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Mazars Submission to the Business and Trade Committee Inquiry on Audit Reform
May 2024

Key Points

1. **More choice in the market is needed, to increase competition and resilience.**
    - The dominance of a few major firms in the audit market, particularly in auditing Public Interest Entities (PIEs), poses challenges to competition and choice, and ultimately to the resilience of the audit market and in turn of capital markets.

2. **Managed Shared Audit (MSA)** is a crucial step towards meaningful change in the audit market. It will provide an opportunity for challenger firms' collective market share to increase from 2% to between 15%-20% over 5 to 7 years. In turn, this will lead to a more resilient sector and better identify when companies are in trouble.

3. **We need to lower barriers to competition within the auditing market.**
    - There are significant barriers preventing new entrants from establishing themselves in the audit market, including regulatory burdens and the perception that only large firms can effectively audit major companies. These barriers hinder competition and innovation.

4. **Audit reform will lead to real impact,** by protecting pensions, increasing business confidence, preventing job losses from corporate collapses, and encouraging inward investment.

5. **The creation of the Audit Reporting and Governance Authority (ARGA) is critical to rebuilding trust.**
    - However, it must be improvement focused and have parliamentary oversight.

6. **This is a once-in-a-generation opportunity to secure change in the audit market**. If the Government is serious about boosting audit competition and quality, we should act now and not wait until the next corporate collapse to implement audit reform.
    - We urge the Business and Trade Select Committee to recommend that the Audit Reform Bill is introduced as a matter of urgency.

Introduction

Reform for the audit and corporate governance frameworks are long overdue with the current round of reform lasting over 12 years, through the hands of 9 different Business Secretaries, with no concrete action taken towards the creation of a modern competitive audit market that is both sustainable and resilient.

Mazars is disappointed with the continuing delays, as this represents a missed opportunity for the UK to take its place as a world leader in effective governance.

We set out below our views on key matters relating to corporate governance (including audit) reform, with appendices setting out further information on the importance of reform and Mazars perspectives on the audit market.

Why good corporate governance is vital for successful investment, job creation and productivity growth

Corporate governance is about the way companies are run and embraces boardroom effectiveness, internal control systems, corporate reporting and auditing. Good corporate governance is vital in enabling companies to achieve their full potential in a sustainable way facilitating the successful growth of the economy and the creation of sustainable high quality jobs. Boards are responsible for determining the company's culture and ensuring its strategy is aligned with it, and delivered, allowing the company to attract investment and enhance productivity in a way which promotes long-term success for all its stakeholders, including customers, employees, providers of finance and wider society.

Leading companies are complex and modern corporate reporting requires significant judgements highlighting the value of thorough audits which assess whether the board's view of the business, in terms of its performance, position and prospects, is 'true and fair' that is balanced and reasonable. This is key to ensuring capital markets have the necessary information on which to value companies reliably, protecting pension funds and other investors and providers of finance and ensuring investment goes to the businesses which will make the best use of it.

Integrated approach to corporate governance reform

An integrated approach to corporate governance reform is necessary given the importance of the respective roles of directors, investors, auditors, and regulators. Much of the emphasis of the discussion at the Select Committee meeting was on "audit reform". As highlighted by ICAS in their comments, this focus is too narrow and risks missing the point. ICAS talked about the three legs of the stool, namely the need for reform relating to auditors, directors and internal controls. We would argue that this should be four-legged chair, adding reform of the regulator to the mix. Overemphasis on the role of any one stakeholder will not lead to the optimal solution.

