MAZARS

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Market Investigation into Statutory Audit Services
Competition Commission
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Dear Sir

Audit Market Investigation - Nature and strength of competition in the supply of FTSE350 audits

1. Introduction

Mazars, the international integrated auditing and advisory organisation with 14,000 professional staff in 69 countries, is pleased to offer its comments on the above working paper.

We would highlight an overall concern with the working paper that whilst it provides much helpful analysis and evidence leading in the direction of this being a very stagnant market with very limited active competition this does not seem to be fully reflected in your initial views.

2. Quality of an audit

We are pleased to enclose in an appendix to this letter a 10 point statement on key elements related to the quality of an audit which we submitted to you in response to Question 73 of the MFQ.

You will see that our guidelines for audit quality include recognition that the shareholders are the client with a number of them focused on ensuring a robust audit is carried out combined with an acknowledgement of the importance of project management and communications skills and of innovation.

3. Industry-specific testing hardly innovative

In paragraph 36 when discussing innovation, the working paper notes that 'some of the largest firms have developed industry-specific audit approaches, suggesting that it is possible to tailor the nature of testing to specific industries'. We would have seen basing the testing on the specific characteristics of the business, which will vary according to the industry or industries in which the business is represented, as core to undertaking an effective audit rather than a sign of innovation.

4. Care needed to distinguish between the role of the FD and the audit committee chairman

We are surprised by the comment in paragraph 43 that audit firms have challenged the point that 'in general the ACC may have to actively request information and that the ACC's available time and

resources may also be a constraint. ACCs have limited part-time engagements and do not have the same resources available to them as a Finance Director (FD) or audit partner.' The roles of FD and ACC are clearly distinct, one being executive, the other non-executive, and the ACC would not generally, for example, have direct access to information on the manner in which the fieldwork was being undertaken or the quality of the team as a whole as opposed to that of its senior members.

The working paper indicates in paragraph 49 that the FD/CFO, the ACC and AC members are the key individuals when it comes to the appointment of the auditor. It goes on to add that the AC/ACCs are most frequently cited as the most influential but that FDs consider themselves to have more influence than they are perceived to have among ACCs. This difference of view raises issues around the objectivity of the survey, an inherent challenge, and, linked to this, the fact that, answers given may have been influenced by the known expected reply.

It is important to draw a clear distinction between the roles of FD and ACC as one of the audit committee's main roles is to exercise oversight over management with regards, amongst other areas, to matters related to the audit of the financial statements. This issue is particularly significant when considering who plays the key role in the appointment of the auditor, a topic discussed in the next section.

5. Need to analyse principal-agent challenge effectively

The working paper does not properly address the principal agent problem or focus sharply enough on the fact that the auditors report to the shareholders who are their clients. Given the shareholders do not wish to be involved in regular dealings with the auditor they appoint an audit committee to carry out this task and whilst it is perfectly natural and reasonable for the finance director to be the senior person involved in day-to- day dealings with the auditors, the shareholders would wish to see the audit committee chair as the lead board member in terms of the overall relationship with the auditor and if this were not happening it would be a source of concern to them. The working paper does not address this matter but rather treats the FD and ACC together as a composite buyer of audit services.

In considering the principal-agent theory, it is important to recognise that the motivations and views of the FD and ACC with regards to what they seek from the auditor may not be the same and this is borne out by the CC survey. In addition, the reasons specified for not wanting to tender or switch auditors are not necessarily just those stated, an issue not addressed in the paper.

Moreover, if well over half the FDs and ACCs have each worked for, or been partners in, Big 4 firms this may impact on the degree of independence within their relationship, even more so if their links are to the same Big 4 firm.

6. Determining how auditor reputation is assessed

As previously discussed with you, the working paper refers in paragraph 67 to the reputation of the audit firm with investors, corporate brokers, analysts and external advisers being important factors in the appointment of the auditor but it is not clear how FDs and ACCs make this assessment. There certainly has not been, for example, much contact with investors to seek their views until now on the choice of auditors apart from the board's recommendation on auditors being put formally before the shareholders for their approval.

