parmalat. The decrease in the use of joint audits they say, demonstrates the significant concerns that audit committees and the market generally have regarding its quality and effectiveness. The reasons for this are that the smaller firms might lack the depth and breadth of expertise and resources to perform such an audit, and the fundamental impact it has on the ability of the group auditor to coordinate the audit. Joint auditors must divide the work between them and then attempt to rely on each other’s work, even though their methodologies may be different. Dividing responsibilities between two firms could cause difficulties in obtaining an overall understanding of the entity and to supervise audit work. There are also inevitable costs of duplication and risks of gaps as two firms consider the issues. (Ernst & Young 2010, KPMG 2010, PwC 2010) Another reason is the risk of intense competition between the joint auditors towards the end of the mandate, and management recognising that seeking agreement to judgements and policies that might be rejected under other circumstances. (PwC 2010) It could also introduce a risk of an audit firm facing liability for the actions of its joint partner. Deloitte (2010) and

KPMG (2010) writes that an artificial attribution for larger audits to smaller firms could risk becoming a disincentive to them to grow as many of them do not want, and could not in practice, bear the liability exposure of the group audit of a major entity.

5.2.3 Mid-tiers

Contrary to the Big Four and the professional bodies, the mid tier firms and SMPs support joint audit and consortia where at least one non-systemic firm is included. (European Commission summary 2011)

It is Grant Thornton's (2010) and Mazars opinion that the French model of joint audits could be an appropriate arrangement and that in time it could increase the mid-tiers credibility and lead to more firms with a meaningful share of the large company audit market. It could also make large companies less prone to disruption in the event of unplanned exit from the audit market by one of the four dominant firms. (Grant Thornton 2010, BDO 2010, Mazars 2010, RSM 2010). A reference is again made to France where the market concentration is lower. (ibid.) BDO (2010) is a bit more cautious in their response saying that mandating audit firm consortia or joint audits should, depending on the arrangement, increase the likelihood of firms outside the four dominant firms, being able to participate in the audit of large listed companies. They recognise that this would take some time to achieve and would depend on the nature of the arrangements. (ibid.) Similar to FAR (2010), BDO thinks that there is a concern that a proposal based on a consortium including a smaller non-systemic firm on the basis of quotas could result in a 'second-class' status, Even if they in fact are capable of handling all but the largest audits in their own right. Consequently, this kind of arrangement would impose a ceiling on the ambitions of these firms which could further secure the dominance of the four largest firms. A joint audit could help dynamise the market but it is important to consider such a proposal carefully to ensure the full and active participation of both firms in the joint audit. To achieve this they propose that over time, the audit fees should be shared equally.

However, Grant Thornton (2010) recognizes that a mandatory joint audit would not enjoy widespread support from investors or companies elsewhere in Europe. They suggest that there should instead be a regulatory code of conduct promoting the wider use of firms outside the four largest firms. Contrary to the BDO, Grant suggests that a first instance could be the appointment of smaller firms as auditors of Thornton subsidiaries of large

public companies. Subsequent instances should make sure that consortia address the problem of concentration. (ibid).

5.2.4 Other studies and standpoints

There are a number of studies regarding the benefits and drawbacks of joint audits. In their responses, many professionals have highlighted that a joint audit can impact the communication and credibility between the company and its auditors, and consequently decrease the level of audit quality. They have also argued that and that the increased audit costs can sometimes exceed more than the added value from a joint audit. However, Francis et al. (2006) studied the requirements on joint audits and concluded that audit fees are not higher in France than in other Member States. Sufficient evidence on whether the joint audit affected audit quality was not found.

Holm & Thinggaard (2010) studied the Danish market where the requirement of joint audits was abolished in 2005, aiming to identify perceived and observed net benefits, as well as consequences and implications when going to a voluntary joint audit regime. They found that most companies decided to use a single auditor when given the opportunity, as they perceived joint audits as an administrative and financial burden that did not necessarily result in benefits such as increased audit quality. Unlike Francis study on the French joint audit requirements, Holm & Thinggaard (2010) found that the cost cut when moving to a single audit was around 25 per cent. Possibly this could be explained by initial price cuts as a result of the increased competition, but it can also be an indication of efficiency gains. The researchers found nothing to indicate a decrease in audit quality as a result of the abolishment. (ibid.) In their response to the Green Paper, IFAC (2010) points out that the requirement for joint audits in Denmark originated in an audit market where the existing firms were small and lacked sufficient knowledge to carry out an audit on large and complex companies. With the establishment of the big audit firms, joint audits were no longer necessary.

There are also those who think joint audits would increase the increase the likelihood of fraud or enable companies to play one auditor against another in the board room, and historically joint audits have created opportunity for abuse (Christodoulou 2010a, 2010b). Parmalat, the Italian dairy company, filed for bankruptcy in December 2003 after falsifying transactions through a subsidiary's books. Grant Thornton was Parmalat's main auditor until Italy passed new laws requiring mandatory auditor rotations. Deloitte & Touche was

hired as a new main auditor for group accounts but Grant Thornton continued to audit some of the subsidiaries. At this time Italian law also allowed the main auditor to rely on a secondary auditor's work, meaning that Deloitte was not required to check Grant Thornton's work and, consequently, was not responsible for its accuracy. Through this joint venture arrangement Parmalat could decide which units would be handled by Grant Thornton and Deloitte respectively, allowing them to organise a fraud that was difficult for the auditors to detect. (Buchanan & Yang 2005) As they did not both take full responsibility when formulating an opinion on the group accounts it has been argued that it did not make out a true joint audit and that joint audit was used as a convenient scapegoat. (Herbinet 2007) However this arrangement is close to what Grant Thornton (2010) suggested as a first instance for the appointment of smaller firms as auditors of large public companies.

Bank of Credit and Commerce International (BCCI) is another example of a joint audit system being used for fraud. PwC (then Price Waterhouse) were the accountants for BCCI Overseas, while Ernst & Young (then Ernst & Whinney) audited BCCI and BCCI Holding based in London and Luxembourg. The system was used to launder drug money, illegally gaining controlling interest in a major American bank and funding criminals and dictators along with various other financial crimes. After suspicion was raised, the bank regulator in Luxembourg required that BCCI change to a single auditor. BCCI's illegal activities unravelled and the bank was abandoned by investors and business partners and several executives were arrested. PwC and Ernst & Young were both sued for negligence. (Hall 1992, Hall 1993)

At the Commission's financial reporting and auditing conference regarding the Green Paper the panellists agreed that something must be done, but generally agreed that joint audits was not the way forward. Røder (Feb 10 3.15 pm.), Secretary General of the Nordic Federation of Public Accountants said that joint audits should be dismissed as a way to address market concentration. When Mouillon (Feb 10 12.25 pm.), Global Vice Chair Assurance at Ernst & Young, was asked to give his opinion on joint audits and responded that "there are more cons than pros for joint audits from my experience." Mouillon also said that he does not see joint audits reducing market concentration; instead it can turn firms against one another. (ibid.) De Cambourg (2011), Chairman and CEO of Mazars was

the exception, saying that the problems with joint audits are less worrying than market concentration.

5.3 Mandatory rotation of auditors and re-tendering

In the Green Paper, the action of mandatory rotation of audit firms as a means to enhance audit quality is taken up for discussion. It is suggested that the appointment of the same audit firm for a longer period of time is incompatible with auditor independence, and should therefore be avoided. The Green Paper also states that even if “key audit partners” are being rotated, the threat against auditor independence remains. The potential loss of knowledge because of a rotation is acknowledged by the Commission; however, they think that advantages can be gained when it comes to objectivity and dynamism in the audit market.

5.3.1 Professional bodies

The comments on the matter of mandatory rotation of audit firms presented in the Green Paper vary among the organisations that have submitted them. ACCA does not support the use of mandatory rotation of audit firms, and is instead referring to rotation of key audit partners as a means to reduce the threat of familiarity to auditor independence. A similar answer is submitted by IFAC, in which it is stated that audit engagements should not be subjected to time limits. IFAC also states that mandatory audit firm rotations can have an effect that decrease audit quality rather than increase it. FEE concludes that the effect of the rotations on the market concentration will not meet the expectations set out, and that they will generate more costs and risks than benefits. Far states that the idea of mandatory audit firm rotations may seem like an appropriate way of enhancing auditor independence at first, but that there are effects from the recently implemented Statutory Audit Directive that may not be visible at this early point. (ACCA 2010, Far 2010, FEE 2010, IFAC 2010)

5.3.2 The Big Four

The Big Four oppose mandatory audit firm rotations. PwC believes that they undermine audit quality and states that the appointment of auditors should be market led and that the current standards effectively reduce the threat of familiarity. Deloitte comments that the company is against mandatory audit firm rotations, partly because those are costly and difficult to implement for multinational companies. Ernst & Young and KPMG refers to

research conducted at the Bocconi University in Italy and states that the Italian audit market is one of the most concentrated in Europe because of mandatory audit firm rotation, indicating that it could have the opposite effect of the Commission's intentions. This is motivated by the belief that the rotations might only occur between Big Four firms, and therefore making it harder for non-Big Four firms to increase their market shares. Another reason for being sceptical towards mandatory audit firm rotation is, according to Ernst & Young, that such a measure removes decision-making from the corporate governance system. (PwC 2010, Deloitte 2010, Ernst & Young 2010, KPMG 2010)

5.3.3 The mid-tiers

The reviewed comments from the mid-tier firms are opposed to the measure of mandatory audit firm rotation. Grant Thornton believes that mandatory audit firm rotation may have the opposite effect on market concentration from the intended one. Because of the Big Four bias. BDO states that they are opposed to mandatory audit firm rotation, and uses the study on the Italian market conducted at the Bocconi University as an argument. In BDO's opinion, the risk of increased market concentration because of audit firm rotation is imminent. Mazars is also negative towards mandatory audit firm rotation, and states that the rotation of audit partner is already sufficient when it comes to enhancing auditor independence. RSM International believes that mandatory audit firm rotation may cause an increase in the market concentration, and states that the rotation of audit partner is an adequate measure. (Grant Thornton 2010, BDO 2010, Mazars 2010, RSM 2010)

5.3.4 Other studies and standpoints

Arel et al. (2005) discuss the introduction of rotation of audit firms in light of accounting scandals such as Enron and WorldCom. One reason for an introduction is the degree of familiarity that can develop from a long-term relationship between a client and an audit firm. Such relationship poses a threat to auditor independence, and the example of Enron and Andersen may be used. Andersen was Enron's audit firm from the 1980s until the scandal was revealed in 2001, which led to a problematic relationship because of the familiarity that evolved over time (Byrnes et al. 2002). This kind of relationship is supposed to be prevented by mandatory rotations of audit firms. Arel et al. (2005) discuss another reason for introducing audit firm rotations, which is that an auditor over time may see the audit as a repetition of last year's work. This can lead to a tendency to anticipate results of the audit process rather than being watchful of circumstances that have changed since the last audit was performed. Chi & Huang (2005) find that the quality of earnings

becomes lower with longer audit firm tenures, and also conclude that the breakpoint of positive and negative effects of familiarity is at around five years.

When it comes to arguments against mandatory rotation of audit firms, there is for instance the need for personal interactions with the management in the audit process. Arel et al. (2005) suggest that even if the auditor is replaced, the new auditor must still work closely with management during the audit. Auditors from the new firm has to go through a process where they get to know the management of the company, a relationship between auditor and client that is important from a knowledge sharing perspective. Another reason for not introducing mandatory rotation of audit firms is presented in a report issued by the US GAO in 2003. Those who oppose the idea mean that the costs of such rotations outweigh the benefits gained from them, and that the risks for audit failures are increased because of lack of knowledge of the audited companies (US General Accounting Office 2003b). In a survey conducted by Cameran et al. (2003), it is suggested that rotating single audit partners is preferred over the rotation of audit firms.

In order to ensure audit quality through increased auditor independence, numerous legislators have enforced mandatory audit firm rotation and hence, limiting the length of the auditor tenures (Lu & Sivaramakrishnan, 2009). Other studies suggest that short-term tenures cause audit quality decrease. According to Gul et al. (2007), first-year audits are often less thorough due to the lack of client-specific knowledge and the extensive time required identifying potential risks when performing the audit.

