Dear Sir

Statutory Audit Services Market Investigation - Evidence on switching costs (and implications for barriers to entry)

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. Lack of attention to investors’ views

There would be merit in the working paper paying much more attention to the views of investors on issues relating to switching as the auditors report to investors, ie the company’s shareholders taken together are the auditor’s client.

In their recently published paper *Audit - a long-term investor position paper on proposed EU reform*, a group of large institutional investors which collectively manage approximately EUR 1.3 trillion, including a number from the UK, have indicated that they believe that there are a number of worrying features of the audit market. They say that ‘at a very fundamental level, we are concerned about auditor independence and professional scepticism’.

The investors specifically express concern about the lack of rotation of audit firms and highlight the very long tenures of FTSE100 auditors and, against this background, point to the risks of auditors becoming ‘captured’ by their own historical judgments. In addition, they point out that ‘where an audit firm knows it will be replaced, it will be incentivised to maintain scepticism as its judgements will be reviewed in detail by the incoming auditor’.

The investors also express the view, which seems broadly similar to that of Professor Vivien Beattie who reviewed the issue as part of her literature review for the Competition Commission, that empirical evidence is inconclusive on rotation’s impact on audit quality and costs. Moreover, they offer the opinion that very few countries have implemented auditor rotation for long enough to offer robust conclusions.
The investors also point out that in the case of independent directors existing guidance/rules with regard to their tenure tends to range from 9-12 years in EU Member States and that after such a period it is widely believed that independence has been lost.

Partner rotation is not considered by the investors to provide a sufficient guarantee of a ‘fresh pair of eyes’ on the audit. Furthermore, they consider that mandatory rotation might support increased competition as it would provide the opportunity for entry by non-Big 4 firms as well as for greater competition amongst the four dominant players.

In terms of specific proposals, the investors suggest that a maximum period of 15 years should be allowed to elapse before rotation is required and that within this period a competitive tender should take place on at least one occasion.

3. Greater focus on benefits of switching

It would be helpful for the working paper to strike a fairer balance between its discussion of the benefits and costs of switching. There is, at present, far more discussion of the costs and drawbacks of switching than of the benefits. The investors have identified a number of important benefits as set out above.

4. Management time and other costs

We note that the general view of companies seems to be that putting the audit out to tender does not require that substantial an amount of management time nor are the direct monetary costs that large. The main input of time comes in briefing the new audit firm once appointed but this process should also generate benefits for management in terms of new insights into controls and processes or on other issues from the newly appointed auditors.

5. Different emphasis of dominant players on problems of switching when incumbent compared to bidder

We note the different emphasis the dominant players seemed to place on the challenges of switching when they were the incumbent as compared to a bidder on an audit they did not currently undertake.

In paragraph 17 you report E&Y advising that if a current audit client wanted to put the audit out to tender partners/staff should ‘highlight the internal time absorbed in a tender process’. In similar vein you note E&Y emphasising in a tender proposal, where it was the incumbent auditor, the risks associated with a new auditor including expressing the view that allegations of failure occurred more frequently when a firm was in its first years of an audit engagement.

On the other hand, in paragraph 66 when discussing establishing a new audit relationship, the emphasis is different even if not entirely inconsistent. In these circumstances, E&Y indicate that it ‘would take positive steps to ensure that the risk of ‘making mistakes initially’ was minimised’.

6. Issues concerning academic literature in relation to switching risks

We note that the audit committee chair citing empirical research undertaken by Bocconi University in support of the view that the risk of audit failure was higher when an audit was first undertaken was a former audit partner. Our understanding is that the Bocconi research has not been published in peer reviewed academic journals and we would also ask for information on whether the university/researchers received financial or other support from any of the dominant auditing firms, directly or indirectly.
In assessing research studies on the risks of switching, care needs to be taken to assess whether the situation being addressed is similar to that being proposed, the nature of the proxy variables used to measure quality and the existence of different legal and regulatory regimes in different countries.

7. Possible influence of Big 4 views on FDs and Audit Committee chairs

We note from paragraph 24 of the *Working paper on Competition Commission survey results* that two thirds of the FDs surveyed and 60% of audit committee chairs had worked for one of the Big 4 and we wonder whether some companies’ views are not influenced by the previous professional background of the FD or audit committee chair as well as by the views being directly offered to their audit clients by the Big 4.

8. Initial views on switching costs

We believe the initial views on switching costs should be modified to take fair account of the views raised in this letter and, in particular, those of investors. Some of the potential benefits highlighted run directly counter to the supposed costs, eg the merit of a fresh pair of eyes reviewing historical judgments compared to the benefits of experience.

We are also not convinced that the academic literature allows reliable conclusions to be drawn on the risk of failure in the early years compared to the subsequent years of an audit.

9. Further discussion

If you would like to discuss any of the issues raised in this letter further, please do not hesitate to contact David Herbinet, Global Head of PIE Audits, on 0207 063 4411 or Anthony Carey on 0207 063 4411.

Yours faithfully,

Mazars LLP