MAZARS

Inquiry Manager
Statutory Audit Investigation
Competition Commission
Victoria House
Southampton Row
London, WC1B 4AD

Direct line 020 7063 4419

Email David.herbinet@mazars.co.uk

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Dear Sir

Statutory Audit Services Market Investigation - Provisional findings report

1. Introduction

Mazars, the integrated international audit and advisory organisation with over 13,500 professional staff in 71 countries is pleased to submit its views on the above report.

We welcome the Competition Commission's provisional findings report and the detailed investigation that it has undertaken of the FTSE350 audit market, the most thorough ever of this important market.

2. Unmet demand - substantial evidence from investors

We fully share your view that there appears to be some unmet demand from shareholders, and potential future shareholders, regarding the audit and audit process (paragraph 12). This is very clear both from the evidence provided by investors to the Competition Commission and from investors' public pronouncements.

3. Important to recognise segmentation within FTSE350 market

We note that you provisionally found that that the relevant market was a single market for the supply of audit services to FTSE350 companies and not separate markets for audit services to segments of this group, eg FTSE100 and FTSE250 companies (paragraph 8). We welcome the statement, however, that defining the FTSE350 audit market as a single market did not stop the Competition Commission from assessing competition within sub-segments of it where relevant (paragraph 6.21) and presume this will continue to be the case as it looks at potential remedies.

We observe that your report highlights some significant differences within relevant segments, eg the FTSE100 and FTSE250 segments, on switching rates and profitability. On switching rates, for example, 67% of FTSE100 companies compared to 52% of FTSE250 companies have had the same auditor for more than 10 years whilst for tenures in excess of 20 years the figures are 31% and 20% respectively (paragraph 8). The total market fees are also very concentrated in the upper end of the FTSE100 when companies are ranked by their market capitalisation. You also reported in Section 7.82 that FTSE100 audits were on average more profitable than FTSE250 audits by between 2 and 6 percentage points.

It is also worth noting that the main challenger firms that have expressed interest in competing in a revitalised FTSE350 audit market have all indicated that there are a modest number of larger FTSE100 companies that they do not consider they would currently be able to audit as sole auditor.

4. Innovation at a low level both with regards to voluntary and regulatory initiatives

We agree with your view that innovation in the FTSE350 audit market seems to have been largely directed towards service delivery mechanisms rather than towards delivering a service which best responds to shareholders' assurance needs (paragraph 11). Innovation has been at too low a level both in terms of voluntary initiatives related to FTSE350 audits and regulatory and professional developments promoting innovation.

We also note your finding evidence of limited differentiation in offering between the Big 4 firms (paragraph 7.27). We believe this results in a lack of choice for companies. This needs to be taken into account when considering remedies and highlights the need for additional players to enter the market .

5. Extremely low levels of tendering, negotiation without tender not a substitute

We share the Competition Commission's view that the conditions of competition and the bargaining power of companies is significantly different, ie higher, within a tender process than outside it (paragraph 17).

Given the individual nature of each audit, a tender is needed in order to have a proper comparison from alternative service providers of fees and of other aspects of the audit offering. It is a very different market that will emerge if steps are taken regularly to avoid tenders and, in particular, it will be a market in which the scope for new players to bring innovation to the market is blocked out.

We also note your calculation in the report that there have been on average between just 8 and 10 competitive tenders each year in the FTSE350 audit market (paragraph 7.21). If one takes the midpoint of 9, and this were to apply on an ongoing basis, FTSE 350 companies would put their audit out to competitive tender on average just once in every 39 years. We do not regard this as a sign of a healthily competitive market.

6. Significant non-auditor services threaten perception of independence

We support your view that the incentives to auditors to accommodate executive management include quite naturally the wish to be reappointed (paragraph 26). You discuss this primarily with regards to the audit but where the auditor is providing significant non-audit services and reporting to management on them there are further risks to independence or, at least, to the perception of independence.

7. No single large investment identified as needed by challenger firms

We welcome and support your statement that the Competition Commission inquiry did not identify any single large investment that firms such as ourselves needed to make in order to have the capabilities to undertake FTSE350 audits (paragraph 22). We have invested significantly in the firm at both national and global levels over a number of years and, as we have indicated to you, consider we could currently audit a large majority of FTSE350 companies on a sole audit basis and nearly all the rest as joint or major component auditors.

We also agree with your conclusion that FTSE350 companies currently seek a substantial track record of experience of auditing FTSE350 companies when selecting auditors and only the Big 4 can point to such experience and, secondly, that use of 'Big 4' clauses in some loan agreement adds to the reputational barriers that Mid-Tier audit firms face (paragraph 22) though we would emphasise as you do later in your report, that these are barriers relate to 'perceived' reputation.

