STATUTORY AUDIT SERVICES MARKET INQUIRY

Summary of hearing with Mazars held on 1 May 2013

Views on proposed remedies

1. Mazars was first and foremost an audit firm and saw the audit market for the large corporate sector as absolutely strategic to its development. It was a market in which it had a significant presence outside the UK and it saw no reason why this success could not be replicated in the UK. It believed it could operate successfully in the UK audit market and did not see its lack of presence in the FTSE 350 audit market as a question of capacity or capability.

2. Mazars had demonstrated that smaller, or what it termed 'challenger', firms had the ability to innovate and compete in the audit market. For the past two years, Mazars had been awarded the Audit Innovation Award from the *International Accounting Bulletin*, the international accounting journal for the audit profession

3. One of its innovations was in relation to 'human rights auditing' and more recently it was awarded the Audit Innovation Award for the development of the 'cultural compass', which was an audit of a company's culture. Mazars believed it was the challenger firms that had more credibility and more opportunity to innovate.

4. Mazars had recently won the audit of [✂] [a large and complex UK insurance group], which it believed was significant for two reasons:

   - It was a very significant audit, with a fee of about £1.7 million, which was comparable to fees towards the lower end of the FTSE 100.

   - The win demonstrated that Mazars could be a competitor in a complex sector as [✂] operated in a sector that many believed was the preserve of certain firms.

5. Mazars supported the Competition Commission's (CC's) view that challenger firms could compete in the FTSE 350 market without any single, major investment. Challenger firms might need to invest to improve their capability in certain areas or sectors and, for example, Mazars would not see itself as a credible player in the oil and gas sector without further investment.

6. Mazars saw investment in capability rather than size as a key consideration. Investment in people was key and if it wanted to move into a new sector, it was essential to recruit senior individuals, partners and managers. It would look to the Big 4 firms to recruit, but this strategy was limited as the opportunities afforded to such individuals, who were used to dealing with exciting, large clients, was limited.

7. Mazars met the needs of the [✂] audit client through complementing its core audit team with resources recruited from other firms. An assignment such as [✂] required [✂] staff for [✂], with [✂] of these coming from existing resources and an additional [✂] staff recruited externally. Mazars felt this was the right ratio of new to old staff and enabled the new arrivals to get up to speed quickly.

8. Mazars supported the proposed remedies but considered additional ones were needed and believed they worked better as a package rather than independently. A combination of the remedies and the weighting attached to each of them would be important going forward. It believed that voluntary initiatives had not worked in the

past and the Market Participants Group report, released in 2007, had not created the change that was intended.

9. Mazars and those stakeholders it had spoken with believed that there was a need for new entrants and innovation in the audit market. There was also a belief that the risk of a move from the Big 4 to only three firms was now more substantial, as highlighted recently by the Financial Reporting Council (FRC), and this risk was not fully addressed until now.

10. Mazars said that the remedies were needed to provide solutions at the top end of the audit market, where it believed systemic risk was highest and the concentration of fees greatest. To achieve significant and sustained change in the audit market, a means of bringing new entrants into the market was required.

11. Mazars had identified a number of barriers to entry and believed that institutional bias was a barrier that had not received the attention it deserved. It was unsure how the CC's proposed remedies would address this issue.

12. Mazars believed that many invitations to tender were no more than token gestures on the part of the tendering company. When a company selected a challenger firm to participate in a tender, the firm selected was not always the firm that had the highest chance of success. Mazars believed that tenders should be open to any firm that had the capability to undertake the audit.

13. There was a lack of understanding of challenger firms by company boards, in particular Audit Committees, and this could be addressed by facilitating equal access to tenders for all firms. Mazars was prepared to take its chances in a fair and open tender competition.

14. A number of high-profile companies such as HSBC, Schroders and Royal Alliance had recently tendered or announced that they might tender. Having discussed this with peers at other challenger firms, Mazars learnt that none of the challenger firms had been invited to participate. Mazars had contacted some of the above companies with a view to meeting them to explain who it was, what it did and why it believed it could participate in the audit.

15. The response it received from HSBC was not encouraging, even though Mazars had banking expertise as one of the joint auditors of BNP Paribas and Mazars had made it clear to HSBC that it did not intend to bid for the full audit. HSBC needed joint audits in France and possibly in South Africa and this was a service Mazars could supply. Mazars also felt that HSBC was a possible target in light of the current regulatory discussions on the separation of activities within banks and whether the ring-fenced part of a bank's operation should be audited by the same auditor as the main bank.

16. Mazars believed it had the capabilities to compete for audits in the FTSE 350 market. But despite significant investment, it was not invited to any tender over the past five years and believed this was systematic of the issues and bias in that market.

17. The role of the FRC with regard to the implementation of the remedies needed to be considered carefully as the Big 4 firms were well represented at the upper echelons of the organization.