7. Issues related to the bargaining position of FTSE350 companies in the context of tenders

In considering the assessment of the performance of the incumbent auditor, you seem to gloss lightly over your statement in paragraph 43 that 'others said it was difficult for an Audit Committee to

examine in detail the work that the auditors had undertaken and that it was not the ACC's role to do so, and that the ACC could not know if the auditors were doing a poor job unless management raised it as an issue or something came to light after the event'. We find these conclusions slightly difficult to reconcile with the view that ACCs have a good understanding of the capabilities of the incumbent audit firms.

We are also concerned by the conclusion in paragraph 82 that 'it appears to us that the tender process generally provides FDs/CFOs and ACCs with detailed information on the capabilities of the audit firm…'. It is not clear how this conclusion has been arrived at without considering whether non- Big 4 firms with the capabilities to undertake many FTSE350 audits are given a fair opportunity to participate in tenders. Given the very heavy presence of FDs and ACCs with a Big 4 background the possibility of selection bias needs to be explored.

It is furthermore important to bear in mind that tenders are very infrequent, occurring at a rate of just 3.6% in the FTSE100 (once every 28 years if that rate were to remain constant) and 4.2% in the FTSE250 (once every 24 years). Audit tendering will tend to enhance the role of the ACC in dealing with the auditor as they tend to lead the audit tender process.

8. Scepticism shared about thoroughness of benchmark reviews

We share the view in paragraph 97 that the analysis suggests to you 'the information provided by benchmarking and other comparable exercises is limited. In particular, these exercises are generally limited to a comparison of audit fees and the expertise, experience and reputation of the audit firms and teams'. Even within such a limited scope, it is hard to see how a desktop review can be effective in assessing alternative teams some of whom a FTSE350 company may know and others not and certainly not in the context of their suitability as potential auditors. The working paper points this out in paragraph 141(a) where it states that 'other than going to tender there appear to be limited opportunities for audit clients to make comparisons with different firms'. Benchmark reviews are also very likely to be led by the FD rather than the ACC.

9. Reasons for not tendering or switching

We also share your conclusion in paragraph 111 that companies which did not consider there was much to be gained from tendering or switching would have based their decision on limited information.

10. Choice available to FTSE350 companies

We share your view set out in paragraph 112 that choice is not just a matter of the number of firms that might submit bids but also whether different firms might offer different approaches. To achieve this goal, we believe it is imperative that there be a level playing field enabling additional players in addition to the dominant ones to compete in an actively competitive market. It is unlikely that members of an oligopoly with relatively stable market shares over a prolonged period will be innovative. Innovation is far more likely to come from new players

11. Exclusion of non-Big 4 firms from tender lists

We note from paragraph 143 that non-Big 4 firms are not included on three-quarters of all tender lists. As this is a considerably larger proportion than the non-Big 4 believe are beyond their capabilities to audit on a sole basis, it would be helpful to explore the discrepancy and, in particular, to see whether it is due to familiarity bias favouring the Big 4.

Linked to the above, we note from paragraph 158 that Big 4 firms 'usually knew about tenders before they were officially launched and that they are more likely to be aware of tenders than non-Big 4 firms'. This enhances the advantage they have from incumbency and is likely to be due, at least in part, to alumni links and the provision of non-audit services. Again, we believe it is important to increase the transparency surrounding forthcoming tenders in order to create a level-playing field for all firms with the necessary capabilities to undertake the audit of particular FTSE350 companies.

12. Challenge to initial views on the strength of competition in winning new engagements

Based on our concerns expressed above, and indeed the analysis and evidence in the working paper, we have serious reservations about your conclusion in paragraph 165 that 'our initial view is that competition in tenders for FTSE350 engagements is strong in relation to the factors on which selection is based, namely the capabilities and experience of the firms and the audit team, the reputation of the audit firm and the audit fee'.