Myers et al. (2003) found that longer audit tenures can be connected to an increase in earnings quality, this because these auditors place more limitations on extreme management decisions regarding financial reporting. Geiger & Raghunandan (2002) propose low-balling, i.e. the initial audit fee is set lower than the cost to perform the audit, as one reason for new auditors being less aggressive. The low pricing creates an incentive for the audit firm to reduce costs in their oversight of management in order to recoup losses. However, Kaplan & Mauldin (2008) found that audit firm rotations, despite of risks of low-balling, do not impair auditor independence.

5.4 Addressing the Big Four bias

The Green Paper has identified that there is a higher level of “comfort” among the larger firms to appoint a Big Four auditor. The Commission would like to assess how much of this “comfort” that is attributable to "perceptions" and how much to "merit". The Commission uses the UK system as an example, where the Professional Oversight Board of the FRC makes such assessments facilitated by transparent reporting of audit inspections of the Big Four as well as smaller firms. (Green Paper) These reports include the principle findings from the inspections of a selection of the firms audit engagements as well as a follow-up of the audits reviews in the previous year and a review of the firms’ policies and procedures supporting audit quality. Examples of policies and procedures covered are transparency reports, ethics and independence, client risk assessment, consultation and review, and audit methodology, training and guidance. (e.g. FRC 2010a and 2010b) The information helps stakeholders and audit committees assessing their external auditor and identifies a number of important areas in which the firms need to further improve audit quality. (FRC 2011) The 2009/10 inspection of the Big Four found a lack of consistency in the procedures and insufficient professional scepticism regarding some audit judgments. The report on smaller firms showed a lower audit quality, especially in their audits of multi-national groups. (FRC 2010c)

Additionally, the Commission wants to address the issue of contractual clauses informally referred to as "Big Four only clauses" which locks out smaller firms from big audits, an issue highlighted by Christodoulou (2010c) in an article in the Accounting Age. According to the article, these covenants have been common in the US but a rare sight in the European bank agreements. In May 2010 the Big Four, Grant Thornton and BDO officially acknowledged the existence of restrictive covenants in the UK through a joint submission to the Organisation for Economic Co-operation and Development. Smaller audit firms claim that the covenants stifle competition in the audit market and would limit companies from appointing a non-Big Four replacement if one of these firms withdrew from the market. Consequently, companies’ could fail to meet listing requirements. (ibid.)

The creation of a European quality certification for audit firms which would formally recognise their aptitude to perform audits of large listed companies is, together with a prohibition of “Big Four only clauses”, suggested by the Commission as possible approaches to deal with this issue.

5.4.1 Professional bodies

ACCA responds that they support and contribute to a greater participation in the listed audit market by non-Big Four firms but that measures taken in UK to facilitate such a development has not had any significant impact on the market. The reason they identify is the lack of drive from investors and audit committees towards change in this area, also, there is no view that systemic risk can or should be addressed by individual companies. Consequently, ACCA believes that the issue of audit market concentration should be left to the capital markets and point out that direct regulator intervention in the market simply poses too large a risk with unintended consequences. This is also the standpoint taken by Far, although they question whether the market domination in the listed and multinational segment should be attributed to Big Four bias as they in most cases are the only ones with the capacity to perform these audits. ACCA also thinks that there are enough incentives on today's audit market for firms to offer a high audit quality, e.g. their reputation and risk of a business collapse. Instead, regulators should develop contingency plans to address any potential consequences of one or more of the Big Four firms withdrawing from the audit market. Another suggestion is requiring audit committees to make these contingency plans through proactively considering the company's response if its auditor was to suddenly withdraw from the market. (ACCA 2010, Far 2010)

There is no direct support for the introduction of a European quality certification for audit firms. FEE responds that before making such an introduction, experiences from certain jurisdictions where a similar concept has been tried should be taken into account as it may present certain benefits, but at the same time create additional barriers to market entry. Additionally, FEE suggests that more harmonised external audit quality assurance reviews and public oversight should applied to all firms in a proportionate manner. The adoption of ISAs for all audits and auditors is another way to reduce the bias. (FEE 2010)

ACCA and FEE support a mandatory disclosure regarding legal, regulatory or contractual constraints on the engagement of smaller firms, and possibly a removal by law. Far does too, providing that such a bias and actions violating competition regulations actually exists. Far also requests that the Commission focus on lowering barriers for other companies to enter the large enterprise market. The professional bodies call for increased transparency about the length of tenure of the audit firm and the engagement partner and their criteria for selection of auditor. Perhaps the process of appointing the auditor and audit tendering

could be carried out through a formal process open to all audit firms capable of meeting the selection criteria. (ACCA 2010, Far 2010)

IFAC suggests measures to create an environment allowing for broader participation beyond the Big Four without a regulatory intervention. These are that regulators should stop correlating size and audit quality in its debates, start with public awareness initiatives about the smaller firms capacity, and encourage audit committees to widen their criteria when making their selection of audit firms (IFAC 2010)

5.4.2 The Big Four

The Big Four point out that reputation is built-up through consistent high quality performance over a long period of time and that it is not the only reason for the market dominance. Instead the so called bias is a result of market preference and reflects the capability, capacity and breadth of these networks. It is also a result of independence requirements and the exposure to most Member States unlimited liability combined with very little professional insurance availability. All these things create extensive entry barriers to the large audit segment, something the Big Four believe should be addressed prior to an intervention in the existing competition. Although, they do agree that artificial bias in form of “Big Four only clauses” should be discouraged, either through corporate governance codes or through inclusion in other market or governance rules to which listed or regulated companies has to apply. (KPMG 2010, Deloitte 2010, Ernst & Young 2010, PwC 2010)

Additionally, the Big Four all support audit oversight regulators considering the publication of inspection results of all audit firms above a certain size. If the quality of the audit work of smaller firms is good, that fact should be disclosed to the general public. KPMG respond that they would welcome more transparency on whether there is a difference in quality between the large audit firms and the rest and that such evidence should be readily available from the independent audit regulators. Additionally, they say that such a system should provide the inspector with the opportunity to continue the communication with firms confidentially about certain areas of their inspections. Ernst & Young also suggests the creation of more incentives for smaller firms to invest in establishing a greater breadth and global scale to meet the needs of the market they wish to serve. (ibid.)

Deloitte is the only firm that gives a direct response regarding the Commission's idea of exploring the creation of a European quality certification for audit firms apt to perform audits of large listed companies. They believe that it could be a helpful tool for smaller firms and that it is something the Commission should consider further. (Deloitte 2010)

5.4.3 The mid-tiers

The mid-tiers are all for a prohibition of Big Four only clauses and a more fair and transparent tendering process. They also agree that European regulators are behind some of this bias and therefore need to start communicating the capabilities of smaller firms. However, none of the mid-tier mentions audit inspection reports as a possible solution. (BDO 2010, Mazars 2010, Grant Thornton 2010, RSM 2010)

They also agree that a regulatory approval should be required for further Big Four acquisitions and that a system limiting auditor liability should be developed at a European level. Additionally, they mention that audit consortia could be used as a measure for decreasing Big Four bias as well. (ibid.) The only mid-tier that mentions more incentives and encouragements for smaller firms to invest and grow is Mazars.

5.4.4 Other studies and standpoints

There are some studies (e.g. Niemi 2004 and Boone et al. 2010) that advocate the use of smaller auditing firms and concludes that the audit quality provided by mid-tier firms is compatible with the one provided by the Big Four. However, most research available to date (e.g. DeAngelo 1981, Bewley et al. 2008, Hunt & Lulseged 2007 and Craswell et al. 2002) have found a substantial amount of evidence indicating that the Big Four provide higher audit quality. For this reason there is little research on how to address a potential bias. The difference in quality is explained by better trained employees and access to more advanced technology resulting in a greater possibility of detecting errors and irregularities (ibid.). The big audit firms are also less dependent on a single client and subject to a higher level of scrutiny and risk of litigation costs, creating incentives to provide the market with a high level of audit quality (ibid.). As a result management prefers to appoint Big Four auditors to signal management credibility (Sundgren 2009).

At the Commission's financial reporting and auditing conference in February, La Via (2011) stated that there is an obvious pro-major-firm bias at work in the market. Although La Via does not think this bias relates to the level of audit quality *per se* as regulators and

oversight bodies ensure that all licensed auditors and audit firms live up to the standards expected of them. Instead, he believes it is due to the perception that only the Big Four can serve certain market segments because of their geographical capabilities and technical resources. Additionally, La Via states that the mid-tier firms have not seemed willing to make the investment required to match the capabilities of the major networks. Perhaps the risk/reward ratio is not attractive enough to create incentives to grow. Incentives for growth were requested by Nusbaum at the same conference, but it was also added that such incentives need to be accompanied with a willingness amongst the profession to change in order to work. (Nusbaum 2011b Feb 10 4:55 pm.) De Cambourg and Nusbaum both emphasised that the Commission should increase the transparency of the audit tendering. De Cambourg also mentioned the prohibition of restrictive contractual clauses and a strict and global control over possible further Big Four consolidations as measures worth discussing further.

5.5 Contingency plans

In the Green Paper, it is stated that the Commission will work with Member States, audit firms and other stakeholders to discuss a contingency plan. This is done in order to prepare a speedy resolution in the event of the fall of one of the so called systemic firms, and by this avoid disturbance of the audit market. The Green Paper also discusses the creation of audit firm groups, where one member firm would be ready to overtake the audit assignments if another member firm that has fallen. This arrangement shall continue until a permanent resolution of the situation has been found. Another similar concept is being discussed, living wills, where there is an audit firm ready to overtake the audits of an audit firm that has demised.

5.5.1 Professional bodies

When it comes to the audit market concentration, ACCA believes that it should be determined by the capital markets, and that regulators instead should focus on developing contingency plans in the event of a withdrawal of one of the Big Four firms. Such contingency plan should be prepared through cooperation between capital market and audit regulators. In ACCA's opinion, the concept of living wills is not relevant in the same way to auditors as it is to financial institutions. Even though IFAC is not convinced that the audit market configuration poses a systemic risk, there is value in considering contingency

planning. However, increased communications would probably be equally effective according to IFAC. IFAC also states that if such contingency plan would be developed, it should be transparent when it comes to the actors, institutions and directives involved in it. In addition, IFAC believes that there should be conducted further research on the area, and that a contingency plan can impede the market dynamics that the Commission seeks. A contingency plan could replace the market force when it comes to the selection of audit firm, and therefore have a negative effect to the desire to involve suppliers of different sizes in the audit market. (ACCA 2010, IFAC 2010)

When it comes to contingency plans, FEE agrees that they can be of assistance in the event of the market exit of one of the major audit firms. FEE believes that living wills are more difficult to develop compared to contingency plans, this because they would have to be arranged by each audit firm in each jurisdiction in order to have validity in different national legal frameworks. FEE concludes that living wills are considered to be both unnecessary and impractical. Far shares the view of the use of the concept systemic with FEE, and believes that there is a need for clarification on the matter. Far supports further discussions on contingency plans, which in their opinion may be useful when preventing or covering the exit of an audit firm. According to Far, living wills do not seem to be appropriate when it comes to audit firms. Living wills are debated in the bank sector with the aim of reducing or eliminating governmental bail-outs, while such bail-outs are not included in today's discussion on audit firms. (FEE 2010, Far 2010)

5.5.2 The Big Four

Ernst & Young support further discussions surrounding contingency plans, while they do not support the idea of living wills for audit firms, which they believe is more relevant in the bank sector. This view on living wills is shared by Deloitte, KPMG and PwC. KPMG adds that the financial sector has experienced difficulties in making such measures as living wills effective across borders. PwC believes that contingency plans deserve consideration, and that the development of such plans depends on the identification of risks. KPMG seeks more preventive measures against audit firm failures rather than measures to counter such failures. Deloitte is positive towards the consideration of contingency plans, and states that they could be discussed between regulators and audit firms on an individual basis. (PwC 2010, Deloitte 2010, Ernst & Young 2010, KPMG 2010)

