

Seizing the chance to change

Increasing competition
and choice in the audit market



48 *years*

A time for



the number of years a FTSE 100 auditor can expect to remain in place, that is if appointed today there would not be a change until 2058.

change?

(and it's 36 years for the FTSE 250)

The need for

CHANGE

Substantial audit market change urgently needed

Creating a sustainable market

Recognition has steadily built up that substantial change in the audit market is essential if shareholders' needs are to be met. We believe the need for change, the resistance it is likely to face and the capabilities of leading firms outside the Big 4 are often understated. The benefits from implementing the right changes will be considerable.

We believe there is a need for a reinvigoration of the debate on competition and choice in the audit market following the recent publication of an independent satisfaction study on clients' views of the UK's twelve most-used audit providers.

The inaugural Finance 360 survey of senior readers of *Accountancy Age* and its sister title *Financial Director* shows non-Big 4 firms such as Mazars – which was ranked first overall – to be out-performing their larger rivals across five separate service areas.

It is hard to overemphasise the level of systemic risk that exists in a market where the Big 4 have a combined 96% share of the market for FTSE 350 audits and the impact if any one of them were to leave the market unexpectedly due to regulatory action or litigation. We must move away from this unsustainable state of affairs.

A handwritten signature in black ink, appearing to read 'D Herbinet', with a large, sweeping flourish underneath.

David Herbinet
Head of Public Interest Markets

FTSE 100 auditors

can expect to remain in office for 48 years

The Oxera report, published in April 2006, which was jointly commissioned by the then Department of Trade and Industry and the Financial Reporting Council (FRC), found that on average only 2.1% of FTSE 100 companies and 2.8 % of FTSE 250 companies switched auditor each year between 1996 and 2004. At these rates of switching, a FTSE 100 auditor can expect to remain in place for a staggering 48 years and a FTSE 250 auditor for 36 years. Or to put it another way, on average only about nine audits per year changed hands annually in the FTSE 350 during the sample period. With an annual switching rate of 4.6% even small company auditors can expect to retain their appointment for almost 22 years.

As you would expect from the above figures, competitive tendering for FTSE 350 audits is very infrequent. The Oxera research found, for example, that more than 70% of the FTSE 100 had not held a competitive tender in the last 15 years.

Sadly, four years down the line, not much has changed and, like many others, we are not convinced that these figures are the sign of a healthy market. Competition and choice is about much more than a few firms contesting an audit tender for a large listed company once in a blue moon.

Many audit committees of the largest listed companies have found that the number of firms which they perceive are a genuine alternative to their current auditor is very limited once one eliminates those conflicted through the provision of other services to the business or by virtue of their auditing a key competitor. In some cases, in practice, there is no alternative if a board is only willing to consider the Big 4.

Resistance to change should not be underestimated

Securing the necessary change is not proving at all easy. It involves both overcoming resistance to change and building the necessary momentum to move from agreement by shareholders and other commentators that widespread change is necessary to taking the steps in individual companies, or in respect of individual shareholdings, to make it happen. Putting audits out to tender at reasonably regular periodic intervals will initially take many boards of listed companies, as well as some audit firms, outside their comfort zones and will involve a modest amount of additional work in order that boards and shareholders can reap the rewards of a more competitive market.

Another important barrier to change is the advantage that the Big 4 derive from their nexus of connections. Many FTSE 350 board members - especially finance directors - and their advisers have traditionally had stronger connections with the Big 4 than with other leading firms and may not be fully aware of the capability of these other firms.

*A competitive
market would...*

Strengthen

I
N
O
V
A
T
I
O
N

“ We believe that only by making the quality of audits more visible and transparent to all players – not least those who pay for audits and for whose benefit they are carried out – will a more vibrant and competitive market develop. ”

Hermes

Competition and innovation are linked

Enhancing competition and choice should lead to a much more dynamic and innovative audit market. There is no reason to think that auditing is different from other sectors in this respect. A reformed market would be more responsive to the needs of the shareholders and have a sharper focus on ensuring the highest levels of client service. Many institutional shareholders and finance directors are not happy with the current state of the audit market and their concerns need to be properly addressed. The debates on competition and choice, the future role of audit and liability reform are not discrete issues – they are interlocking pieces of the same jigsaw.

Some institutional investors have, for example, indicated they would like to see a move from standardised wording in audit reports to the provision of more company-specific information. There are different ways in which the desired information could be provided - in the financial statements, in the report of the audit committee and/or in the auditor's report - and further discussion is needed to identify the best route forward. We need, however, to be receptive to calls for change in the way our audit findings are reported.