8. Impact of alumni on FTSE350 market and regulatory and professional matters

We note that you indicate that to date you have not identified sufficient evidence to support the other theories of harm as set out in paragraph 30. In particular, we believe the potential theory of harm arising from the dominant firms being able to exercise undue influence over the formation of regulation or regulatory bodies though their alumni networks deserves fuller exploration. To express our views more precisely, we consider the impact of the alumni networks on the market generally and of the dominant firms and the alumni networks on regulation together with their influence on regulatory and professional bodies should be further examined.

We note that around 66% of FDs of FTSE350 companies and around 60% of the ACCs have worked for Big 4 firms. Allowing for other alumni being members, but not chair, of FTSE350 audit committees and some companies having an FD who is ex-Big 4 but not the ACC or vice versa, this highlights the pervasive impact of the Big 4, through their alumni networks, on the appointment of FTSE350 auditors and on related issues such as whether to hold a tender and, if so, which firms to invite to tender.

We were also interested to note that the Competition Commission found that the Big 4 firms usually knew about tenders before they were officially launched and that this might arise from an FD or ACC being an alumnus (paragraph 9.137).

There can hardly be another market in which so many people move from working for the suppliers of a particular service to having substantial influence over the purchasing of that service. The links formed by alumni with their firms are particularly strong because many of the FDs and ACCs will have trained at the Big 4 firms and will link this formative stage of their career with the firm. The firm's brand name will also be important to them with regards to their CV.

In the context of the above, it is interesting to note that over 70% of FTSE350 companies said that they would formally consider only Big 4 firms if their current auditor ceased trading (paragraph 20). This seems to be in marked contrast to the views of the main challenger firms to the Big 4 as to our capabilities and your assessment that no single large investment is needed for firms outside the Big 4 in order for them to be able to compete effectively in the FTSE350 market. You also state that 'in our case studies the interviewees (all FDs or ACCs of FTSE350 companies) generally had much better awareness of the capabilities of the Big 4 firms than they had of the Mid Tier firms (paragraph 10.11)' and it is worth noting that 9 out of the 10 FDs in your case studies had trained with (7) or spent time after qualification with (2) a Big 4 firm (paragraph 9.61)

In addition, as you point out, current or former partners and staff also hold a significant proportion of the posts on FRC committees which you estimate to be around 50% (paragraph 12.12) and we would add that this also applies to staff positions. Moreover, the posts held include many of the key ones having a direct influence on FTSE350 audits. You also rightly indicate that there is very limited representation from other firms. With regards to possible regulatory impact, we would again draw your attention to ISA600 which, at least in practice, has been used in the case of large audits to reduce the likelihood of auditors other than the incumbent Big 4 group auditor being appointed as the auditor of some subsidiaries of a company. It would also be insightful for the Competition Commission to look at the positions held in the relevant professional bodies actively involved in the auditing arena by those with links to the Big 4 firms.

We believe further exploration of the issue of whether there is 'institutional bias' that consciously or otherwise, is favouring Big 4 firms in matters related to the FTSE350 audit market is needed.

9. Not persuaded by the view that the market is operating competitively

We are not persuaded by the arguments advanced in paragraph 5.62 on what are the central issues for a proper understanding of the market. These arguments are linked to the view that the FTSE350 market is operating in a competitive fashion.

We agree that both technical and service quality are important but this does not seem inconsistent with the views being put forward by the Competition Commission.

It is suggested by a Big 4 firm that were auditors to align themselves with management at the expense of auditors this would be very risky. We wholeheartedly share this view but sadly some corporate failures have highlighted one cannot be sure this has not regrettably occasionally occurred with devastating consequences.

On the general issue of whether primacy is afforded to shareholders' views, it is interesting to note that 88% of FDs compared to only 53% of ACCs have been approached by a rival firm to their incumbent auditor offering to audit the company in recent years, with the approaches coming predominantly from the Big 4 firms (paragraph.43). This might be thought to suggest these firms have seen the FD as the primary decision-maker on the choice of auditor.

On the FDs and ACCs being informed and expert buyers, the real issue is whether they are fully open to comparing alternative service offerings provided by a range of different firms with the necessary capabilities and to undertaking competitive tenders from time to time or, alternatively, whether there is some predisposition, which may not even be a conscious one, to tend to focus only on some of the potential providers and not to see the potential merits of competitive tendering.

Directors may also, as suggested, be very conscious of their duties to shareholders but until now there has been very little linkage between audit committee chairs and investors making an effective dialogue difficult. To help address this issue, Mazars in conjunction with Hermes, Railpen and USS have recently established the Centre for Audit Committee and Investor Dialogue, under the independent chairmanship of a FTSE350 chair, to do as the Centre's title suggests is its role.