5.5.3 The mid-tiers

Grant Thornton supports discussions on contingency plans, but adds that living wills will not prevent audit firm failures. BDO sees the current market concentration as unhealthy, and believes that more choice in the audit market is a necessity. BDO also supports further discussions on contingency plans, but are opposed to such plans that would protect systemic firms while allowing non-systemic firms to collapse. Mazars states that the market concentration of today leads to a fragile system, which is being exposed to risks because of the low number of big actors. Furthermore, Mazars believes that the market concentration can have negative effects on innovation, talent management and pricing. When it comes to contingency plans, Mazars promotes further discussions on them, but adds that such plans should address the market players in the same way. RSM International considers the current audit market configuration to potentially pose a systemic risk to the provisions of audit services. However, RSM does not believe that contingency plans are key factors when addressing systemic risks and risk of audit firm failures. Instead, RSM states that it is more important to focus on preventive measures to address these issues, and that the moral hazard should be considered when providing safety nets for some of the audit firms. (Grant Thornton 2010, BDO 2010, Mazars 2010, RSM 2010)

5.5.4 Other studies and standpoints

The IOSCO Technical Committee discusses contingency planning in a paper from 2008. According to the paper, the audit function creates investor confidence in capital markets, and it is therefore important to avoid disruptions of the audit market. Harms from disruptions such as the availability of audit capacity and audit services can be reduced by contingency planning. Furthermore, it is suggested that increased concentration of the audit market and increased integration within audit firms can affect availability of audit services in the event of a crisis. Such crisis can come from e.g. the involvement of an audit firm in a financial fraud. When it comes to effective contingency planning it should involve creating, evaluating, maintaining and executing action plans. Two aspects are discussed; preventive measures and crisis management. Preventive measures include continuing communications with auditors, auditor oversight authorities, standard setters and professional organisations. The main focuses for crisis management are to ensure that public listed companies receive audit services and to release relevant information to the public and other stakeholders on the progress of the situation. Practical actions that may be taken when an audit firm is exiting the market include for instance granting relief on

reporting deadlines or making the transition process of changing auditors easier for listed companies. (IOSCO Technical Committee 2008)

5.6 Reassessment of the drivers of previous consolidation

The Commission says that they would like to examine the larger firms' previous consolidations and whether the complex products and processes developed by these firms delivered the innovation in audit methodology that was expected. Additionally the Commission would like the respondents' views on whether the broader rationale for consolidation of large audit firms over the past two decades is still valid and whether these consolidations should be reversed.

5.6.1 Professional bodies

IFAC, FEE, Far and ACCA all believe that the consolidations has been a natural response to environmental factors such as the emergence of transnational commerce, greater regulatory complexities, and the growth of investor markets. These reasons remains valid and consistent with the realities of today's global marketplace as multinational enterprises requires large audit firms with the necessary capacity to provide a uniform level of quality.. Therefore they state that a reversal of past consolidations would be difficult, if not impossible from a legal and practical point of view. It would also get yet unknown and uncontrolled consequences and be counter-productive as EU companies would be hindered in their quest to be world leaders in their markets. Instead of a reversal, they suggest alternative actions to improve the competitive dynamics of mid-tier firms and SMPs. These are related to the simplification and harmonisation of EU legislation regarding professional standards, licensing and registration requirements as well as facilitating greater public awareness regarding the capabilities and benefits of small, mid-tier and large firms. Additionally, proposed new regulations impact on SMPs should be carefully assessed before implementation. (ACCA 2010, Far 2010, FEE 2010, IFAC 2010)

5.6.2 The Big Four

The Big Four also considers the past consolidations to be a natural evolution to acquire the technology, intellectual property, infrastructure, training and methodology necessary to perform good quality audits for large and complex multijurisdictional companies. Regarding the term broader rationale KPMGs response refer to independent reports by

Oxera (2006) and London Economics (2006) which identified drivers for audit market concentration were reputation; greater capacity to serve global and complex organisations; technological innovation; need for industry knowledge; and liability risk. The Big Four says that this broader rationale remains valid; in fact they argue that it is even more relevant in today's globalised marketplace. They also respond that breaking up existing large firms would diminish rather than enhance audit quality for companies whose audits require the depth and breadth of resources offered by the largest audit firms. Additionally, reducing the audit firm's economic independence and ability to invest could increase risk for investors and companies. They also question whether a reversal of the consolidations would be practicable at a European level since the networks are global. (Deloitte 2010, Ernst & Young 2010, KPMG 2010, PwC 2010)

PwC emphasise that the previous consolidation between Price Waterhouse and Coopers & Lybrand was specifically approved by the Commission in 1998. In 2002 they also approved the consolidations of Ernst & Young with Anderson in Germany, France and the UK. In these decisions (Case Numbers IV/M.1016, COMP/M.2824, IP/02/1271 and IP/02/968) the Commission found a sufficient level of competition with four large market competitors. and acknowledged the importance of size when it determined that: "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 necessary reputation in the financial markets (in the case of quoted companies), the geographic breadth to cover the company's needs worldwide (in the case of multi-nationals), the depth of expertise in the particular sector (large companies in general and, in particular, regulated sectors such as banking and insurance) and significant resources (all large companies) ...all these features are only provided by one of the large global audit and accounting networks."

The only Big Four firm that suggests an alternative to a reversal of the Big Four consolidations is PwC responding that the Commission should encourage consolidation amongst the smaller firms and networks so that in time, a fifth or sixth competitor for the present four major networks could emerge.

5.6.3 Mid-tiers

BDO responds that they do not think that the consolidations taken place the last few decades was necessary for the purposes of synergies, nor for providing a global service offering. Instead they believe that the consolidation has primarily been driven by the desire

of those firms to achieve greater profitability and to 'catch up' with the size of their competitors. Despite this BDO do not support a reversal, neither does Grant Thornton, RSM or Mazars. Grant Thornton's response recognises that the largest global public companies need an audit on a scale currently provided only by the Big Four. However, using France as an example, they state that they do not think that sufficient resources to audit the very largest companies necessarily have to lead to the extensive market dominance they have in most EU countries. (BDO 2010, RSM 2010, Grant Thornton 2010, Mazars 2010)

As an alternative measure to prevent further market concentration, RSM, BDO and Grant Thornton asks the Commission to consider requiring regulatory approval for any further acquisitions of established audit firms within the EU by the Big Four. Mazars require careful monitoring, or perhaps even a ban, of these acquisitions. They also suggest that the Commission communicates this issue in a global context to prevent the Big Fours rapid expansion in emerging countries. (ibid.)

5.6.4 Other studies and standpoints

Hamilton, professor of accounting and finance at IMD Business School is one of the advocates of Big Four breakups, and the AAI another. Hamilton argues that there is inadequate choice in the market and that it is only when we have enough firms to allow clients a real choice, and where none can feel any complacent sense of immunity, that we will see real reform. (Hamilton 2010, AAI 2010) The discussion about breaking up the Big Four have surfaced from time to time after the collapse of Arthur Andersen but never received any wide-spread support. Davey, parliamentary Under-Secretary of State for Business, Innovation and Skills in the UK dismisses such a suggestion as it is simply too radical. (UK Parliament 2011)

5.7 Other measures

In some of the responses the appointment of auditors by a third party and overseeing auditors legal liability are mentioned as alternative and/or complementary measures to systemic risk than those discussed in the Green Paper.

5.7.1 Appointment of auditors by a third party

In the Green Paper, appointment, remuneration and duration of the engagement of auditors by a third party, e.g. a regulator, is suggested as a measure to govern the independence of audit firms and to develop the role of the audit as one of statutory inspection. The Commission says that such a concept may be particularly relevant for the audit of large companies and/or systemic financial institutions. The Commission is aware that it might increase bureaucracy but that it, on the other hand, also could bring societal benefits of independent appointments. However, such a concept could theoretically also be used as a tool to reduce the systemic risk by appointing firms other than the Big Four and/or joint audits.

ACCA (2010) agrees that there could be some public interest entities where an independent appointment of auditor could lead to higher societal benefits. However, neither ACCA nor the other professional bodies or Big Four are aware of any conflicts that justify this kind of market intervention as threats to independence are mitigated by good corporate governance and other safeguards put in place with the Statutory Audit Directive. (ACCA 2010, Deloitte 2010, Ernst & Young 2010, Far 2010, FEE 2010, IFAC 2010 KPMG 2010, PwC 2010) ACCA (2010) also points out that if these conflicts were to exist it is likely to be an enterprise with global presence and extraterritorial impacts making the appointment of a third party difficult. Therefore the shareholders and audit committee are in the best position to determine which auditor to appoint based on their knowledge of the company. (ACCA 2010, Deloitte 2010, Ernst & Young 2010, Far 2010, FEE 2010, Grant Thornton 2010, IFAC 2010 KPMG 2010, Mazars 2010, PwC 2010) Additionally, some considers the creation of the role of an auditor as a statutory inspector to be extremely unlikely to meet the Commission's goals. If the only function of an auditor will be the performance of inspection style audits it may create other unanticipated consequential problems, such as an inability for audit firms to attract the best talent to perform audit and the undermining of the duties of audit committees and shareholders. (KPMG 2010, Mazars 2010) Board and management must have confidence in the auditor in order for the auditor to have a successful communication and obtain the necessary information about the company, something that might be difficult to build up through a forced collaboration. (ACCA 2010, Far 2010) This causes a general concern regarding third party appointment of auditors' impact on audit quality and actual auditor independence.

Among the mid-tiers, BDO believes that there are significant safeguards in place, but recognises that there may be public interest reasons to justify the third party appointment of auditors to certain large companies. Financial institutions of systemic importance is mentioned as an example but BDO is careful to point out that third party appointments should be the rare exception and not extended to all audit appointments. RSM can also identify certain situations where there could be justification for the third party involvement in the audit appointment process. The situations mentioned are; that the previous auditor has resigned or was removed due to disagreement with the entity; the entity refuses to appoint an auditor or is unable to identify an auditor who is able or willing to accept the appointment. Additionally, RSM also suggests that if the entity receives government or public funds, the funding party could be involved in the auditor appointment. They point out that it is important that the third party is open to firms other than the Big Four to ensure there is no reduction in choice, so perhaps the RSM have seen the possible use of third party assignment as a tool to reduce the systemic risk. (RSM 2010)

Some of the professional bodies point out that Article 37 of the Statutory Audit Directive already allows Member States to introduce different systems than the appointment by shareholders in order to ensure independence. (ACCA 2010, Far 2010, IFAC 2010) This is the case in Sweden where the FSA, has the statutory right to appoint their own auditors in financial institutions to work jointly with the auditors elected by the institution, and when doing so the FSA decides the level of remuneration. The FSA also has the right to engage third party experts to examine the operations of a financial institution when needed. (Far 2010)

Companies listed on the Korean Stock Exchange and considered to have strong incentives and/or great potential for opportunistic earnings management are required to do audit firm rotations every one to three years (Kim & Yi 2009). This rule is accompanied by an auditor designation rule meaning that these companies are not allowed to select their own auditors. According to research conducted on audit quality (e.g. Myers et al. 2003, Gul et al. 2009 discussed in section 3.2) this should result in a severe decrease in audit quality as the tenures are short and the auditor designated by the regulatory authority may not be an industry expert. On the contrary, a study by Kim & Yi (2009) conducted on companies listed on the Korean Stock Exchange showed that these rules limit managerial influence on the selection of auditor and reduced the level of discretionary accruals, a proxy for

earnings management. Therefore, the authors concluded that these rules enhanced auditor independence as well as the credibility of financial reporting and audit quality. (ibid.)

5.7.2 Limiting legal liability

Many of the Green Paper respondents have identified issues around the legal liability systems in place in many Member States. According to the Big Four and the professional bodies' large legal claims pose the main risk for a future collapse of one of the Big Four. The responses also identify the liability risk as a major entry barrier for mid-tiers to the large segment of the audit market as the Big Four firms can be seen as providing an additional insurance against loss. (European Commission summary 2011) These problems have also been identified in a report about the audit market concentration by Oxera (2007), in a working paper by AAI (2010), and in study by the Commission from 2008. As a result of the 2008 study, the Commission recommended its Member States to adopt measures to limit liability, consistent with their own legal systems. (European Commission recommendation 2008) ACCA, Ernst & Young and IFAC are three of the respondents' that wants the Commission to take this matter to a harmonised European level and requests a mandatory capping of auditor liability within the EU. Ernst & Young suggests that this cap could be tied to the audit fees of the entity being audited; regardless of which firm is conducting the audit. (ACCA 2010, Ernst & Young 2010, IFAC 2010)

In the debate about limiting auditor liability some argue that it decreases incentives to perform a good quality audit (e.g. Hwang & Chang 2010 and Maijoor & Vanstraelen 2006), something ACCA (2010) does not support. Additionally, other international studies (e.g. Lam & Mensah 2006) have found that a high litigation risk environment is not a necessary prerequisite for high quality audits. There is also empirical evidence that suggests that the threat of increased liability might have a detrimental impact, encouraging a check-box approach and focus on form over substance. Increasing liability could also encourage unmeritorious litigation, a cost which is ultimately borne by audit clients and their investors and stakeholders in the form of higher audit fees. (Moizer & Hansford-Smith 1998, Pacini et al. 2000, Francis 2004)

5.8 Summary of responses

In the following table we have, in short, compared the general opinions of the Big Four and the mid-tiers.