More choice in the market is needed, in order to increase competition and resilience

One of the key objectives of ARGA, which could more simply and clearly be renamed the UK Corporate Governance Authority, was going to be to drive competition and choice in the audit market, not least in order to strengthen market resilience, and the question of market structure is absolutely critical. It is difficult for potential new entrants to the PIE audit market to make the significant financial commitments to enable a successful transition in an uncertain regulatory environment. The dominance over many decades of now just four major firms in the audit market especially for Public Interest Entities, and with no significant new entrants, is virtually unparalleled in other sectors of the economy, and poses challenges to:

- **competition and choice** which is severely impacted by barriers to entry, including regulatory pressures, preventing potential and new entrants establishing themselves in the market, leading to many FTSE350 companies having the choice of at most two of the dominant firms when tendering their audit

- **resilience in the audit and capital markets**, especially for leading listed companies, which would be severely adversely affected if any of the dominant audit firms were to leave the market whether of their own accord or involuntarily. While this may appear unlikely, it is only 20 years since Arthur Andersen left the market at short notice, notably driven by factors outside of the UK. If this were to occur, there is a real risk that systemically important companies at the upper end of the FTSE100, as well as others across the FTSE350 and other Public Interest Entities, could be left without an auditor.

Managed Shared Audit (MSA)

MSA is s a crucial step towards meaningful change in the audit market and the main one in practice that will yield real change with regards to the audit of leading companies. After years of talking about reform the four largest firms still account for 98% of FTSE350 audit fees. MSA will provide an opportunity for challenger firms to gain traction in auditing larger entities and contribute to market diversity. If introduced, as proposed by the Department of Business and Trade, it would be expected to lead to challenger firms having at least 20% of audit fees in the FTSE350 audit market after a period of 7 to 10 years and would be far less intrusive on market choice than alternatives such as that linked to market share caps for individual firms. Even at a collective 20% share, challenger firms' total market share would still only be equal to the average market share of each of the four largest firms. Moreover, without such meaningful intervention, the achievement of this level of growth could take decades leaving resilience risk at an unacceptably high level in the meantime.

Audit and corporate governance reform will have a real-world impact

Increased competition in the audit market leads to increased choice, a more resilient audit market, increased quality and innovation, with the latter being much needed in areas related to, for example, sustainability and AI. Allied with stronger corporate governance and internal controls, and strengthened regulation, this would in turn lead to increasing business confidence and greater inward investment as well as a greater chance of preventing unexpected corporate failures.

The FRC highlighted five gaps in its regulatory toolkit which would enhance its ability to effectively regulate both auditors and corporate entities. We believe that **enhanced powers for the regulator are critical to rebuilding trust,** with or without the creation of the Audit Reporting and Governance Authority (ARGA). It is imperative that proper regulation is underpinned by a stable legislative framework to provide both regulators and those they regulate with certainty. However, we also believe that regulation should not just be a process for identifying where things have gone wrong but, equally importantly, **a focus on improvement and preventative measures is critical for a strong and effective regulator to enable a "right first time" outcome and a learning culture** and we encourage the FRC to take more of an "ex-ante" approach to regulation.

Solutions are needed and the time for action is now. Each successive delay represents a missed opportunity to address issues that affect our entire society. Implementing these reforms present an opportunity for Britain to set world-leading audit and corporate governance standards and mitigate the risk of future corporate scandals such as Carillion.

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Appendix 1: The importance of audit and corporate governance reform

Audit Market Reform

The delays in implementing audit market reforms have posed significant challenges for firms like Mazars, hindering firms' ability to invest further and challenge the existing market structure. Despite talk about competition and choice, there is a reluctance among companies to appoint challenger firms, even when there are limited options amongst the Big Four. Market reform has been minimal without legislation, and we have witnessed firms withdrawing from PIE audits due to tougher regulation.

The concentration in the audit market, particularly in the FTSE350, where the four largest firms dominate, underscores the need for legislative and regulatory action. MSA is a crucially needed reform with the potential to bring about significant change.

While some very modest progress has been made in terms of competition and choice, some of this is due to strategic shifts by large firms from certain audits due to prioritising non-audit work and "de-risking" their audit portfolios, transferring this risk to challenger firms. The level of change is not substantial enough to make a meaningful difference and, importantly, we are seeing signs that the pace of change has started to slow. Market intervention, especially through Managed Shared Audit, is necessary to generate a meaningful step-change in the market.