We also need to ask whether as a profession we have fully thought through the impact of the switch to IFRS around the world on the way in which audits are undertaken – including the effect of the increasing use of valuations in financial statements. Auditors, every bit as much as standard-setters, have a pivotal role to play in ensuring we maintain a principles based system of reporting that fully reflects the specific circumstances of the company being audited and its transactions. We must not drift towards a rule-based system based on generic solutions.

Narrative reporting, which was for too long the Cinderella of corporate reporting, is also of vital importance if shareholders are to gain a rounded picture of the performance and development of, and prospects for, their business. A wide-ranging study of what assurance shareholders would find useful in this area and how it could best be provided would be helpful.

Overall, an auditing environment that was more receptive to change would benefit from a less monolithic approach by audit firms and would be better able to respond to the changing expectations of the market place.

Key reforms. Key reforms.

More frequent audit tendering

Key reforms. Key reforms.

A fair and open selection process

Key reforms. Key reforms.

Effective audit firm governance and transparency

Key reforms. Key reforms.

End of restrictive covenants on auditor choice

Key reforms. Key reforms.

Independent study on the merits of joint audit

Sharp focus needed on high impact changes

The primary focus needs to be on making changes that will have the greatest impact in practice. The 80:20 principle is as applicable here as it is in many other areas of business life. We believe the key reforms include more frequent audit tendering; a fair and open selection process for auditors; improving disclosure in audit committee reports and effective implementation of the new Audit Firm Governance Code including enhanced dialogue between shareholders and auditors.

More frequent audit tendering

The arithmetic on switching rates makes a compelling point on concentration. Without a significant increase in the number of auditor changes each year the market will not achieve the necessary reduction in concentration. This will undoubtedly require audits being put out to tender on a much more regular basis than has been the case.

The Financial Reporting Council's *Guidance on Audit Committees*, 2008 indicates the audit committee section of the annual report should normally include supporting information on tendering frequency, the future of the incumbent auditor and any contractual obligations that acted to restrict the audit committee's choice of external auditors.

We believe that institutional shareholders should carefully review and follow up on disclosures made by listed companies and that the FRC should identify trends arising from such disclosures and decide what future action is required.

Companies may also wish generally to review their audit committee reports to ensure they are informative and avoid 'boilerplate' analysis.

A fair and open selection process

When the audit is put out to tender, audit committees should set out the key factors that will determine their choice of auditor and management's role in the process and invite firms who are interested to submit a brief preliminary proposal of a few pages in length. A shortlist should then be drawn up with firms on it being invited to submit a full proposal. The names of the firms which submitted proposals and of those which were shortlisted should be disclosed in the audit committee's report.

The above would reduce the concern of leading firms outside the Big 4 that they may incur significant costs in bidding for an audit in a tender which they do not have a realistic chance of winning.

10 Public interest audit firms should be highly transparent

We believe that audit firms, in view of our public interest role, should embrace good governance and display a high degree of transparency in the way we undertake our work.

We welcome the Audit Firm Governance Code, published by the FRC and the Institute of Chartered Accountants in England and Wales in January 2010, and are committed to applying it ourselves. It is the first such code to be developed and we consider this innovative initiative deserves the strong support of leading audit firms together with that of the boards, audit committees and shareholders of listed companies.

The Code calls for shareholders to enter into a dialogue with audit firms to enhance mutual communication and understanding. We would encourage institutional shareholders to invest the necessary time in such dialogue in order to gain a full appreciation of a range of firms including a number outside of the Big 4.

Moving away from restrictive loan covenants – a need to go beyond transparency

Issues have come to light of situations where banks have imposed conditions, effectively requiring the use of a Big 4 firm prior to issuing loans or as part of loan covenants. We do not believe this is acceptable.

We consider that such disclosures of restrictive covenants, as recommend by the FRC's *Audit Committee Guidance* discussed above, should always be made and, more importantly, that banks should not impose such covenants in the first place.

Independent study on joint audits

We support initiatives to encourage companies to be more willing to appoint auditors from more than one firm, network or alliance. There are two ways in which this can be achieved: the appointment of joint auditors or the appointment of a group auditor who is also likely to be responsible for auditing some of the group's subsidiaries with another auditor auditing the remainder.

The use of more than one auditor recognises that different firms or networks/alliances, including those of the Big 4, have varying relative strengths in different market sectors and geographic regions and that by combining their resources a client may secure optimum levels of client service and audit quality.

We would therefore support a move from the situation where many audit committees have been reluctant to use audit firms from more than one network or alliance to one where audit committees seek to appoint auditors for individual components of the group financial statements based on how best to achieve audit quality for that particular component and for the group as a whole.