	Big Four	Mid-tiers
Systemic risk	The Big Four say that the withdrawal of one firm would only cause a temporary disruption and that the audit market therefore does not pose a systemic risk.	There is not the same systemic risk as one would refer to regarding financial institutions, but there is a risk to financial stability nonetheless.
Joint audits/Audit consortia	Sees no justification for such a regulatory intervention, instead this should be left to the shareholders to decide. They also question whether it would provide a solution for market concentration.	The mid-tiers believe that this will decrease the market concentration and therefore supports joint audits and audit consortia where at least one non-systemic firm is included.
Mandatory rotation of auditors and re-tendering	Oppose mandatory audit firm rotation because it will not provide a solution for the market concentration as the companies' are likely to rotate between the Big Four. It will also be too costly and remove the decision-making from the shareholders and/or management.	Believes that mandatory audit firms rotations will make the companies rotate between the Big Four and therefore not affect the market structure. Neither will it improve auditor independence.
Addressing the Big Four bias	There is no bias; instead they have a better reputation due to their superior capability, capacity and breadth. However, Big Four only clauses should be disclosed or discouraged.	Believes that there is a bias towards the Big Four, and that European regulators have a part in this. They suggest increased communications of the smaller firms' capabilities, a regulatory for further Big Four acquisitions and a discouragement of Big Four only clauses.
Contingency plans	Do not support living wills but supports a further discussion about contingency plans.	Support further discussions about contingency plans but do not believe that such a plan will prevent a Big Four firm from collapsing.
Reassessment of drivers of previous consolidations	Previous consolidation is a result of a natural evolution depending on the market's needs. These broader rationales remain valid.	The consolidations were not driven by market needs. Instead, they were a result of these firms desire to increase their profitability. Despite this, they do not support a reversal.

6 EMPIRICAL RESEARCH

In this chapter the data collected from the interviews is presented. The headings in this chapter are mainly the same as in chapter five, responses to the Green Paper, to avoid connecting responses to a specific respondent. We begin with the term systemic risk and continue with the different measures suggested; joint audit, mandatory rotation, Big Four bias, contingency plans and reassessment of Big Four consolidations. The chapter concludes with the respondents' general attitude towards the Green Paper.

6.1 Market concentration and systemic risk

In the interviews, the risk of the audit industry was compared to that of financial institutions, an industry more often referred to as systemic. None of the respondents were of the opinion that systemic was the appropriate term to use regarding the audit industry as it does not play the same part in the economies of individuals and countries as e.g. large banks (B1, B2, S1, S2, S3). However, one of the respondents do believe that the current market structure poses a risk as it moves towards a monopolisation of listed company audits. The respondent adds that it is his opinion that no action needs to be taken to reduce this risk as the market will correct the structure if it experiences more serious audit failures. (S3)

Two respondents (including one from the Big Four) believe that the big firms are essential to scrutinise complex corporations but that the industry conditions themselves pose a risk. This risk comes from litigations due to large audit scandals. (B1, S2) One of them also points out that this risk will remain present as long as someone at the audited company stands to gain on conscious and unconscious errors and that consequently, the only way to reduce the risk of audit scandals resulting in a Big Four collapse is to revise the current legal liability system (S2). The other respondent from one of the Big Four says that he does not believe that a collapse the size of Arthur Andersen could happen again as 'the remaining firms learned from their mistakes and made sure to reduce the proliferation effects to protect their member firms'. Therefore, it will remain to be at least four big firms but with the right incentives another one or two firms could arise in the future. (B1)

It is the respondents' general belief that even if one of the large firms would be forced to withdraw from the market it would not get any long term consequences as those auditors

will continue with the same assignments but at a new firm, which was the case when Arthur Andersen fell and their auditors in Sweden started to work for Deloitte (B1, B2, S1, S2, S3). One of the Big Four says that some areas might experience more consequences than others as a result of a withdrawal. The reason being that some of the Big Four are very dominant in particular markets and regions, making it impossible to provide a universal answer and analysis. He also adds ‘the real systemic risk would be if competent people were to leave the industry’. (B2)

6.2 Joint audits/Audit consortia

Some of our respondents believe that mandatory audit consortia involving at least one smaller firm would reduce the concentration on the audit market (S1, S2). One respondent thinks that such a consortium should be regulated (S2). The Big Four respondents and one of the smaller firm respondents acknowledge that such a regulation might be suitable in some countries, e.g. it has worked well in France, however, they remain negative in their response to such a regulation at a European as well as a national Swedish level (B1, B2, S3). One respondent believes that such a regulation might be feasible and in time, increase the smaller firms’ credibility on the market segment for large audits, but more research regarding its potential impacts needs to be conducted prior to moving forward with this measure (S2).

Three of the respondents point out that the Statutory Audit Directive allows for the use of joint audits and audit consortia but that it is seldom used in practice. Also, the Swedish FSA (FI) who has the opportunity to appoint their own auditors to take part in the audits rarely uses that anymore. Reasons identified are that the added cost exceeds the added value and that it creates organisational problems like how to share the workload as well as legal problems regarding the legal liability risk. With an enforced joint audit these problems are likely to increase as it is far from clear which firm will be responsible for what if things were to go wrong. (B1, B2, S3) One of the smaller firm respondents also sees a risk that the smaller firm might be left out of the audit and an arrangement is made for them to simply sign the audit report and as a result carry a large risk for a lesser part of the audit fee. The same problem will arise if they, due to fewer resources, would have to rely more on the testing conducted by large firms than the large firms have to rely on them. (S2) The Big Four respondents also believe that mandatory consortiums involving one

smaller firm are likely to decrease the quality of the audit and create overlaps and gaps in the scrutiny. (B1, B2) One of the respondents explains this by saying that it would be difficult to trust their work as “we do not know what tools and methodology they use and whether they possess the necessary expertise” (B2). One of the respondents from one of the smaller firms agrees and said that many of the smaller firms may lack the necessary capacity to perform these audits, but that there might also be a lack of will to actually take part in that segment (S3). Contrarily, two of the respondents believe it could increase audit quality (S1, S2). One of them has experience from these kinds of joint audits in other countries, as well as experience from consortiums where the smaller firms audit some of the subsidiaries in Sweden. He believes that in the problems generally identified with joint audits can be resolved and that a big/smaller firm collaboration provides a better quality outcome than one between two big firms as they can become too competitive with one another at the end of the tenure. (S1)

One of the Big Four respondents adds that the main problem with enforcing these arrangements is the lack of trust not only from the other audit firm, but also from the companies’ stakeholders (B1). Two smaller firm respondents (S1, S2) agreed, and as a whole the majority of the responses conclude that it should be left up to the market to decide its structure and up the shareholders to appoint the appropriate auditor or auditors. One Big Four respondent points out that if a smaller firm were to grow and with that become appointed a part in a joint audit a big part of the trust issues will be overcome, and qualifying on merit instead of being appointed on a basis of quotas should also be in their interest. It is therefore important to start lowering the entry barriers to this market segment and increase the incentives for them to want to take part. (B1) Some respondents agreed that there are severe barriers in place for the smaller firms to audit this segment (B1, B2, S2, S3). One barrier mentioned by all respondents is that of legal liability and whether the smaller firms have the resources required to take on such a risk (B1, B2, S1, S2, S3). Some suggest a capping of the risk whilst others say that the Commission or the Member States need to make sure that the smaller firm can access sufficient liability insurances (B1, S2). One smaller firm respondent mentions that a possible way to create incentives for companies to use joint audits would be to prohibit two auditors from the same firm to sign the audit report. The respondent believes that many of these companies might consider two signatures to provide “status” and enhanced credibility to the financial statements. With a prohibition of the current system, this company would have to use a joint audit. (S3)

None of the respondents claim to believe that joint audits could be one way of mitigating disruption in the audit market if one of the large audit networks fails. Instead, the Big Four respondents as well as the smaller firm respondents think that the auditors of the failed firm will carry on their work in another firm. (B1, B2, S1, S2, S3)

6.3 Mandatory rotation of auditors and re-tendering

One Big Four respondent believes that mandatory rotation of audit firms might benefit the public confidence for the audit function. He adds that the rotation of partners is good because an auditor is at risk of becoming too familiar with the client after a period of time and that new people working with the client provide a fresh perspective on the audit, a positive feature of both rotation of audit firms and rotation of audit partners. (B2)

Another Big Four respondent questions the benefits that come from rotation of audit firms, and considers those to decrease audit quality. Additionally, it is likely that the rotation of audit firms will only involve the Big Four firms, and therefore not have any effect on the audit market concentration. The Big Four respondent also believes that from an auditor independence perspective, it is sufficient to use rotation of audit partner and that the system that is currently used is effective. It is added that by only rotating audit partner, the new partner can use the experience that has been gathered by his or her predecessor. (B1)

The common opinion from both Big Four respondents is that audit firm rotation is associated with additional costs of the audit process, and that experience and knowledge become lost because of the measure. In order to do an audit of a new client, the auditor must become familiar with the client's organisation and industry, which can be both costly and timely. (B1, B2)

According to one smaller firm respondent, the measure can prove effective for certain types of companies, such as financial institutions (S2). Two of the smaller firm respondents consider mandatory rotation of audit firms to be more logic than simply rotating audit partners, this because partners of the same firm share that firm's particular organisational culture. For rotations to be effective, those should involve the audit firms according to these two smaller firm respondents. (S1, S3) One smaller firm respondent believes that mandatory audit firm rotations can be effective in preventing audit firms from

becoming dependent on particular clients (S3). Another smaller firm respondent adds that it can be both positive and negative for an auditor to have the same client for a longer period of time. The reason for this is that the auditor gets a good insight in the business of the client. However, such insight can also be negative, since the auditor gets the perception that he or she has sufficient knowledge of the client's organisation and thereby becomes reluctant to see changes in the conditions. (S1)

One smaller firm respondent thinks that the periods of such rotations ought to be between five and seven years, since it takes time to get to know the organisation and industry of the new client (S3). Another smaller firm respondent thinks that the measure can decrease the audit market concentration, depending on the reaction of large audit firms (S1).

6.4 Addressing the Big Four bias

Our Big Four respondents say that the Big Four bias is all due to merit and the fact that a large audit places high demands on the auditing firm's resources, competence, methodology and international networks (B1). The other Big Four respondent adds that they have these capabilities due to the large economies of scale generated by their past consolidations. The resources and established brand also gives them a head start when recruiting the most attractive students. (B2) Two of our respondents from smaller firms disagree to the bias being explained by merit alone, saying that a fairly large part of the bias is attributable to perceptions (S1, S3). One of these respondents believes that it might be around 50/50 when it comes to merit and perceptions (S1). The remaining smaller firm respondent says that it is impossible to know how this bias is attributed in Sweden and adds that it may vary on different markets and between the auditing of different industries (S2). However, one of the respondents that believed that much was due to perceived quality does not necessarily want to take measures against it. Instead, he advocates that the market (e.g. banks and suppliers) needs this perception in order to ensure their safety to the rest of their stockholders. (S3)

During the interviews the measures suggested in the Green Paper to come to terms with the bias were discussed. The first one, transparent reporting, gets no real support from our respondents. One smaller firm respondent says that it can be a good idea depending on how the evaluation is designed, what they want to measure and how (S2). The Big Four

respondents believed that the market is the best at judging the quality of the audits, whilst one mid-tier opposes the idea of reports as he doubts whether it can be done in an objective and legally secure way (B1, B2, S2). Questions on the selection of a body to perform these assessments and whether it should be conducted at a national or regional level were also raised during the interviews. One Big Four respondent says that the Big Four's output are not always 100 per cent the same which might complicate a report on a regional level, e.g. some member firms may focus on financial institution while other firms avoid that kind of audits (B2). One of the respondents from a smaller firm also said that he cannot see anyone in Sweden with the necessary expertise (S3).