We would draw particular attention to the concerns raised in this letter related to the power of the Big 4 amongst relevant board members, the exclusion of many non-Big 4 firms from tenders for audits which they seem capable of performing and the preferential notice the Big 4 receive of forthcoming tenders.

13. Efforts made by firms to retain clients may be signs of an uncompetitive market

You state in paragraph 177 that 'we consider that the effort made by firms to retain FTSE350 clients may be evidence of the competitive pressure faced by firms'. We would urge you to consider an equally plausible alternative view, namely that there is an oligopoly and that those with market share are keen to avoid the emergence of a competitive market and are thus willing to cut fees to avoid a tender as a result of which they may see their fees further cut, tenders generally become more popular or them losing a major client none of which would be regarded as a desirable outcome. This is especially so given the stagnant nature of the market since the opportunity of winning a new FTSE350 client to counter the loss of an existing one will be very limited and would not be likely to be in the same sector leading to partner and staff deployment issues.

14. Evidence on the gains from switching may be signs of an uncompetitive market

We also have reservations about your initial view in paragraph 192 that FTSE350 companies are 'experienced and knowledgeable buyers that have a degree of bargaining power when renegotiating engagements'. Given your noting that it is hard to gain the necessary information on alternative offerings without a tender, your initial view does not seem altogether consistent with the evidence in the following paragraph that 40% of FTSE350 audit clients contacted had not put their audit out to tender in the last 10 years or had never put it out to tender and that one-third of FTSE350 companies do not even appear to carry out moderate benchmarking exercises.

15. Further discussion

If there are any issues you would find it helpful to discuss further with us, please do not hesitate to contact David Herbinet, Global Head of PIE Audits, on 0207 063 4419 or Anthony Carey on 0307 063 4411.

Yours faithfully,

Mazars LLP

Mazars LLP

Appendix: Mazars views on Audit Quality

We consider that the key elements characterising audit quality are:

1. **Culture – tone at the top**
   A culture within the firm where quality, and continual improvement in quality, is seen as being a key driver of the business. This is generally referred to as the 'tone from the top'. It, and the linkage between quality and recognition and reward, has a key role to play in ensuring the importance of high quality audit work is recognised by everyone in the firm.

2. **Challenge and scepticism**
   A mind-set where audit, through the exercise of scepticism, is seen as a challenge to the opinions and judgements of management; and the skills to deliver that challenge in a way which is constructive and not destructive.

3. **Courage**
   The auditor needs the courage to arrive at his or her judgment on the truth and fairness of the financial statements regardless of the pressures to take a view contrary to that which they believe to be right.

4. **A clear understanding that the shareholders of a company are the client**
   It is essential to avoid any confusion on the responsibility of the auditors to report to shareholders on whether the financial statements show a true and fair view

5. **Robust methodology**
   A well-defined and thorough audit methodology, supported by training, so that all members of the audit team understand what is required of them to deliver a quality audit and to encourage efficiency as well as effectiveness in the audit approach.

6. **Understanding of sector and business**
   A good understanding of the client's business and the sector in which that business operates. Most businesses face challenges which are specific to their sector and without the relevant knowledge there is a risk that audit procedures are not effective.

7. **Learning approach**
   The adoption of a learning approach, both amongst members of the audit team and between the team and members of the staff of the audited company, in order to generate improvements in efficiency and effectiveness with regards to the audit and, where applicable, the business of the audited entity.

8. **Good project management skills**
   Audits are complex projects which need to be managed to ensure all elements are brought together at the appropriate time.

9. **Strong communication skills**
   Audit requirements and audit findings need to be clearly explained to management and the wider governance body, many of whom will not be expert accountants.

10. **Commitment to innovation**
    Actively seeking to foster innovation both on individual audits and at a profession-wide level.