We need to move from anecdotal comments on joint audits to a proper evidence-based assessment of their potential to address current market place concerns together with an analysis of any obstacles to introducing them and how these may be overcome. A thorough independent study on joint audits should therefore be undertaken under the auspices of the FRC. The views of those with experience of joint audits should be carefully considered in the study. A summary of the potential benefits of joint audit is set out in the Appendix on page 20.

Other ideas – we have an open mind

We recognise that, in addition to the issues discussed above, other commentators have raised other ideas including in relation to the way in which auditors are appointed and recommended. We would be supportive of these being explored further to assess their feasibility and likely impact on competition and choice.

Making Change

HAPPEN

Institutional investors

The support of institutional investors is critical to making change happen in the audit market just as it has been with all the other major governance reforms over the past two decades.

Institutional investors will need to invest the time and resources to engage with individual companies and audit firms on competition and choice and other auditing related issues. Time will probably also be needed to increase their familiarity with some auditing issues but there will be very worthwhile returns from their investment. They will need to be willing to challenge companies when they have not had an audit tender for many years or when they do not appear to have been willing to judge firms on their merits rather than on preconceptions.

Audit committees

Audit committees are in the driving seat when it comes to implementing the necessary changes. These are likely to involve making additional disclosures in their report each year; engaging in more active dialogue with major investors on audit related issues; undertaking more rigorous evaluation of their auditors and putting their audit out to tender on a more frequent basis. In fulfilling their enhanced role, audit committees may find some more time is needed to discharge their duties effectively which should be taken account of in the remuneration of committee members. There may be benefit in an enhanced independent secretarial function to support the committee.

Audit firms

Leading audit firms outside the Big 4 have a responsibility to make sure that listed companies and institutional investors are aware of their strengths and market positioning. At Mazars we are committed to strengthening our dialogue, and working relationships, with the boards and management of public interest companies and their shareholders.

A preference for market-led reform so long as it delivers the necessary change

Our preference, all other factors being equal, is for market-led change. That said, the current playing field is far from level. It may be that regulatory intervention will be needed to increase competition and choice. It will be far better for there to be some regulatory action than for the necessary changes not to take place. At the very least, government and relevant regulators need to make clear that unless market reforms produce real change within a reasonable timeframe they will intervene.

The issue is far too important for it not to be at the top of the agenda of everyone with a stake in high quality audits that meet shareholders' needs in today's world.

Vital need to turn
back the clock on
increasing levels of
concentration

We must not ignore the need to turn back the clock on ever increasing levels of concentration in the audit market. We must create an innovative market that is strongly focused on **audit quality** and which meets the needs of companies and their shareholders.

Appendix 1

The benefits of joint audit:

- the group audit opinion is formed jointly by the joint auditors which ensures that contentious issues are considered and agreed by both firms leading to increased confidence in the audit opinion;
- it enables work within the audit to be rotated periodically between the joint auditors, by market sector or geographic region, thereby maintaining a freshness of approach on the audit;
- it allows one of the joint auditors to be changed whilst maintaining continuity of knowledge and expertise on the audit;
- it allows benchmarking of the quality of audit work, client service and the level of fees between the firms involved, providing the audit
- it would facilitate leading firms/networks alliance outside the Big 4 playing a substantial role in global audits, bringing the market benefits of greater competition and choice, when they may not immediately be in a position to undertake the whole group audit on their own.



- Mazars is a unique integrated partnership with global reach and local roots
- Mazars international reach extends to 72 countries with a single integrated international partnership in 55 countries
- Mazars acts for 17% of the FTSEurofirst 100
- Mazars audits more FTSE Global 500 companies than any other single firm outside the Big 4
- In the UK we act for 18 FTSE 350 clients and for over 65 UK listed businesses plus the UK subsidiaries of over 70 overseas listed companies.

Please get in touch. . .

For more information, please contact:

David Herbinet
Head of Public Interest Markets, Mazars LLP
Telephone: +44 (0)20 7063 4419
Email: david.herbinet@mazars.co.uk

Anthony Carey
Partner, Mazars LLP
Telephone: +44 (0)20 7063 4411
Email: anthony.carey@mazars.co.uk

mazars.co.uk

Mazars LLP is the UK firm of Mazars, an international advisory and accountancy group, and is a limited liability partnership registered in England with registered number OC308299. Mazars LLP is registered by the Institute of Chartered Accountants in England & Wales to carry out company audit work.

We have offices in Bedford, Birmingham, Brighton, Bristol, Dudley, Edinburgh, Glasgow, Leeds, Liverpool, London, Luton, Manchester, Milton Keynes, Nottingham, Oxford, Poole, Southampton and Sutton