The second measure suggested by the Commission regards 'Big Four only clauses'. All respondents say that restricting such clauses either by demanding disclosure or by prohibition would be difficult as no one could know or control what is said behind closed doors (B1, B2, S1, S2, S3). One of the Big Four respondents also believes that prohibiting such demands will result in consequences such as increased interest rates for companies that appoint an auditor the bank has less confidence in (B1).

The creation of a European quality certification is something that gets support from some of the respondents (S1, S2, S3). One Big Four respondent is indifferent about this proposal, saying that it may or may not have the desired effect on the market structure, but the smaller firms respondents are positive to it and believe that such certification could help them get credibility to enter the larger segment (B1, S1, S2, S3). However, they all identify a need to combine this with other interventions, but regarding which interventions that are the most appropriate the opinions are diverse (S1, S2, S3). For instance, one smaller firm respondent believes that a measure such as audit consortia will be necessary to change the market structure (S1). Another small firm respondent says that even though third party appointments can be used to alter the market structure, he does not support it as it deprives the shareholders their right to decide the cost and selection of auditor (S3). The Big Four respondents, once again, emphasise that the Commission should focus on the entry barriers and incentives to encourage consolidations and growth in the smaller firms before enforcing changes upon companies. (B1, B2)

6.5 Contingency plans

From the interviews conducted for this thesis, the general view seems to be that contingency plans may be hard to implement in reality. Theoretically it appears to be a good measure, but the reality might differ (B1). One Big Four respondent states that it is a measure worth considering, and that different countries need different contingency plans. The same respondent adds that such a measure would be sound from a financial markets perspective, and that the audit market would benefit from having clear rules. By having clear rules, the risks that come from uncertainty could be reduced. (B2)

One respondent from a smaller firm believes that a comparison of audit firms and financial institutions is hard to make, since the industries are different as well as their roles in society. However, it is added that the fall of Andersen has given reason for considering such contingency plans, and that national supervisory boards could be in charge of constructing and maintaining them. (S1) Another smaller firm respondent adds that it would be more efficient to create preconditions for the event that one individual auditor should fail with his or her assignment and thereby bring down an audit firm (S2).

One Big Four respondent does not believe that there are impressions in the audit market that some audit firms are “too big to fail”. Furthermore, if one audit firm network would collapse, it is likely that the network will be reorganised into a new network. (B2) What is commonly believed by some respondent is that the fall of an audit firm can result in a short-term reduced audit capacity, but that this will eventually disappear. The reason for this is that the people working within the audit firm that has fallen will probably not leave the industry, but rather start working at a different firm. Therefore, in that scenario the long-term audit capacity remains the same, while the number of audit firms decreases. (B2, S1)

According to one smaller firm respondent, the discussion of contingency plans is strange from a societal point of view and another smaller firm respondent believes that if there is a need for those, the market will find a way to construct them (S2, S3). One Big Four respondent thinks that the construction of contingency plans could be made at a governmental department level, while a smaller firm respondent states that the task may be performed by a national supervisory authority (B2, S1).

6.6 Reassessments of drivers of previous consolidations

It is the Big Four respondents' opinion that the creation of international networks, quality assurance systems, education and economies of scale was necessary in order to audit the increased number of MNEs. The previous consolidations were therefore a result of the markets' needs. (B1, B2) One of the Big Four respondents says that "the growth of the Big Four is a result of globalisation, as all other industries so why then should the audit industry be broken up? And why should auditing receive a different treatment than other industries?" (B1) One of the respondents from a smaller firm agrees with this, another believes that the consolidation was partly driven by the market needs and partly by an interest to increase profits (S1, S2). The third smaller firm respondent is of the opinion that these consolidations are the result of the firms' own business choices and not by the needs of the market. That respondent acknowledges that big firms must exist in order to audit large clients, but says that he has not seen an example where the growth has happened in that order. Furthermore, he identifies the reasons behind the past consolidations in Sweden as a lack of leadership due to a generation change as well as a lack of alternative solutions for the smaller firms to remain in business. (S3) One of the respondents also says that with the slow growth in the Swedish listed companies and the abolishment of statutory audits for many small companies we are not likely to see any consolidations in the near future (S2).

Regardless of the standpoint towards the Big Four's consolidations and dominant size, none of our respondents believe that a reversal of these consolidations provides a reasonable or legally feasible measure to change the market structure (B1, B2, S1, S2, S3). One Big Four respondent suggests that instead of breaking up the big firms, two of the mid-tier firms could consolidate. He adds that the integration process would be tough but if the smaller firms were keen on reaching the segment of large audits they would have chosen to consolidate, as there are no external obstacles to prevent it. (B1)

Two of the smaller firm respondents say that instead of breaking up the Big Four there could be a legislation to cap their size and prevent them from becoming even larger. Such a cap could, for example, be connected to the number of employees or number of assignments. (S1, S2) One of these respondents adds that further studies on possible negative side-effects from such a cap needs to be conducted and that the Commission's first step should be the creation of a European quality certification (S2).

6.7 Other measures and general attitudes

When it comes to the appointment of an auditor by a third party, one smaller firm respondent believes that it might work, but that it is a controversial measure. He adds that it could be justified for some companies, such as large public companies, where there are many small shareholders. (S3) However, it is not certain if this third party appointment of auditor would have any effects on the current audit market structure, since it probably would be considered more safe to appoint one of the Big Four audit firms (B1, S3). There is a need for a clearer view of the problems that the Commission wants to address, according to one Big Four respondent. In his opinion, an important feature of the audit market is well functioning supervision, while the appointment of auditor by a third party is probably not the solution to any problems. (B2) Another opinion on the matter, made by one Big Four respondent, is that it is a question of confidence to appoint an auditor, and why would the auditor designator come to a different conclusion on the choice of auditor than the owners of the company? Additionally, the respondent questions whether there is any value added from third party appointments, and that the seldom use of it on the Swedish audit market can be seen as evidence of this. (B1)

When discussing liability risk, one smaller firm respondent does not consider it to be a problem in Sweden as there are insurances to cover it (S3). One Big Four respondent believes that it is a difficult question since there are a number of different jurisdictions in Europe. However, he adds that a reduced liability risk might decrease the entry barriers in the audit market. (B1) A liability cap could be just, but there is most likely a desire from auditors to have responsibility and to be able to be held responsible, according to one smaller firm respondent. It is added that the responsibilities of the management should be separated from the responsibilities of the auditor and that this matter must be clarified. (S2)

One Big Four respondent believes that the main issue with the Green Paper is that it fails to explain the problem that it wants to address. He also thinks that there might be difficulties in predicting the effects that the measures can have on different levels, such as national level and EU level. (B2) One smaller firm respondent states that the Commission may wrongfully assume that all audit firms have a desire to audit large companies, and therefore ignore the different segments of the audit market (S2). Another opinion on the Green Paper in general, given by one Big Four respondent, is that it looks at the audit market from a too theoretical perspective. Instead, the Commission could work to promote smaller firms to

become larger through their own qualifications. (B1) When it comes to changes in the audit market, one smaller firm respondent thinks that they will occur when the market recognises a need for them (S3). From a Swedish audit market perspective there are actions that are not mentioned in the Green Paper. One Big Four respondent believes that the confidentiality rules can sometimes have negative effects on the audit market. Additionally, he thinks that supervision with severe penalties for the breach of rules can have positive effects on the audit market. (B2)

7 ANALYSIS

In this chapter we compare the primary data collected through our interviews with reviewed responses to identify changes between the regional and the Swedish opinions. We also compare these opinions and previous research with the aim of the Green Paper to provide a basis for conclusions regarding the thesis purpose and research questions. The analysis will follow the same order as the chapters' empirical research and responses to the Green Paper.

7.1 Market concentration and systemic risk

When allowing the consolidations between Andersen with Deloitte or Ernst & Young in 2002 the Commission concluded that the four big firms would provide sufficient transparency and competition. However, after the most recent financial crisis, the Commission has changed their mind and the four big firms are no longer enough to provide the market with sufficient quality and trust in the financial systems. Instead, the Commission has concluded that the audit is such an important tool in order to provide market confidence that the lack of competition in the audit market poses a systemic risk to financial stability.

As most of the reviewed Green Paper responses have pointed out, systemic risk is generally used when it comes to describing the risk in financial institutions. Our respondents, the professional bodies and the Big Four believe that systemic is not the appropriate term to use in this context as financial institutions and audit firms serve

different purposes and play different parts in the global economy. (B1, B2, S1, S2, S3, European Commission summary 2011) This is also the standpoint taken by the majority of the mid-tiers; Grant Thornton is the only exception by stating that the Big Four pose a systemic risk as a collapse of one of them would lead to a significant short term market disruption and potentially leave the European market with reduced price competition and reduced incentives to maintain audit quality. (BDO 2010, Grant Thornton 2010, RSM 2010, Mazars 2010) In contrast, those that dismiss systemic risk believe that, in case of a failure, there will be no market disruption as the audit market will reorganise and the auditors at the failed firm will continue the audits at another firm. Worst case scenario, there will a temporary disruption in the delay in filing their financial statements but these companies would not suffer collateral damage or risk their survival. (e.g. KPMG 2010, FEE 2010 and ACCA 2010) This was true in the case of Arthur Andersen and could very well be the case in a possible failure of yet another firm, however Grant Thornton (2010) has a point when they say that the choices of big audit firms are often less than four as one or more of these firms may provide non audit services and are therefore not eligible to perform audits. So the companies employing three of the firms for consultancy work would face serious problems to find a new audit firm if the one they use were to withdraw from the market. The ones employing two firms, something that is quite common, could also face problems as it would leave only one choice when appointing a new auditor and that firm could set practically any price in order to accept the audit.

It may be difficult to follow the Commission's reasoning when deciding to refer to the audit industry as systemic, but the audit firms are part of the financial industry and the audit market construction impacts the auditor's role and the audit quality. They may not be systemic in the sense that a Big Four bankruptcy would result in a devastation that exceeds the direct consequences of their bankruptcy, but they can be considered systemic in the sense that they are of great importance as they provide the financial markets with crucial information. The Commission Director General for Internal Market and Services acknowledged that by saying "of course risk in the audit sector is not the same as in the banking sector. But is that really the point?" (Faull 2011) Besides the emphasis on potential impacts of a Big Four withdrawal, there are several things that indicate that the majority of the profession, including our respondents, have thought of systemic in that first sense and as a result concluded that the audit market is not systemic. For instance, risks have been identified regarding the impact on innovation and audit price (e.g. European

Commission summary of 2011, BDO 2010 and Mazars 2010) so perhaps the Commission made a mistake by using the term systemic without defining it further as, most likely, there would be very few to question the importance of the big audit firms.

The Commission is, with the suggested measures, trying to increase the competition in a market where it fails to occur spontaneously due to the size and resources of the Big Four. They also believe that the profession is exposed to too many self-interest threats and is too important to the financial markets to self-regulate. The main focus of the measures are therefore to reduce the importance of the Big Four firms by either breaking them up, favouring smaller firms or giving them an opportunity to collaborate with, and learn from, the existing major players.

The majority of the Green Paper responses and two of our respondents (B1, S2) also believe that the industry conditions themselves pose a risk and that this risk mainly comes from litigations due to large audit scandals. This risk can never be eliminated, but it can be reduced by a revision of the current legal liability system. (e.g. BDO 2010, KPMG 2010, Far 2010 and Deloitte 2010) This risk is not assessed in the Green Paper.

7.2 Joint audits/Audit consortia

In the Green Paper it reads that an audit consortium would be similar to a joint audit, but require the use of at least one smaller firm. However, it does not further explain how such consortia should be regulated and how it should function, something that have been criticised in the responses from the professional bodies and the Big Four, as well as by the majority of our respondents (B1, B2, S2, S3), the one exception representing a smaller firm (S1). The professional bodies, Big Four Green Paper responses together with our Big Four respondents (B1, B2), also agree on the need for the Commission to undertake tests regarding the potential impacts on audit quality, legal liabilities, and the balance of costs and benefits that a consortia could bring. It is also questioned whether such a consortia is compatible with existing legal, regulatory and economic systems in the different Member States. The mid-tier firms do not question the concept and, with the exception of one of our respondents (S3), they are generally positive to audit consortia. The Commission's suggestion is likely to provide a short-cut into the market segment of large audits for the mid-tiers, so for that reason they might want to encourage the Commission to take this

measure to the next level through simply not mentioning any potential problems they have identified with it. (FEE 2010, Far 2010, ACCA 2010, IFAC 2010, KPMG 2010, Deloitte 2010, Ernst & Young 2010, PwC 2010, RSM 2010, BDO 2010, Grant Thornton 2010, Mazars 2010)

In the pro-consortia debate, France has been used as a functioning example by the Commission, the Green Paper responses as well as by some of our respondents (*ibid.*). The reason is that it has allowed for the growth of Mazars into one of the national ‘Big Five’. A study by Francis et al. (2006) concluded that audit fees are not higher in France than in other Member States and that sufficient evidence on whether the joint audit affected audit quality was not found. But the study might not be representative to the rest of Europe as it says nothing on whether general audit fees in France are lower, if there is more low-balling involved in the tendering processes and whether it is often the same two firms that participate in the joint audit. If so, they might have established a trust and a relationship that functions well, something that the rest of the Member States have not.

