

The Director  
Market Investigation into Statutory Audit Services  
Competition Commission  
Victoria House  
Southampton Row  
London WC1B 4AD

Direct line 020 7063 4419  
Email david.herbinet@mazars.co.uk

21 September 2012

Dear Sirs

**Audit Market Investigation- The framework for the Competition Commission's assessment and revised theories of harm**

**1. Introduction**

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

**2. Primacy of true and fair view**

It would be helpful for the paper to bring out more strongly the primacy of the auditor's responsibility to offer an opinion on whether the financial statements show a true and fair view. This responsibility is set out in paragraph 5 but only after some of the auditor's other responsibilities have been mentioned in the previous paragraph.

There would also be merit in making clear that the responsibility to offer an opinion on the truth and fairness of the financial statements is an absolute one not restricted by virtue of the accounting conventions under which the financial statements have been prepared. This is an important issue as the shareholders, to whom auditors report, pressed for, and secured, a change in companies legislation to clarify previously ambiguous wording. This highlights that it is the judgement of the auditor that is critical to investors and others using audited financial statements and that they need to have the confidence that it has been exercised independently. We discuss these issues more fully in later sections of this letter.

**3. The board and management**

We would encourage a review of the working paper with regards to the description of the relationship between the board, management and shareholders. Paragraph 8 says that 'in large companies, shareholders delegate the management of the business to managers' whereas under company law the board of directors (generally made up of executive and independent directors in the case of listed companies) is responsible to shareholders for the successful direction of the company and it is

Mazars LLP - Tower Bridge House - St Katharine's Way - London - E1W 1DD  
Tel: +44 (0)20 7063 4000 - Fax: +44 (0)20 7063 4001 - www.mazars.co.uk

Mazars LLP is the UK firm of Mazars, an integrated international advisory and accountancy organisation. Mazars LLP is a limited liability partnership registered in England and Wales with registered number OC308299 and with its registered office at Tower Bridge House, St Katharine's Way, London E1W 1DD.

Registered by the Institute of Chartered Accountants in England and Wales to carry out audit work.



INVESTOR IN PEOPLE



MEMBER  
GLOBAL ALLIANCE OF  
INDEPENDENT FIRMS

collectively responsible for appointing the management to run the business on its behalf. Certain matters will be reserved for board decision.

#### **4. More attention needs to be paid to regulation and auditing standards**

The section entitled ‘Requirement for accounts to be audited in accordance with specified principles and standards’ mainly focuses on accounting standards and pays much less attention to the role of auditing standards and to the part played by the regulation of auditors in promoting high quality audited financial statements. We believe it would, in particular, be helpful for the working paper to discuss regulatory matters, in particular, in more detail.

It is primarily through the reports of the audit regulator, the Audit Inspection Unit (AIU) in the case of the firms auditing a significant number of public interest entities, and to a lesser extent the pronouncements of the disciplinary schemes of FRC and the professional bodies, that shareholders and directors are able to gain an insight into the quality of auditing at particular firms. Whilst the AIU looks both at firm-wide issues relevant to audit quality and reviews individual audits, given that the latter are not a representative sample of the firm’s work the conclusions have to be understood in their appropriate context. There is probably scope for public reporting on audit firms to be reviewed to see if it is providing the most relevant and reliable information possible to shareholders, directors and others involved in the appointment of auditors.

Paragraph 37 indicates that ‘we consider that a reputation acquired by audit firms for sound judgement in the application of accounting standards will be a key factor in the value of the audit output within the company (including its shareholders) and to the wider market value of audited financial statements’. Firstly, reference is only made to accounting and not to auditing standards as well but it also does not provide an insight to the central question namely whether the reputations of the different firms are reliably grounded to the extent they can be, subject to the limitations outlined in the previous paragraph, on published data related to the firms’ performance of audits or alternatively are based, for whatever reason, on other factors such as size and an influential network of relationships.

It seems to us that reputation is too often not based on independent evidence but on size, brand awareness and, unlike in many industries, close relationships between the providers of audit services and those *de facto* leading on the purchase decisions. We are not saying all of the bias is deliberate, much of it may be unconscious, for example many finance directors and audit committee members trained with and, in a number of cases were partners in, Big 4 firms. It is not surprising that many are supporters of their previous firms as it in effect validates their career choices and the resultant bonds are likely to be strong ones in many instances. There are also powerful relationships between the dominant audit firms and the largest professional advisers in other sectors and providers of banking and related services to FTSE 350 companies.