In paragraph 7.30, we are not persuaded that it is appropriate to use the median fee to estimate the general trend in audit fees. The audit fees are not evenly spread throughout the FTSE350 but are very heavily weighted towards the top end of the FTSE100 and the movement in these fees will not be picked up by looking at the change in median fee which is likely to be that for a FTSE250 company.

10. Strong indicators of high profitability of FTSE350 audit market

We note that the Competition Commission inquiry was not able to reach a conclusion on whether audit firms were making profits above competitive levels or otherwise in this market (paragraph 10). Whilst recognising the challenges in forming a conclusion both given the difficulties in measuring profitability on individual assignments and capital employed in the Big 4 firms, we also note the number of significant indicators pointing in the direction of significant profitability:

- the level of remuneration of audit partners in the Big 4 firms (paragraph 7.75)
- the fact that Big 4 audit partners rarely leave voluntarily before retirement (paragraph 7.76)
- the average remuneration for audit partners in the Big 4 compared to their counterparts in other firms (not discussed in the report)
- the increase in partner remuneration at most of the Big 4 firms in the past 8 years (paragraph 7.71)
- the attractiveness of their remuneration relative to equivalent benchmarked positions (paragraph 7.75)
- the substantial growth in FTSE100 audit fees in recent years (paragraph 7.71)
- the seeming profitability of engagements even in the early years of an appointment even when it is not at its peak (paragraph 7.33)
- the existence of a number of FTSE350 audits where the audit firm seemed to enjoy consistently above average profitability (paragraph 10)
- your provisional conclusion that FTSE350 and similar audits seem to be a 'relatively attractive' service line for the firms concerned (paragraph 10)
- the resources that have been poured into defending the *status quo*

We also note that the higher profitability clients were more likely to be in the FTSE100, to have longer audit tenure and to have higher audit fees than other clients in the FTSE350 and were less likely to have tendered their engagement over the last five years (paragraphs 7.87 and 7.88). Again this does not seem to us to be indicative of a healthily competitive market and will be important to bear in mind when looking at the effectiveness of potential remedies.

11. Support for view on AEC – adverse effect on competition

We support your views that:

- barriers to switching and mid-tier audit firms facing experience and (perceived) reputational barriers to expansion and selection in the FTSE350 audit market give rise to an AEC, subject to our comments below on management time (paragraphs 31 and 32)
- there are misaligned incentives for auditors between shareholders and company management and barriers to the provision of information that shareholders demand and that this gives rise to an AEC (paragraphs 31 and 32)

We are not so sure that it is company management, as you suggest, that has primarily prevented more informative audit reports. The largest firms have had many years to press for reform in this area and have only fairly recently started to take active steps to support initiatives, to a significant extent following shareholder pressure.

You indicate that company management face significant opportunity costs in the management time involved in the selection and education of new auditors (paragraph 31). Undoubtedly, some costs will be incurred but we believe these should not be overstated and need to be set against the benefits from tendering and/or switching auditors, eg fresh pair of eyes, enhanced quality of service and reduced fees.

In summary, we support your conclusion that 'as a result of the AEC, we provisionally found that companies are offered higher prices, lower quality and less innovation and differentiation of offering than would be the case in a market without the features and shareholders and investors (as potential future shareholders) have demands which are unmet' (paragraph 33).

We discuss in a separate letter the potential remedies we believe need to be considered in order to address the AECs identified.

12. Other points

para 4, the reference should be to 'auditing' rather than accounting in the reference to an international *accounting* standard.

para 4, it may be helpful to make clear the AQRT's monitoring role covers public interest entities and that this includes, but extends beyond, FTSE350 companies.

para 5.39, references to audit committees being made up of '*non-executive*' directors should strictly refer to them being made up of 'independent' directors.

para 6.4 you refer to the audit report being signed by the AEP 'on the letterhead of his or her firm'. It may be helpful to make clear that rather it is signed by the AEP on behalf of his or her firm.

para 9.204, you suggest that the costs of preparing a tender varies significantly between companies but represents 'on average between 20 to 60% of the first year audit fee' This figure seems unduly high especially for the largest FTSE100 companies and, as we have previously stated, we do not believe that tendering costs should be measured by reference to normal charge-out rates of staff involved in preparing the tender as this will lead to estimates being too high.

13. Further discussion

If you would find it helpful to discuss any of the matters raised in this letter, please do not hesitate to contact David Herbinet on 0207 063 4419 or Anthony Carey on 0207 063 4411.

Yours faithfully

Mazars LLP

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