The professional bodies, with the exception of ACCA, and the Big Four also have the same standpoint when it comes to questioning any consortia’s capacity to act as “a catalyst for dynamising the audit market”. Our Big Four respondents (B1, B2), however, share ACCA’s opinion and believe that such consortia would affect the market structure but potentially at the cost of audit quality, management’s trust in the auditor and audit cost carried by the companies’ stakeholders. (*ibid.*) So why did our respondents acknowledge that such consortia could help dynamise the market? It may be because their focus is national and that the Swedish market could handle such a change better than many of the other Member States, but it may also be explained by the fact that expressing their opinions in our interviews will not affect the Commission. Hence, they could say that it is likely to function without risking the Commission taking the discussion further, whilst the Big Four and the professional bodies may not. Increased audit costs have also been used as an argument against audit consortia in the Big Four’s responses but as there are studies to both support and contradict this effect they have all chosen to use the research that support their own theories (*ibid.*). That means that the Commission could find, and conduct, research that provides them with sufficient evidence to move forward with the concept of audit consortia if they so wish.

Generally, the professional bodies and Big Four responses, together with our Big Four respondents (B1, B2), believe that the use of joint audits should be left up to the market to decide. Potentially it could also be left up to national regulators that are closer to the market circumstances and local cultures. (ibid.) The reason for the ‘let the market decide’ approach is that they do not consider themselves as systemic so therefore they see no justification for regulatory intervention to artificially change the market. However, the Commission do and they might ignore the Big Four’s standpoint in order to make changes. But one issue that the Commission cannot disregard is the fact that previous corporate bankruptcies have shown that various forms of joint audits have been used as tools to commit fraud. The lack of the market’s belief in joint audits is also evident when looking at the recent abolishment of this system by countries, as well as by companies due to its practical, organisational and legal problems. So in order to bring back the joint audit in any way that provides the market with a level of confidence there are many issues to resolve. One identified in all responses and by our respondents (B1, B2, S1, S2, S3) is that of how to share the legal responsibility and whether the smaller firms could take on the legal liability exposure a large audit brings. Far (2010) and our Big Four respondents (B1, B2) also question whether the smaller firms in Sweden and other Member States have the knowledge, resources and the established international collaboration required to undertake a large audit. This is not mentioned by the mid-tiers in their official responses. They may be of a different opinion but even if that is not the case, a lack of competence is not something they are likely to acknowledge.

One of our respondents representing a smaller firm suggests that instead of making regulations about such consortiums there should be a prohibition of the use of two auditors from the same firm. This, he means, could provide an incentive for firms to appoint a joint audit in order to get the status and the safety of having two signatures on the audit report. (S3) Looking at Swedish audit reports, this phenomenon is not unusual so if this is due to “status” then it might be a suggestion that could get an effect on the market structure. But if it is the audit firms that prefer to have two auditors, in order to provide an opportunity to younger associates to take more responsibility and enhance their careers, than this is unlikely to get the same effect.

ACCA (2010), Far (2010) and one of the Big Four respondents (B1) also find it unlikely that the mid-tier firms would want to be allocated auditors on the basis of quotas and not

merit. This appears to be inaccurate as three of the mid-tiers and some of our smaller firm respondents (S1, S2) regard this as an opportunity to increase these firms' credibility over time. In time they might be right but if any troubles are to arise within the first few years, they are likely to get the blame and could damage their reputation for a long time to come, increasing the Big Four's dominance and reputation even more.

The mid-tiers official responses also consider audit consortia to reduce the disruption in large companies in the event of unplanned exit from the audit market by one of the Big Four. (Grant Thornton 2010, BDO 2010, Mazars 2010, RSM 2010) However, it is not certain that such a disruption would occur as was proved in the collapse of Arthur Andersen in 2002, but if it does then it requires that the remaining firm in the consortia has the capacity to carry out the audit on their own.

7.3 Mandatory rotation of auditors and re-tendering

In the Green Paper, it is suggested that the rotation of key audit partners is not a sufficient measure when mitigating the threat of familiarity and that mandatory rotation of audit firms could be a more efficient measure. The responses to the Green Paper that are reviewed in this thesis are negative towards the proposed measure, this for various reasons. For instance, ACCA refers to rotation of key audit partners as an adequate measure of reducing the threat of familiarity between the auditor and the client. Another reason for not implementing the measure is that it is believed to increase costs, while at the same time not necessarily gain any benefits. PwC states that the process of appointing auditors should be market led, while Deloitte considers the measure to be hard to implement for multinational companies. In some of the responses there are references to a study carried out at the Bocconi University in Italy, suggest that mandatory audit firm rotations can increase the market concentration. Concerns are also raised over the belief that such rotations will only involve Big Four firms, and therefore oppose the effects that the Commission desires. Grant Thornton states that the concerns over increased audit market concentration can be explained by Big Four bias. As for re-tendering, which is suggested in connection to mandatory audit firm rotations, the Big Four are opposed to the idea. ACCA uses an example from the Belgian audit market, and means that compulsory tendering can lead to higher level of market concentration because the smaller firms lose audits to the Big Four

firms. Mazars are not supportive of mandatory rotation of audit firms, but believes that re-tendering for listed companies can be a way to reduce the audit market concentration. (ACCA 2010, Deloitte 2010, PwC 2010, Grant Thornton 2010, Mazars 2010)

The responses that we have received from our respondents are generally not negative towards the measure, especially when it comes to the auditing of financial institutions. One smaller firm respondent states that mandatory audit firm rotations might be suitable for certain types of companies such as financial institutions, this because a new audit firm sees the audit from a different perspective and can thereby provide a possible increase in audit quality (S2). This suggestion is in line with the suggestion made by Arel et al. (2005), which states that an auditor over time may regard the audit as repetition of last year's work. Furthermore, two of the smaller firm respondents consider mandatory rotation of audit firms to be more logic than just rotating audit partners, this because partners of the same firm share that firm's particular organisational culture (S1, S3).

Some respondents also state that the measure can be a good way of preventing audit firms from becoming dependent on particular clients, which may have a negative effect on audit quality (S1, S3). However, one Big Four respondent believes that the measure can be unnecessary from an auditor independence perspective, and that the current system in the Swedish market is effective in mitigating threats to independence (B1).

From the empirical research, the most frequently mentioned negative aspects of mandatory audit firm rotations are the increased costs and the additional time it takes to get to know the client's organisation (e.g. B2). For instance, one Big Four respondent states that it is likely that the process of becoming acquainted to a new client's organisation takes at least two years (B1). It is also suggested that the risk of audit failures is increased by mandatory rotation of audit firms, this because of the new auditor's lack of knowledge of the new audit client (US General Accounting Office 2003b).

Perhaps one reason for the differences in opinions regarding mandatory rotation of audit firms between the responses to the Green Paper and our interviewees is that such measures can have different effects in different markets. Four of our respondents, without regard to the size of their firms, are not negative towards the measure, which indicates that the measure might find support in the Swedish audit market. However, difficulties in implementing mandatory rotation of audit firms at an EU level can occur because of

differences in national attitudes. The Swedish audit market might be better suited for the measure than other European audit market.

7.4 Addressing the Big Four bias

The Commission has identified that the appointment of a Big Four auditor provides a higher level of "comfort". This "comfort" is referred to as bias and the Commission wishes to assess how much of this bias is attributable to "perceptions" and how much to "merit". The majority of the professional bodies and the Big Four believe that the bias is attributable to merit alone and built-up through consistent high quality performance. It is also due to the fact that large audit places high demands on the auditing firm's resources, competence, methodology and international networks. Our Big Four respondents (B1, B2) share this opinion and add that it is a result of market preference and confidence. (e.g. Far 2010, KPMG 2010 and Ernst & Young 2010) They also get support from many researchers that have concluded that the big firms provide higher quality audits as their resources give them a greater possibility of detecting errors. It also makes them less dependent upon single clients. Contrarily, some of our smaller firm respondents consider a fair part of the bias to be attributable to perceptions. One speculates in a 50/50 merit/perception allocation, while one says that it is impossible to know and that it may vary between the markets. (S1, S3) The World Bank Group's CFO agrees that there is a perception that the Big Four are the only ones that can serve certain market segments and that the mid-tier firms possess greater qualities than they are given credit for (La Via 2011).

One suggested approach to address this bias, as well as assessing how much is due to merit and perception, is the introduction of transparent inspections reports similar to the ones in use in the UK. These reports, if conducted on audit firms above a certain size, receive support by the Big Four and ACCA. (ACCA 2010, Ernst & Young 2010, KPMG 2010, PwC 2010, Deloitte 2010) Such a report could be a tool in the assessment of merit and perception, but in order for it to be useful when addressing the bias to increase competition the reports need to show the market that the mid-tier firms perform audits of equal or better quality. Most likely it needs to be of better quality or equal quality combined with a lower price, otherwise it is unlikely to create an incentive for companies to appoint a mid-tier firm as investors and audit committees may lack a drive to change the market structure. Looking at the reports in the UK, this has not been the case. Instead, the reports show that

the Big Four provide higher quality audits which, if implemented in the EU, could be counter-effective and increase bias as well as concentration. The mid-tiers might be aware of the results in the UK, and the potential consequences, as they do not support the suggestion. Neither does it get any widespread support from our respondents. Partly because they doubt it will change the market structure, and partly because they question whether the quality assessment required by such a report could be conducted in an objective and legally secure way. One of the respondents also says that he cannot see any organisation in Sweden with the necessary expertise to perform such an assessment (S3).

Another suggestion to address and assess the bias is the creation of a European quality certification for audit firms to formally recognise their capacity to perform audits of large listed companies. Our respondents representing smaller firms are positive to this suggestion and believe it could help mid-tier networks gain credibility (S1, S2, S3). However, they all identify a need to combine this with one or more of the other measures suggested by the Commission, as the market lack incentives to appoint an auditor outside of the Big Four. One of our Big Four respondents (B1) was indifferent about this proposal, and so were the majority of the Big Four in their official responses (KPMG 2010, PwC 2010, Ernst & Young 2010, Deloitte 2010). The one exception is Deloitte, saying that it could be a helpful tool for smaller firms and should be taken into further consideration. (ibid.) This suggestion could help decrease a potential bias but only up to a certain level as it will certify that the mid-tiers in question provide a sufficient level of audit quality, not that they provide an equal level. Depending on how these qualifications standards are set it could create additional entry barriers into the large audit segment, then if the qualifications are set too low and one of the mid-tiers proves to provide a poor audit quality the market concentration could increase dramatically.

The last measure suggested in regards to Big Four bias is the issue of contractual clauses, informally referred to as "Big Four only clauses". A mandatory disclosure, and possibly a prohibition of these clauses, received widespread support from a majority of the reviewed responses as well as from some of our respondents (e.g. B1). However, the mid-tiers do not consider this intervention to be enough on its own but needs to be complemented with larger direct interventions such as joint audits or third party appointments. Contrarily, the professional bodies and the Big Four do not advocate these large changes as they believe such direct interventions are too radical and could bring unintended consequences. (e.g.

ACCA 2010, Far 2010, KPMG 2010, Deloitte 2010, BDO 2010, RSM 2010 and La Via 2011) It would be very difficult to prohibit such clauses as much would be said behind closed doors (S3). It would also still allow e.g. banks to do risk assessments of their clients, so appointing a smaller audit firm could result in increased interest rates (B1). Therefore, the mid-tiers have a point when saying it would need to be accompanied by more changes in order to have an effect on the market structure and Big Four bias.