Joint and shared audit

18. Mazars saw a number of benefits with joint audit. Quality would be enhanced and the market made more fluid through the ‘four-eyes’ principle, two auditors for one company. Joint audit provided real-time quality control, which was better and more reliable than quality control undertaken after the event by the regulator. Auditor rotation would be organized more effectively if the appointment of two auditors at one company was staggered. The loss of one auditor did not automatically mean the loss of the knowledge and understanding of the company and this would be passed on to the new auditor by the existing auditor. Joint audit would also encourage new entrants partly as more audit opportunities were created.

19. In France, where Mazars operated joint audit, companies liked the comfort of having a Big 4 firm signature on their audit report, even in a joint audit environment. But the feedback it received from companies where it operated a joint audit demonstrated that these companies saw a greater technical robustness in decisions and reviews. In a world where accounting was increasingly about making judgements on complicated issues, companies welcomed a real debate on key judgements. A debate between two or three organizations was more powerful than that between one or two and created what Mazars termed ‘co-petition’. This was a combination of cooperation and competition which, from company feedback, pushed quality and client service upwards as there was a constant benchmark to aim for.

20. Criticism of joint audit was anecdotal and based on historical experience. Audit Committee Chair (ACC) criticism of joint audits might also be based on knowledge of an audit proposal different from that offered by Mazars. It would be constructive to speak with ACCs with regard to the joint audit offered by Mazars.

21. Mazars believed that voluntary joint audits would often lead to single audits as the larger firm would try o achieve this outcome and there was a perception that joint audit was more complex to manage and incurred additional costs. Research had been undertaken on the impact of pairing firms on a joint audit and it showed that a company with a Big 4 auditor and a challenger firm preferred the arrangement to those companies that had two Big 4 auditors.

22. Mazars’ own feedback suggested that companies preferred the Big 4 auditor/challenger firm arrangement as it provided diversity in the audit. Companies received different outputs, different viewpoints and quite different cultures in terms of the execution of the audit. With two Big 4 firms, it was perceived as having the same firm twice, with the complexity, but without the benefits being so obvious. The CEO of Société Générale, where the joint audit was shared between two Big 4 firms, had said in the past that he did not like this system of auditing. In contrast, BNP Paribas and GDF Suez both recently appointed three auditors for their global audits and looked for diversity in pairing Big 4 and challenger firms.

23. Though the vast majority of joint audits involved two firms, it was possible to make three auditors work and Mazars believed its success was due to the auditors working as a profession, as opposed to competing businesses. A more professional approach to the audit was developed by forcing auditors to work well together.

24. Mazars had recently spoken with an ACC who had taken up a position at [✂] which had a joint audit. The ACC had no expectation that he would like or appreciate the joint audit, but his own experience had led him to change his mind.

25. Mazars did not see joint audit necessarily as always a superior form of auditing, but believed it had a role to play as part of a package of remedies. It did not view joint

audit as a compulsory measure, but saw the remedies as a mechanism to incentivize companies to understand what joint audit consisted of and to enable companies to form a view through practice.

Non-audit services

26. Mazars believed that the reduction in non-audit fees compared with audit fees over the past few years was partly due to the dramatic reduction in transactional activities, which were historically a significant area where auditors made their fees. Mazars was surprised to see that 113 of the FTSE 350 companies had non-audit services (NAS) fees that were greater than 50 per cent of their audit fee and around 67 companies had NAS fees greater than 75 per cent of the audit fee. There was a significant opportunity for firms to build relationships and credibility through NAS and Mazars believed that restrictions on the level of NAS would help achieve some of the CC's objectives.

27. With regard to restrictions on the type of NAS offered, a judgement needed to be made as to whether a NAS was acceptable or not. Tax and corporate finance, particularly merger and acquisition activity, were very sensitive areas and even where everything appeared above board, conflicts could still arise.

28. NAS had the potential to affect the quality and independence of an audit. NAS also facilitated access to certain companies that potentially led to a future audit relationship. When Mazars was invited to a tender, even though it was unsuccessful, a relationship around NAS nearly always developed and Mazars was in a better position when the audit was next put out to tender.

Mandatory tendering/rotation

29. Mazars' preference was for a tender every seven years or at the time of the audit engagement partner (AEP) rotation. The UK had a partner rotation period of every five years for listed companies, but under European law this could be increased to seven years. Mazars current view was that it preferred the seven-year period in the UK as against the FRC's ten-year, 'comply-or-explain' proposal.

30. It believed it was important to consider the link between tendering and rotation. A group of investors had recently advocated rotation every 15 years. The European Parliament arrived at a period of around 14 years and this could increase to 25 years where there was retendering, joint audit or Audit Committee assessment. If the period to be adopted was around every 15 years, Mazars believed that it was sensible to have a tender once in that period.

