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Dear Sir

Statutory Audit Services Market Investigation - Notice of Possible Remedies

1. Introduction

Mazars, the international accountancy and audit organisation with over 13,500 staff in 71 countries is pleased to submit its comments on your Notice of possible remedies under Rule 11 of the *Competition Commission Rules of Procedure.*

Our key comments are presented below with detailed comments on the specific questions that you asked set out in the Appendix. This letter should be read in conjunction with our letter on your Provisional findings report.

2. Integrated reform package essential

We believe an integrated package of remedies needs to be considered in view of the interaction between various individual reforms. There is very limited merit in considering each remedy proposed on a stand alone basis. Instead, the need is to consider how the package of remedies will address the causes of the AEC. We believe our proposed package of enhanced remedies would promote the development of a competitive FTSE350 audit market in which the interests of shareholders and the public interest are afforded primacy. In particular, the enhanced package of remedies would enable the problems to be tackled relating to new entrants having difficulties in accessing the FTSE audit market and then to working at the upper end of the FTSE100 market as well as in the other segments of the FTSE350 audit market.

3. Mandatory change needed- voluntary initiatives have not worked

In exploring remedies we would counsel the Competition Commission against relying on voluntary or similar arrangements since whenever they have been tried they have not been successful. The FRC has accepted, for example, that the voluntary reforms proposed by the Market Participants Group in 2007 were not effective. As the Competition Commission has pointed out, the currently very high levels of concentration have existed for a prolonged period. When one adds to this the market impact of long

established alumni networks, the degree of influence of Big 4 firms on regulatory and professional issues and the strength of their lobbying activities, both in absolute terms and relative to that of challenger firms, the need for mandatory change seems clear to us.

In the context of supporting mandatory change, we note the recent introduction into the UK Code on Corporate Governance of a provision calling for FTSE350 companies to put their audit out to tender at least once every ten years, on a comply or explain basis. It is far too early to assess the likely degree of compliance, as opposed to explaining the reason for non-compliance, with the relevant provision and thus such an approach should not be relied upon.

4. Broadly supportive of the seven proposed remedies but not sufficient on their own

We are generally supportive of the proposed seven remedies and amongst them mandatory tendering and mandatory rotation merit particular attention if the necessary change is to be brought about in the FTSE350 audit market. Tendering, however, must be both regular and fair if there is to be a reasonable probability that it will achieve its objective. We discuss this further below.

Moreover, we do not consider that the proposed remedies will, on their own, address the causes of the AEC. As discussed in paragraph 6 below, additional remedies are needed to deal especially with the challenges facing mid-tier firms seeking to build a reasonable combined share of the FTSE350 market in order that the public interest need for a more vibrant competitive market can be met.

5. New entrants needed to promote innovation and reduce risk of Big 4 becoming the Big Three

A strong presence from challenger firms, or other possible new entrants, is essential if a market that is innovative is to be created. As the history in other industries shows, including airlines, telecoms, computers, to name a few, it is new players that introduce major innovations to markets and not longstanding existing ones with substantial settled market shares.

We also consider there is a need for the new entrants to be involved in all segments of the market, including the upper end of the FTSE350, if their modernising impact is to be felt across the market.

Furthermore, additional players are needed to deal with the major systemic risk that one of the Big 4 firms might leave the market unexpectedly as it only just over a decade since Arthur Andersen did so and there has been the largest financial crisis in generations since that time. This is a major systemic risk and it should be noted that the market shares in the FTSE350 of each of the Big 4 firms is well above that of Arthur Andersen at the time of their demise.

6. Remedies needed on non-audit fees and joint or major component audit

In view of the above, we consider that the Competition Commission should also explore two further remedies that it has indicated it is currently not minded to consider namely those related to constraining non-audit services provided by the auditor and joint or major component audit.