The Big Four and professional bodies, as well as our Big Four respondents (B1, B2) and some panellists at the Commission's financial reporting and auditing conference, suggest that the Commission should focus on lowering barriers and increasing incentives for mid-tiers to enter the large enterprise market prior to an intervention in the existing competition. A harmonised external audit quality assurance and an adoption of ISAs are also suggested as ways to reduce the bias. (ibid.) The only one of the mid-tiers that mentions entry barriers and incentives is Mazars (2010). Perhaps the mid-tiers might see the suggestions in the Green Paper as a quick way to gain ground in the listed segment and therefore disregard measures that leave it up to them to make their own firms more competitive.

7.5 Contingency plans

In the Green Paper, the possibility of creating contingency plans in the event of the demise of one of the so called systemic audit firms is discussed. ACCA (2010) believes that contingency plans could be valuable when it comes to the risk of the fall of one of the Big Four firms. This is in contrast to the responses of some mid-tier firms in which they are expressing concerns regarding the proposed measure (BDO 2010, Mazars 2010, RSM 2010). The reason for these concerns is that the contingency plans that are discussed might only involve the audit firms that are considered to be systemic, leaving other audit firms without safety nets. The proposed measure might be seen as an unfair way of protecting the big audit firms, and giving further belief to the impression that some firms are "too big to fail". However, there is still support for further discussions on the matter from the mid-tier firms, except for RSM, who believes that such contingency plans do not solve the issue of audit firm failures (BDO 2010, Grant Thornton 2010, Mazars 2010, RSM 2010). Three of the Big Four audit firms are positive toward further discussions on the matter, while one believes that the focus should be put on preventive measures rather than measures that

counter audit firm failures (Deloitte 2010, Ernst & Young 2010, KPMG 2010, PwC 2010). The reason for the support of the measure from three of the Big Four firms might be that it can be beneficial to them. Another reason could be that they have been negative towards many other measures proposed in the Green Paper, and that this one is considered to be good in comparison. Furthermore, the Big Four firms question the measure of living wills, which is considered to be better suited for the bank sector. In the banking sector, living wills are supposed to reduce the need for government bailouts (Ernst & Young 2010). The main assets of an audit firm are its employees and clients (PwC 2010), while the main assets of a bank might differ, making a measure that is proposed for the banking sector difficult to implement in the audit market. The Commission Director General for Internal Market and Services also acknowledged that there are differences between the sectors by saying that “of course risk in the audit sector is not the same as in the banking sector.” (Faull 2011)

The negative opinion on living wills is shared with some of the professional bodies (e.g. Far 2010). As for the mid-tiers, the only firm that expresses a positive opinion on living wills is Mazars (BDO 2010, Grant Thornton 2010, Mazars 2010, RSM 2010). This is because they believe that the measure can be effective when addressing systemic risk and the risk of audit firm failures (Mazars 2010).

When it comes to the respondents, there are questions on how contingency plans could be executed in reality. One Big Four respondent states that contingency plans would have to be organised at a national level rather than an EU level, this because of differences in the audit markets (B2). Furthermore, it is considered hard to make the comparison of audit firms and financial institutions according to one non-big respondent (S1). Therefore, problems might occur when proposing similar measures for the audit industry as for the banking industry, this because of the differences between them. Some of our respondents believe that the demise of an audit firm may affect the short-term audit capacity, but that the market disruption will eventually be solved by the movement of staff from the collapsed audit firm to other audit firms (B1, S1). Since the economic effects can be harder to calculate when it comes to the collapse of an audit firm, compared to the collapse of a financial institution, there may be difficulties in recognising the need for the Commission’s proposed measure. However, there is a demand for investor confidence in capital markets,

which makes it important to avoid disruptions in audit markets (IOSCO Technical Committee 2008).

The reason for differences in opinions between our respondents and the responses to the Green Paper might be that they consider the proposed measure from different perspectives. While it can be easy to see the benefits of the measure from a global or EU perspective, it might be harder to see them from the national perspective of our respondents.

7.6 Reassessment of the drivers of previous consolidation

The majority of our respondents (B1, B2, S1, S2) and reviewed Green Paper responses consider the growth of the Big Four to be necessary to reach economies of scale (European Commission summary 2011). Economies of scale are, in turn, essential to acquire the technology, intellectual property, infrastructure, training and methodology required to perform good and uniform quality audits for large and complex MNEs. Consequently, the respondents and responses mean that previous consolidations were a result of market needs and a natural response to environmental factors such as the emergence of transnational commerce, greater regulatory complexities, and the growth of investor markets. (e.g. FEE 2010, IFAC 2010, KPMG 2010 and Grant Thornton 2010) Only BDO (2010) and one of our smaller firm respondents (S3) believed that the consolidations were not driven by market needs but by a desire to become larger and achieve greater profitability than its competitors. However, they still admit that the largest and most complex audits can only be performed by one of the Big Four and that the broader rationale for the past decades of consolidations therefore remains valid. With that they acknowledge that firms the size of the Big Four need to exist and that the current mid-tiers do not have the capacity to take on the task of auditing the world's largest companies.

The Commission has, at earlier stages, come to the same conclusion regarding the characteristics, resources and reputation necessary to provide a credible audit of large cross-jurisdictional companies. When allowing the merger between Deloitte & Touche and Andersen UK (Case No COMP/M.2810) the Commission also concluded that “these features are only provided by one of the large global audit and accounting networks”. As the Commission used the term large and not big, they might have included BDO, Grant Thornton as well as other firms to the global accounting firms with sufficient capacity.

Perhaps the Commission also thought that these firms would grow larger and increase their market share, when in reality they have done the opposite. As a last means to increase competition and reduce the systemic risk the Commission suggests a break-up of the Big Four firms by reversing some of the past consolidations. None of our respondents support this suggestion and neither do any of the responses submitted from the profession. (B1, B2, S1, S2, S3, European Commission summary 2011) The main questions are whether such a reversal would fulfil its purpose of dynamising and re-establishing trust in the audit market, as well as whether it is actually feasible.

The professional bodies and the Big Four say that breaking up the Big Four could result in decreased audit quality as no firm will have sufficient resources and skills to audit the largest companies. It could also compromise the audit firm's economic independence and, if performed only in the EU, also hinder the growth of European Companies. (ACCA 2010, FEE, 2010, Far 2010, IFAC 2010, KPMG 2010, Ernst & Young 2010, PwC 2010, Deloitte 2010) Naturally, the Big Four want to protect their businesses and are not likely to ever suggest their own break-up. Despite this, they do have a point. If the firms left do not possess the necessary capacity then what would happen? If the break-up will be on the European market alone then perhaps the companies will turn to the Big Four on other continents which would diminish the European audit industry. A possible scenario could also be to team up with former co-workers to perform joint audits. Another issue is that much research uses firm size as a proxy for audit quality and auditor independence, so with that logic a decrease in firm size should reduce the quality. Even if it does not turn out to affect real audit quality and independence it is likely to affect the perceived. That might, in turn, affect the investors' trust in the financial reports and be counter-productive to the Commission's main aim – financial stability. On the other hand, increased competition could also favour innovation, audit costs, financial regulation and promote financial stability. The advocates for such a break-up say that a functioning market requires competition and choice (Hamilton 2011). Increased choice could help increase the market's confidence in the audit as it would no longer risk that a firm becomes so large that moral hazard comes into play. The conditions in France have also shown that, even if not all the mid-tiers have sufficient resources to audit the very largest companies, good audits can be provided without it resulting in absolute market dominance by the Big Four.

The general opinion in the responses and conducted interviews was that a reversal of the Big Four consolidations would be difficult to perform at a European level, as the networks are global, if not impossible from a legal and practical point of view. It is unlikely that the EU could enforce a break-up at a global level so moving forward with it at a European level can diminish the audit industry within the Union. If the Commission revoked an approved merger it could also bring on legal consequences as the market may no longer rely on the EU's decisions and recommendations.

Instead of moving forward with something as radical as a break-up, alternative suggestions were made in the responses and in the interviews. Our Big Four respondents (B1, B2) and PwC (2010) suggests encouraging consolidations between the smaller firms to create one larger. This could work, but might only provide the 'quick fix' the Commission seems to be looking for. Also, there seems to be a disinterest for consolidation amongst the mid-tiers as there have been no external obstacles for them to consolidate during the past decades. Perhaps the mid-tiers are looking for the same 'quick fix' that would give them the opportunity to grow without having to go through the hard integration process of a consolidation.

The professional bodies suggest an overall improvement in the competitive dynamics of mid-tier firms and SMPs. These include a number of smaller interventions such as simplification and harmonisation of EU legislation regarding professional standards, the creation of a European quality certification and communicating the capabilities and benefits of small, mid-tier and large firms. (ACCA 2010, Far 2010, FEE 2010, IFAC 2010) This measure has the same draw-back as consolidations between the smaller firms: it simply takes time. However, it would make the smaller firms become larger, as well as increase their credibility.

Two of our respondents from smaller firms suggest a capping of firm size to prevent them from becoming even larger as an alternative measure (S1, S2). Such a cap could, for example, be connected to the number of employees or number of assignments. The mid-tier firms' responses to the Green Paper do not suggest a cap, but instead a restriction on the Big Four to conduct any more acquisitions. (RSM 2010, BDO 2010, Grant Thornton 2010) The difference in approach might be that there have not been any Big Four consolidations on the Swedish market for some time and that they instead have expanded their dominance from acquiring a greater number of the assignments. Not surprisingly, this

is not taken up as a possible measure by the Big Four or by the professional bodies as they generally do not think the current market structure poses a systemic risk.

7.7 Other measures and general opinions

Third party decisions regarding the appointment and remuneration of auditors as well as the duration of the engagement is suggested as a measure in the Green Paper. The Commission states that such measure can be relevant when it comes to the audits of large public firms and financial institutions. This measure is proposed in the third section of the Green Paper regarding governance and independence but it could also be used as a tool to affect the audit market concentration as identifies by Mazars (2010) and a few of our non-big respondents.

The professional bodies and the Big Four do not believe that there is a need for this kind of measure, and that there are adequate safeguards in place to assure auditor independence (ACCA 2010, Deloitte 2010, Ernst & Young 2010, Far 2010, FEE 2010, IFAC 2010 KPMG 2010, PwC 2010). ACCA (2010) acknowledges that there are some companies of increased public interest, where the appointment of auditor by a third party could lead to societal benefits. This opinion is shared by one smaller firm respondent, who thinks that the measure could be justified when it comes to certain companies such as those with many small shareholders (S3). Among mid-tier firms, BDO and RSM acknowledge that the measure can find justification in certain situations, such as the audits of financial institutions (BDO 2010, RSM 2010). However, BDO points out that such appointment of auditor should not be made for all audits (BDO 2010). Mazars (2010) states that the appointment of joint auditors in appropriate situations could be a way of reducing audit market concentration. What could be future issues from the measure are the objectivity and the supervision of the appointers.

Perhaps the negative attitudes towards appointment of auditor by a third party are due to the potential adverse effects it could have on the market concentration. Two respondent state that there might be an impression that it is safer to appoint a Big Four auditor (B1, S3). So why would the auditor designator be of a different opinion? Furthermore, one Big Four respondent believes that the appointment of auditor is a matter of confidence, and that

it should be up to the owners of a company to make this decision (B1). It may also be harmful to the market when the appointment of auditor is made by a third party, since it after all is a cost of the audited company.

A study conducted by Kim & Yi (2009) showed that auditor designation increases auditor independence as well as the credibility of financial reporting and audit quality. On the contrary, one Big Four respondent cannot see the value added from such measure, and refers back to a time when it was used in the Swedish audit market (B1). Perhaps the effects of the measure are changing depending on the audit market in which it is implemented.

In the third section of the Green Paper, liability risk is discussed. The matter can have impacts on audit market concentration, because of the entry barriers that it creates (European Commission summary 2011). There are opinions (e.g. IFAC 2010) that suggest that large legal claims may increase the risk of the demise of Big Four firms. The problem is discussed in a working paper from 2010 by the AAI where it is suggested that the Big Four are highly vulnerable to lawsuits (AAI 2010). Furthermore, RSM (2010) believes that there is a need for an appropriate system of limiting auditor liability so that it is not seen as an insurance against loss to choose one of the Big Four firms because they are able to coup with larger legal claims. Therefore, a liability cap could be a way to address the problem of systemic risk that is discussed in the Green Paper. However, some suggestions (e.g. Hwang & Chang 2010) mean that reduced auditor liability can have negative effects on audit quality, this because incentives to perform high quality audits are decreased. A liability cap may also have negative effects on the impression that the Big Four are “too big to fail”, or as discussed by Dwyer (2003) “too few to fail”.