#### **5. The shareholder-auditor relationship**

We consider that it would be helpful for the working paper to expand on the relationship between shareholders and auditors and the different forms it could take. This will provide useful insights into how to address the principal-agent issues as they relate to the audit.

At its simplest, the potential principal-agent problem as regards shareholders and auditors could be significantly reduced by the shareholders directly appointing the auditors through a special committee of shareholders and their requiring the auditor to provide no services apart from the audit to FTSE 350 audit clients. This would aim to avoid conflicts of interest as a result of the audit firm having close ties

with management. In addition, if the audit appointment was subject to mandatory firm rotation after a set period, the risk of over familiarity would be significantly reduced and hence threats to auditor independence, and/or the perception of it, would also diminish.

From the above simple model one can then consider what modifications are needed to it to accommodate the needs of shareholders as opposed to others involved with the company such as management and the board. The distinction is important as it is the shareholders to whom the auditor reports and, as the working paper highlights, the principal agent issue may arise between shareholders on the one hand and the board and/or management on the other.

Whilst shareholders could make the appointment of auditors directly, without the intermediary involvement of the board, in proposing its preferred firm, it is not clear that they would wish to invest the time to do so and certainly if they were going to liaise with the auditors on an ongoing basis those shareholders involved in the process would risk becoming insiders which would restrict their ability to deal in the company's shares. Hence, they currently delegate the task to the audit committee made up of independent directors. The main challenge here is that the independent directors on the audit committee may be swayed in their choice by the executive directors whose interests may not be the same as the shareholders and they themselves may have, or have had, some links with particular auditing firms which may mean they have a leaning towards them. They may also be keen to retain the incumbent because they know how they work and there are less likely to be unpredicted issues arising on the audit, a not inconsiderable issue as it minimises the risks of differences, for instance, between management's/the board's expected view of profit and the audited results.

The best way to address the potential conflicts between shareholders' interests and those of the board in this area would seem to be to maintain the audit committee's role in the appointment but to make sure the shareholders have enough information on which to form a view when it comes to voting to appoint or reappoint the auditors. This would include information such as the date of appointment of the auditor; when a competitive tender was last held; past and present links between members of the board and the audit firm; information on the tender process when tenders occur and on how the selection was made; and commentary on the audit so that the shareholders have reasonable information on which to base their assessment of the robustness and soundness of judgement of the auditor. Consideration could also be given to the proposal put forward by the European Commission that the board put forward the name of two alternative audit firms for appointment with an indication of their preferred choice.

When it comes to the provision of non-audit services in addition to the audit, the shareholders may conceptually want this to occur if there are benefits to the company, given they will benefit as shareholders, though it would be likely that in most instances similar benefits could be obtained by FTSE 350 companies using an alternative firm to the auditors without significant additional cost. Moreover, any net benefits to the business would have to be weighed against the loss of independence, or perception of independence, which would be likely to occur if significant non-audit related services were provided. This would suggest the auditor of FTSE350 companies should generally only be expected to provide a modest amount of non-audit related services to the company. The shareholders may obtain some additional comfort through the audit committee being asked to approve the provision of any non-audit services by the auditor in advance and by them being asked to consider whether the overall volume of such services seems reasonable. The cost-benefit equation relating to the provision of non-audit services may well work out differently for sub-FTSE350 companies as they have much

smaller finance departments and so tend to need to rely on their auditors to a greater extent for advice and support.

As pointed out in paragraph 39, it is also very important for shareholders to have direct contact with the auditors in order that the auditors can understand the needs of shareholders. The Audit Firm Governance Code calls for audit firms within its scope to meet with shareholder representatives of their audit clients periodically to discuss relevant non-client specific issues.

## **6. The role of professional bodies and the FRC**

As the working paper points out in paragraph 44 ‘...regulatory solutions may provide further example of principal-agent problems (eg the role of professional bodies and the FRC). Each of these bodies is meant to protect the interests of shareholders, but in each case the shareholder is poorly placed to determine how effectively they complete their mission’. The issues regarding professional bodies and the regulator (FRC) respectively are broadly similar even if not entirely the same.

Professional bodies have a duty to represent the public interest but the risk is that they may get captured by members’ interests and, in particular, those of the dominant auditing firms, for example through their controlling key committee chairmanships.