7. Limiting non-audit services

As you recognise in your remedies notice, non-audit services that are not related to the audit can naturally pose a threat to the auditor's independence and/or, we would suggest, at least to the perception of it. This is especially the case if the total of non-audit fees earned by the auditor are large in absolute terms or large relative to the audit fee and the concern is valid even if individual non-audit services are deemed acceptable for the auditor to undertake. We note that a number of large investors have called for a 50% cap on non-audit fees. At present 7 firms in the FTSE 100 have non-audit fees that exceed the audit fee as do 39 FTSE250 companies with 20 of the 39 having non-audit fees above twice the level of the audit fee. Restrictions on non-audit services may also take the form of narrowing the range of permitted services.

In addition to independence concerns, greater restrictions on the auditor offering non-audit services are also needed to increase the opportunities challenger firms have to get to know FTSE350 companies through undertaking non-audit work for them. This is one of the ways companies have indicated to the Competition Commission that they get to know firms better and so feel able to form an assessment of them.

We do not understand your comments in paragraphs 71 and 72. Regardless of whether audit was a loss leader, the provision of non-audit services, where the reporting line is to management, might undermine independence. Secondly, it is hard to see how restricting the non-audit services provided by the auditor will undermine the board's ability to assess other firms which are not the auditor. If anything it will enhance that ability as these firms will have a chance to provide a wider range of services if the auditor is limited in what it can undertake. Strong limitations are generally placed on the provision of non-audit services with regards to public sector audits and it is not clear why the generally accepted practice is different in the private sector for major listed companies.

8. Joint or major component audit

We note that you have said in paragraph 74 of the remedies notice that at this stage 'we have not formed a view as to whether joint or major component audit has a beneficial effect on independence or not nor whether it would be likely to reduce barriers to entry to the reference market'.

We urge the Competition Commission to further explore this potential remedy, in addition to the other remedies proposed, as in our current and practical experience:

- it enhances audit quality;
- it enhances service quality;
- it is a less expensive alternative to audit rotation;
- it enables new entrants to build up their share progressively in the audits of leading listed companies;
- It is the only remedy proposed that has proven track record over a sustained period of delivering the benefits sought by the Competition Commission in a major global economy.

In more detail:

Joint audit would enhance audit quality through the 'four eyes' principle as each firm would be checking the others' work carefully and coming to a common view on subjective and complex issues arising on the audit since they would be forming a joint audit opinion and be jointly liable for it.

If there were a requirement that the audits of larger FTSE350 companies should be undertaken by joint auditors, or through the use of shared/major component auditors, with at least one of the firms chosen coming from outside the Big 4, this would be an assured way of removing the barriers to non-Big 4 participation at the top end of the FTSE350 market. The requirement for at least one of the auditors to come from outside the Big 4 could be a transitional one. Once the barriers to entry had been removed, both with regards to needing experience to get appointed and perceived reputational barriers, the limitation on who could be appointed could be lifted.

Alternatively, there could be an incentive for joint audit, as suggested in your remedies notice, with joint or major component auditors not being subject to mandatory rotation, or at least the period before rotation being significantly extended so long as the joint auditors rotated the audit work carried out by each firm. Again if desired, under this model there might be a transitional requirement to appoint at least one non-Big 4 firm if this option were being adopted.

Even if there were not a requirement to appoint at least one non-Big 4 firm as joint auditors, it would still be likely to lead to a more comprehensive solution to the AEC as it would be hoped some non-Big 4 firms would get appointed to leading listed audits which they would not have been able to undertake on a sole basis.

As we discussed when we met you, France the EU Member State with a requirement for joint audit, has a lower market concentration than in the audit market in any other one and that is without any restrictions as to which firms may be appointed as joint auditors.

You mention in the remedies paper, that there appeared to be limited appetite for joint or major component audit by companies or institutional investors. This appears to be due to some very dated and limited experience of joint audits in the UK often going back forty years or more and operating on a different basis than proposed above. Outdated anecdotes would not seem to constitute empirical evidence to justify not exploring the idea further. In addition, at least some of the Big 4 firms have been strongly lobbying against the concept of joint or major component audit.