According to one Big Four respondent, a reason for decreasing liability risk is that it may reduce the entry barriers into some segments of the audit market (B1). This implies that the willingness of audit firms such as mid-tiers to enter the audit market segment of large listed companies could be enhanced. Furthermore, the effects could in turn affect the audit market concentration by reducing it.

One smaller firm respondent does not think that there is a need for change of the auditor's liability in Sweden, because of well covering insurances (S3). This may suggest that the need to examine the liability risk differs between different audit markets.

8 CONCLUSIONS

In this chapter we answer our research questions. The conclusion is based upon the discussion in the analysis. The conclusion will answer our research questions. Lastly, we provide suggestions for further research related to the thesis subject.

The Commission questions the auditors' role in the recent financial crisis and has on their quest towards re-establishing trust and financial stability determined that audits and audit regulations can be used as a tool to regulate the financial markets. Since the Commission is targeting the market concentration they must also have concluded that the concentration had some role in the financial crisis. It is said in the Green Paper that the Big Four have grown so big in the past two decades that they have taken on systemic proportions and therefore pose a systemic risk. Systemic risk as associated with large financial institutions means that they, due to their size or importance to the financial markets, would induce severe consequences for the entire market if they were to collapse (Faull 2011, Power 2011). As the majority of the responses have concluded, a withdrawal of an audit firm would not result in such consequences as its main assets are the clients and the employees. The employees will either carry on with the audits at another firm or the clients will find new auditors. However, even if the audit market does not pose the same systemic risk as large financial institutions it is our opinion that they pose as a systemic risk in another sense as they have such substantial market shares and have a role as an intermediate to the financial markets providing them with important information regarding the accuracy of the financial reports.

Much research has shown that the big companies provide a higher audit quality than other firms (e.g. Bewley et al. 2008, Hunt & Lulseged 2007 and Craswell et al. 2002) and we have found no real evidence to support that the current audit market is too concentrated to be competitive or that it would have a negative impact on audit quality. But allowing such an important industry to be dominated by such few firms can be seen as negative. There is

also a risk that another firm is forced to withdraw causing a further monopolisation of the audit market which in turn could lead to higher audit costs and decrease innovation (Doogar & Easley 1998).

The Commission seeks to address the Big Four's systemic risk by increasing the competition on the audit market. The Green Paper refers to a study by London Economics (2006) regarding the audit market concentration. This study concludes that smaller audit firms face a number of barriers to entry into the market for audits listed companies such as: reputation, capacity and breadth of their networks and the exposure to unlimited liability. This means that in order to change the market structure London Economics suggests starting with the entry barriers i.e. work from the bottom-up. This is not something the Commission has taken into consideration when writing the Green Paper, which some of our respondents and reviewed responses from the Big Four and professional bodies have questioned. Instead, the measures suggested in the Green Paper follow a top-down approach forcing changes upon the audit industry, the companies and its shareholders. The companies' perspective has not been regarded at all and most of these measures will limit the shareholders' choices when it comes to determining audit costs and appointing an auditor. Seeing how the audit market poses a systemic risk in a 'limited' sense, it is contradictory that the Commission suggests measures that have been developed for financial institutions, such as living wills.

The responses from the Big Four and the professional bodies were negative to the majority of the suggested measures. We believe that much of this negativity can be explained by the top-down approach and them not considering the current audit market configuration to pose a systemic risk. If the Commission would have spent a bit more time researching the possible effects on the measures suggested and asked the questions in a different, and less threatening manner, e.g. 'could any of these measures help in order to create another big audit firm?' and avoiding the term systemic, then perhaps we would have seen more positive answers in the official responses as well as from our respondents.

Even though the European Commissioner for Internal Market and Services, Barnier, said that "status quo is not an option" we find it unlikely that many of the suggested measures would ever be recommended in the European Parliament report (due at the end of May), and even less likely to be implemented.

We believe that the envisioned audit consortia where at least one of the appointed firms has to be a non-big firm and a reversal of the Big Four's previous consolidations would be the fastest ways to achieve changes in the market construction. A reversal of the Big Four firms' consolidations did not receive any support from our respondents or in any of the reviewed responses. Audit consortiums however, received a widespread support from the reviewed mid-tier responses, and the 'quick-fix' it would provide is likely to be the explanation. However, none of these suggestions are likely to be enforced, the audit consortia due to many Member States' previous experiences of joint audits, and a reversal of the consolidations because it will most likely not be feasible from a legal and practical point of view. Breaking up the Big Four firms may result in new sub-practices that suffer a shortage of expertise and finances to perform the large audits which would jeopardise the quality of the audit as well as investors and other stakeholders' confidence in the companies' financial reports. This opposes the purpose of the Green Paper which was to 're-establish trust in the financial markets'.

One measure that received support in the majority of the reviewed responses was contingency plans, which indicates that it could be implemented in the EU. From the empirical research, we get the impression that such plans could be hard to implement in reality, and that each Member State would have to design and maintain them because of differences in the legal environments. Furthermore, some mid-tiers believe that the implementation of contingency plans could work as safety nets for the Big Four, while allowing smaller firms to collapse. We believe that contingency plans may be a reaction to the threat of having fewer big audit firms in the audit market, and thereby nurture the impression that the Big Four are "too few to fail".

Regarding Big Four bias, the Big Four and the professional bodies believe it is all explained by bias whilst the mid-tiers believe that a part of it is due to perception. It is our opinion that it is difficult, if not even impossible, to assess exactly how much of this bias that is attributable to merit and how much to perceptions. The suggested audit inspection reports could be an effective way to reduce any potential perceived bias, but it is likely that these reports will show that the mid-tier firms provides lower quality audits (as is the case in the UK, see FRC 2010a) which could be counter-effective and increase the market concentration even further. We therefore believe that introducing a European quality certification for firms capable to audit large companies is a better idea. This suggestion

also receives support from the majority of the reviewed responses and our respondents and could help reduce any perceived bias and increase the smaller firms' credibility. Another suggestion that is supported in the responses is the prohibition of Big Four only clauses. Our respondents do not believe such clauses could be regulated as banks remain free to make risk assessment and could find other ways to force their clients into appointing a Big Four auditor. We believe that assessment to be correct and that a demand on disclosing such information would be a better idea to come to terms with the bias. Additionally, we believe that even if the introduction of European quality certificates and demand for disclosure of clauses restricting competition are good ideas they will not necessarily bring on changes in the audit market construction as the main problems regarding extensive entry barriers and lack of incentives for the smaller firms to grow remains present.

An enforcement of mandatory rotation is another measure that will struggle to have an effect on the market structure, as the companies will rotate within the Big Four, and for this reason it does not get any support in the reviewed Green Paper responses. However, we believe that it is a suggestion worth pursuing as it could increase auditor independence and re-establish trust in the financial statements. If enforced alongside the introduction of a quality certificate, an incentive scheme and a reduction of entry barriers it could also help change the market structure. One way to lower entry barriers is to cap the auditor liability or make sure all larger firms have access to sufficient responsibility insurances so that the Big Four cannot be seen as providing an additional assurance against loss. Capping liability could also help decrease the risk of the collapse of another audit firm. The issues regarding liability risk was pointed out in almost all of the reviewed responses, but according to our respondents it is not a large problem in Sweden.

When analysing the data collected in this thesis, it was evident that the professional bodies and the Big Four responses generally agree with one another. This is most likely explained by the fact that the majority of members active in the professional bodies' boards and policy groups are also employed by one of the Big Four, making the Big Four very influential. We did not see such a distinct difference between Big Four and non-Big Four in our primary data instead, the difference was more distinct between them and the official responses. We have not performed enough interviews to draw any conclusion regarding this difference but the result indicates that their opinions are more affected by conditions and experiences from the Swedish audit market rather than the size of their firms. It also

indicates that different measures might be appropriate in different jurisdictions within the EU.

If the Commission decides to enforce measures to increase competition and succeeds, we believe it may be necessary to promote stricter independence and ethics rules. The reason being that competitive markets result in an increased business risk by nature as the firms' main goal are to win the client, and the audit market should not be a market for taking these kinds of risks. Before enforcing any larger changes on the market, such as audit consortia, the Commission needs to conduct further studies on whether it is supported by the shareholders and the rest of the financial market. If it is not, then introducing it will not contribute to re-establishing trust, nor will it contribute to create financial stability.

8.1 Contributions

We believe that this thesis has contributed to its field by providing an in-depth analysis of the Green Paper's suggested measures regarding audit market concentration. In order to do so we collected data, primary and secondary, that we thought would be relevant for the discussion. We hope that by illuminating the affected measures from two perspectives, that of the global profession and that of the national Swedish profession, the thesis has given a clearer view of the matters discussed in the Green Paper's fifth section and the problems associated with trying to find one measure that is appropriate in all Member States.

8.2 Suggestions for future research

- It would be interesting to do a similar study regarding one of the other topics in the Green Paper in order to see what the profession in Europe and Sweden thinks of it.
- It would also be interesting to do a comparative empirical study on the views of market concentration between Sweden and other EU Member States.
- A suggestion that is further in the future is to see which of the measures of the Green Paper's section five that was implemented and if it had the effects desired by the Commission and predicted in the professions responses.

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Attachments

Interview questions

1. Vad är er befattning på XXX?
2. Anser Ni er vara väl insatt i EC:s Grönbok om revisionspolitik: Lärdomar av krisen?
3. Systemrisk
 - a) Anser Ni att de fyra stora revisionsbolagen utgör en systemrisk?
 - b) Hur betraktar Ni denna systemrisk i förhållande till exempelvis den som utgörs av finansiella institutioner?
4. Gemensamma revisioner
 - a) Vad är Er generella åsikt om gemensamma revisioner?
 - b) Skulle sådana fungera för att minska marknadskoncentrationen och därmed den så kallade systemrisken, av revisionstjänster till stora företag i Sverige?
 - c) Hur skulle dessa gemensamma revisioner kunna arrangeras? Ser Ni några möjligheter respektive risker med olika alternativ?
5. Obligatorisk rotation av revisionsfirmor
 - a) Vad är Er generella åsikt om obligatorisk rotation av revisionsfirmor?
 - b) Europakommissionen vill att sådana rotationer ska minska den så kallade systemrisken och stärka revisorns oberoende. Anser Ni att detta är möjligt genom obligatorisk rotation av revisionsfirmor?
 - c) Vad skulle vara mest positivt respektive mest negativt med införandet av obligatorisk rotation av revisionsfirmor?
6. Partisk inställning till de fyra stora
 - a) Upplever Ni att marknaden har en partisk inställning till de fyra stora?
 - b) Skulle en offentlig och årlig utvärdering av de fyra stora samt mindre revisionsfirmor vara ett effektivt medel för att se hur mycket av denna partiskhet som är hänförlig till "uppfattningar" respektive "förtjänst"?

- c) Bör rättsliga begränsningar (t.ex. lånevillkor) av företagets val av revisor förbjudas?
- d) Anser Ni att det finns andra sätt att angripa detta, av Kommissionen identifierade problem?

7. Beredskapsplan

- a) Anser Ni att det finns ett behov av en beredskapsplan för händelsen att ett av de ”systemviktiga” revisionsbolagen skulle upphöra att existera på marknaden?
- b) Om ja, vad skulle vara viktigast att lyfta fram i en sådan beredskapsplan?
- c) Vem bör ansvara för upprättandet och underhållet av en eventuell beredskapsplan (ex. nationella tillsynsmyndigheter)?

8. Utvärdering av de fyra storas tidigare konsolideringar

- a) Anser Ni att de stora fyra har växt fram som ett resultat av marknadens behov?
- b) Är dessa behov fortfarande aktuella eller skulle de senaste decenniernas konsolideringar kunna återgå?

9. Vad anser Ni om andra möjliga åtgärder för att minska systemrisken (exempelvis utnämning av revisorer av tredje part eller förändring i det ansvaret som revisorer bär för eventuella brister i revisionen)?

10. Har Ni några övriga åsikter om grönboken? Anser Ni att den tillför något nytt?