Mid-tier firms like Mazars and BDO have made strides in recent years, but significant barriers remain for new entrants and Grant Thornton has recently left the FRC 's Tier 1 of audit firms covering those with significant PIE audits. The barriers include financial commitments, a proclivity towards larger firms, and a lack of regulatory focus on companies and directors. Indeed, the total number of PIE audit firms has decreased in recent years, and only a small percentage of FTSE350 companies have switched from Big Four to challenger firms. Moreover, there is a very heavy concentration of audit fees in the upper part of the FTSE100 making change in this part of the market essential and it has just not been happening. There is also concern that the widening of assurance over non-financial information (e.g. sustainability reporting) could further consolidate the existing oligopoly in the audit market.

Corporate Governance Reform

We believe that reform is needed not just in relation to audit, but also in relation to corporate governance, and we were disappointed when the Government withdrew the Statutory Instrument in October 2023 introducing some key reforms around reporting on internal controls, company resilience, distributable reserves and fraud statements by directors.

While we appreciate the introduction of internal control requirements in the UK Corporate Governance Code, the application of the Code is restricted to a relatively small number of entities, and it was disappointing to see other proposals from the draft Code removed before it was finalised. The requirements included in the draft Statutory Instrument would have led to significant strengthening of corporate governance and potentially mitigated some of the risk of corporate failure across a much wider range of entities, as envisaged by Donald Brydon in 2019.

Much greater emphasis must be placed on corporate governance and the role of directors in enhancing confidence in UK plc, and the granting of enhanced powers over directors to the FRC would be a step in the right direction.

Appendix 2: Mazars perspectives on audit market reform

Market concentration and Mazars' development in the audit sector

Mazars has made significant strides in the Public Interest Entity (PIE) audit market, doubling our share of PIE audit fees to 4% from 2021-2022. We are now the joint largest challenger firm alongside BDO. Our growth has been particularly visible in the Financial Services sector, including a number of banks, asset management and insurance entities, as well as auditing 12 out of 42 building societies, providing competition to the Big Four in regional markets. Additionally, Mazars exhibited the largest audit fee income growth (32%) among the top eight firms over the past year.

However, there are clear limitations to our future growth. Winning larger audit contracts worth £1 million or more remains challenging due to the prevailing lack of confidence among FTSE350 boards in firms outside the Big Four. Moreover, regulatory hurdles and the difficulty of team mobility in a capacity-constrained market pose significant barriers to entry and expansion. As noted above, MSA is the minimum required step to achieve meaningful change in the audit market. Without intervention, the concentration of audit services among the Big Four will persist, limiting choice and competition.

Our modelling suggests that, with the implementation of MSA, **challenger firms could collectively represent 20% of the market within the next 7 to 10 years**. Without such meaningful intervention, the achievement of this level of growth could take decades.

Insights from experience: learnings on Managed Shared Audit

Mazars' success in securing major audits like Goldman Sachs was partly driven by regulatory intervention and our international experience in joint audits of major financial services groups.

Regulatory changes, such as mandatory rotation and enhanced independence requirements, created opportunities as the largest firms opted out of tendering for UK subsidiary audits. We capitalised on these opportunities, leveraging our international experience to build on existing joint audit models.

Winning Goldman Sachs and similar contracts significantly enhanced our reputation and allowed us to expand our financial services audit practice. This growth included substantial investment in skilled jobs, recruitment, and expansion into regional markets like Manchester and Leeds, ensuring competition and choice beyond London. Our entry into previously monopolised markets, such as building societies, brought about positive changes, with now 50% of them audited by firms outside the Big Four.

These wins also facilitated engagement with regulators (e.g. Bank of England, PRA, FRC) and strengthened relationships with Big Four firms, leading to constructive dialogue and sharing of best practices.

However, we have concerns as the cooling-off period for major audits is just four years, risking regression to a big four oligopoly if access to large UK domestic audits through MSA is not introduced. While progress in financial services was driven by regulation, change outside this sector has been slower and we advocate for regulatory intervention to overcome unnecessary barriers and dispel the misconception that challenger firms lack the capability to audit major entities.