We are also conscious that economic theory suggests dominant players will seek to capture their regulator. This issue is not really covered in the paper and deserves fuller exploration. In this context, it is interesting to note the prominence of those with Big 4 backgrounds on the boards, committees and staff of FRC. One might expect a stronger investor and smaller auditor presence on FRC. It is also very noticeable that the presence of those from large firms outside the Big 4 is very limited.

Prominence in key regulatory and professional roles both allows the dominant players the opportunity to influence policy and to demonstrate to clients and potential clients their leadership of the profession.

## **7. The need for fair and regular audit tendering**

You indicate in paragraph 58 that the bespoke nature of FTSE 350 company audits makes the comparison of audit fees more difficult. Whilst some broad benchmarking should be possible, if the previous assertion generally holds it is a strong argument in favour of regular and fair tendering so that bespoke alternative offerings can be compared against each other by the audit committee. This will enable it to ensure it has the offering which best meets the needs of the company and that the audit fee is competitive.

If the audit committee is to remain properly in touch with the market, the interval between tenders should not be unduly long and it should take all steps to ensure that a range of providers with the necessary capabilities are invited to submit a tender. Improved means of tendering may also be possible, for instance, two-stage tendering whereby a number of firms are invited to submit a preliminary tender and a small number a full tender once they have been selected for the shortlist.

## **8. Switching costs**

Those currently holding a significant market share in the FTSE 350 emphasise the costs of switching and the problems associated with it. Yet the results from the IFF survey commissioned by the Competition Commission present a very different picture- of those surveyed following a switch of auditors 64% reported an improvement in audit quality and only 3% a decline and 52% reported a lower audit fee and only 15% a higher one.

Estimates of costs are inherently highly subjective as they generally involve staff, management and partner time for the client, the incumbent auditor and other potential auditors. It would be interesting to understand how the cost of time is calculated as the use of normal charge-out rates for those in audit firms is unlikely to be representative of the actual cost to the firms. Moreover, clients' time spent may be regarded as an investment leading to the benefits set out above.

#### **9. Visibility of FD and Audit Committee Chairman on technical quality of the audit and quality of service**

The working paper suggests in paragraph 63 that the management and audit committee chair of a company have a high degree of visibility on many aspects of the technical quality of the audit and the quality of service. This is more likely to be true in the case of the finance director than the audit committee chair, again giving rise to potential principal-agent issues. Whilst the audit committee chair will have access to the audit partner and will see how he or she deals with the major issues arising on the audit they will have to rely on the finance director for evidence of how the team generally performed on site in the UK and overseas.

#### **10. The issue of a firm leaving the market unexpectedly**

The working paper does not discuss the potential impact of one of the dominant players leaving the market unexpectedly which would have an impact far greater than would normally be the case in other sectors. It would be likely to lead to major detrimental changes that would be irreversible and the risk of it happening cannot be lightly dismissed as it occurred just a decade ago in the case of Arthur Andersen.

Were four to become three, regulatory capture would be virtually guaranteed as the regulator could not afford to lose any other firms through withdrawing their licence to operate. The potential for disruption in the market would also be immense including amongst systemically important financial institutions and other businesses. The exact scale of the problem would depend on which firm was involved given their varying market shares but in all cases the market share is significantly above that of Arthur Andersen with regards to FTSE100 audits. Relying on living wills is an untried and highly inadequate response not least because if a firm's reputation has been severely damaged it has few assets of value remaining.

Addressing the above issue, requires the introduction of additional players into the market as does securing the goal of creating a more dynamic vibrant market focused on better serving shareholders' needs and the wider public interest.

Whilst conscious that this stage of the enquiry is not particularly focused on remedies, we believe the introduction of joint audit at the upper end of the FTSE 350 is the single measure that will most help to create the change that is needed. It would enhance quality through the 'four eyes' principle and not reduce the choice of companies as they could retain their existing auditor as joint auditor who would then be jointly responsible for the audit opinion on the group consolidated accounts. Moreover, it would enable a change in one of the joint auditors whilst maintaining continuity if a staggered system of auditor appointments were adopted and it would, at least to some extent, address the issue raised in paragraph 54 that industry demand is inelastic- although the total size of the market would remain broadly static the number of engagements would increase allowing new entrants to take market share and build up their expertise and experience with the largest FTSE 350 companies.



## 11. Conclusion

If there are any issues arising from our response which you would find it helpful to discuss with us, please do not hesitate to contact David Herbinet, UK Head of Public Interest Clients on 0207 063 4411 or Anthony Carey on 0207 063 44111.

Yours faithfully,

*Mazars LLP*

Mazars LLP