You suggest that greater visibility of firms' capabilities could be more likely to be achieved through mandatory tendering and enhanced AQRT reporting but you provide no reasoning to support this view and it does not seem to us to be the case. Only joint or major component audit will provide non-Big 4 firms with the opportunity to participate in the audit of the largest FTSE350 companies and this is where a substantial proportion of the market is, by fee income.

Joint auditors, where there were staggered appointments, would also overcome the challenges of first year audits highlighted by some firms as you would be able to change one of the auditors whilst retaining continuity through the ongoing appointment of the other

There would also be a need if joint or major component audit were to be introduced to discuss transitional arrangements under which the share of the auditor with the smaller proportion of the work was allowed to build up in the early years after they were first appointed but once in steady-state situation there should be a requirement for the share of the auditor with the smaller proportion to be around 20-25% of the total group audit fee. The enhancements to audit quality arise mostly in a situation where the allocation of the work between the two firms is not too unbalanced.

We would urge further exploration of the possibilities of joint or major component audit and we would be very pleased to facilitate this with practitioners, companies and regulators who have recent experience and real expertise in this area.

9. Tendering should be fair as well as regular

It is important that any system of tendering be fair as well as regular. We do not have strong opinions as to whether this is done at intervals not exceeding five or, alternatively, seven years, the two figures mentioned by you, though we do see merit in aligning the period with the maximum length of tenure for an engagement partner which is currently five years in the UK for FTSE350 audits (although the Eighth Directive permits it to be up to seven years).

Your Provisional findings report has suggested that around 70% of FTSE350 companies would not consider inviting a non-Big 4 auditor to tender even if their existing auditor, nearly always a Big 4 firm, ceased trading which is very surprising as there would only be three dominant firms left at that stage. The report also highlighted that FTSE350 FDs in your case study had far more experience of Big 4 than challenger firms. Thus, there cannot be a high degree of assurance that tendering and rotation will provide many real new opportunities for non-Big 4 firms unless supplemented by other relevant measures.

To provide a level playing field, or as level a one as possible, companies should be required to make public their plans to hold a tender with any firm who considers they have the necessary capabilities and which wishes to be considered. The companies could then produce a shortlist and invite those submitting the best summary proposals, say around three firms, to submit full proposals. There would also be merit, in terms of trying to address institutional bias, in asking boards to state their links with particular firms when putting the audit out to tender.

We also believe the quality of tenders could be enhanced and the costs of holding them reduced through developments such as two stage tender processes and agreement on what information should generally be made available by the company and possibly also the incumbent auditor. We believe this is more practicable than an open-book approach as mooted in your remedies document. The firms and the professional bodies and/or FRC should work together on how to make tendering more efficient and more effective. Under a two stage process, for example, firms might reply to the initial tender request and the company would then select a shortlist amending its specification based on ideas emerging in the first stage of the process. In our experience such an approach has generated more innovative approaches.

There should also be clear requirements for companies to indicate which firms tendered, which were shortlisted and the reason for selecting the winner. We also see merit in the idea of shareholders being provided with a shortlist of two firms and being asked to vote on which they would prefer to appoint.

10. Mandatory rotation

If there is to be mandatory rotation, we would suggest a period of around 15 years subject to tendering at five or seven yearly intervals. Fifteen year cycles would seem to us to provide an appropriate balance between the benefits of a fresh pair of eyes at reasonable intervals and the costs, even if they should not be overstated, of changing auditor. This also accords with the maximum time before rotation as suggested by a group of leading institutional investors. This period could be extended, or the need for rotation even removed, in the context of a joint or major component audit arrangement.

11. Attendance at Board meeting

Taking account of the disconnect between auditors and shareholders, we would suggest you explore the possibility of auditors being systematically invited to Board meetings. This is already the case in a number of European countries and has proved to be an effective mechanism to bring auditors and independent non executive directors closer together as not all will necessarily be on the audit committee. It will also enable auditors to have a better understanding of the interactions of management and the board with shareholders.

12. Further discussion

If there are any issues in this letter which you would find it helpful to discuss further, 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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