These insights underscore the need for meaningful regulatory reform, particularly the implementation of MSA, to sustain and enhance audit market competition and quality.

Mazars audit fees

The Committee asked about increases in audit fees in recent years.

Over the last 3 years, we estimate that fee increases on average have been between 20% and 25% while inflation for goods and services over that same period has been in excess of 21%.
In addition, we have had to bear a massive increase in costs arising from regulatory oversight – estimated at more than £10m across multiple streams (governance, IT, ethics, audit quality, etc).

In addition, our investment in technology has been enormous. We are lucky that we are part of an international group and that many of these investments have been supported by the wider group, most notably on technology. We could not have done this as a UK firm only.
MSA offers smaller firms, without similar international support, the ability to step up and invest over time with reasonable assurance of a fair return on their investment.

Our profitability today in relative terms is less than what it was in 2019. We need a bigger audit fee base to absorb the very significant fixed costs of operating in the PIE audit market and to be in a position to attract Big Four partners (in particular) by offering them comparable packages to their existing ones.

Has reform focused enough on smaller firms' ability to enter the market?

The current audit reform measures have not adequately addressed the entry of smaller firms into the market. Mazars, as part of Group A and EGIAN, recognises the potential of challenger firms in diversifying into the PIE audit market.

However, significant barriers hinder new entrants, including disproportionate regulation imposed on PIE auditors. Some challenger firms have recently withdrawn from the market due to regulatory burdens, and others are hesitant to either enter the market or to expand their presence.

Regulation should focus not only on identifying failures but also on facilitating improvement and being proportionate both regards to reviews of individual audits and overall through there being a clear focus on the audit of systemically risky entities at the top end of the FTSE100. While the FRC has made strides in enhancing its approach, there is a need for a more proactive stance, engaging in consultation before actions are taken.

Mazars views on the FRC

We set our detailed thoughts on areas for improvement by the FRC in our response to the Government's call for evidence on Smarter Regulation. We summarise below some of key highlights of our response.

It is imperative that proper regulation is underpinned by a stable legislative framework to provide both regulators and those they regulate with certainty. In the case of the FRC, the lack of legislation establishing the new Audit, Reporting and Governance Authority (ARGA) is frustrating. Such powers are needed to enable the FRC to effectively regulate all parties in the corporate reporting ecosystem, including company directors, and address the present asymmetrical approach to regulation and enforcement, where the focus is primarily on auditors.

We often hear the phrase "Who audits the auditor?". Perhaps we should also ask "Who regulates the regulator?". The legislative framework should provide the clarity of purpose and overall objectives of the regulator and the arrangements by which they demonstrate that they are having a positive impact on auditing and the audit market and with regards to which they should be held accountable.

When it has been granted the enhanced powers it seeks, it is important that the FRC (ARGA) effectively manages, and is held accountable for, its full range of powers, covering competition, choice and market resilience, regulation, enforcement and market supervision which need to be carefully balanced if the optimum outcomes are to be achieved. It is equally important the FRC is proportionate in its range of regulatory activities, including standard setting, quality review and enforcement. It is noticeable, that the level at which enforcement activity becomes possible in relation to audits is set at a far lower level than in other similar professions.

We are pleased to note steps taken in recent years by the FRC to move towards being what it often refers to as an "improvement regulator" and encourage the FRC to continue its efforts in this direction under its new leadership. In doing so, we also encourage the FRC to take more of an "ex-ante" and participative approach to its regulatory activities where appropriate. This would entail the FRC being more open to consultation and discussion prior to decisions and actions being taken by auditors and others rather than merely acting as a judge after the event. Such an approach would help to ensure that the right outcomes are achieved in the public interest.

About Mazars

Founded in Europe, Mazars is present in over 95 countries and territories, with 47,000 professionals dedicated to helping clients make the most of business opportunities and operate with confidence. In the UK, Mazars is among the largest firms in its sector and a leading auditor to Public Interest Entities (PIEs). It employs over 2,500 people in 14 locations across the UK, providing a balanced perspective and empowered expertise to clients of all sizes.