31. Mazars acknowledged that seven years was a subjective judgement and there was merit in linking the tender period with the AEP rotation. If one took into account investor views, who suggested rotation every 15 years, and European law, which allowed seven years for partner rotation, the obvious figures that emerged were re-tendering every seven years and rotation every 14 or 15 years.

32. In Europe, mandatory tendering took place every nine years in Italy (with no possibility of change in between) and six years in France. Mazars' Italian partners considered that nine years prevented a dynamic and fluid market. Mazars' own experience was that six years, by comparison, was preferable.

33. Transitional arrangements were also an important consideration as, based on the CC's data, there were only eight to ten competitive tenders a year and tenure periods

could be measured in decades. Mazars believed it was important to have a number of competitive tenders within a reasonable number of years, though this would need to be balanced against an excessive number of tenders that made it difficult for firms to respond. On a fairness point, those companies that had been with an auditor for a long period of time, or had not recently rotated their AEP, should tender earlier. In tandem with regular tendering, it was important that the tender process was open and fair with regard to invitees and feedback on how a firm was chosen.

Enhanced shareholder engagement

34. Mazars saw merit in the choice of two auditors being presented at an AGM. It gave shareholders a choice and allowed challenger firms and other new entrants to build a presence in the market. It was also a means to address the desire of institutional shareholders for a less concentrated audit market.

35. Mazars primary concerns with regard to institutional bias was with regard to Chief Financial Officers (CFOs) and ACCs rather than investors. There was an ongoing sense of frustration that not many CFOs would form a view on the appointment of an auditor without talking to a number of intermediaries such as brokers who had established views on which were the “good” audit firms.

36. Mazars accepted that some of the bias might be unconscious. Accountants trained, took their exams and qualified with a professional firm, whereas in some other professions most of the exams were taken before someone joined a firm. As a result, very strong bonds were formed between accounting firms and their alumni and it was important to recognize that loyalties might lie in a certain direction and senior personnel might have better knowledge and understanding of certain audit firms.

37. Mazars did believe that the opportunity existed to provide professional guidance on tendering and how to ensure effective switching. The demand for such guidance had been low due to the lack of switching, but in a world where the number of tenders increased, with a subsequent increase in switching, the scope existed to ensure that the processes were as smooth and as effective as possible.

38. Mazars believed that a higher volume of tendering would happen in both the UK and across Europe. It firmly believed that its chances of being successful in this new environment depended on investor behaviour and addressing the issue of institutional bias.

39. Mazars was developing a pan-European approach to tendering in anticipation of a high volume of tenders. Local resources were being utilized to bring added value and specific inputs required for each tender. On all tenders, parties expected to see certain information, which was exactly the same from one tender to another, and there was significant scope to ‘industrialize’ the process with no detriment to quality.

Auditors’ attendance at board meetings

40. One of Mazars’ biggest challenges was to be invited to tenders. To help with this, it had created, in partnership with three leading institutional investors, the ‘Centre for Audit Committee and Investor Dialogue’, which was a platform for ACCs and investors to talk about current issues. Three events had been held over the past eight months and had proved effective and successful. This had proved a reasonable investment for Mazars, with the intention of meeting as many ACCs as.

41. Bringing ACCs and investors together was a distinctive part of the initiative and allowed the focus to be on market rather than company issues and had led to positive feedback from participants.

42. In a number of countries outside the UK, Mazars' partners were invited to attend board meetings. Depending on the country, attendance was either viewed as best practice or mandated by law. In Germany, for example, the auditors were invited to the supervisory board, but in France was also invited to meetings of the management boards.

43. From discussions with colleagues, Mazars had identified three main benefits of board attendance:

- The auditor had a much better understanding of the strategic and business risks.
- The auditor had a much better understanding of shareholder engagements as it was at the board table that shareholder engagement took place, essentially between non-executives who act as shareholder representatives.
- The auditor received a better understanding of board dynamics; in many companies, if relationship issues around the board table were understood, the large majority of the high-risk audit issues were captured.

44. Attending board meetings gave an auditor a unique insight into the functioning of a company, which was vital when forming opinions. When the management team, non-executives and auditor met, it provided exposure to a vast number of people with a wide range of roles and responsibilities. Mazars believed that a challenger firm at the table promoted diversity.

Conclusion

45. Mazars believed that the CC's investigation was a major opportunity to change the structure of the audit market for the benefit of shareholders and create wider benefits around trust and confidence. A more diverse market would be a better market. Challenger firms were at a critical point in their development and there was a limit to how much time and effort they would put into competing in the listed markets. If change was not forthcoming, firms would have to revisit their strategies.

46. If remedies did not address institutional bias, there was a greater chance of creating costs without benefits. An important consideration was to ensure that added competition in the market did not create a race to the bottom in terms of quality and price.