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August 3, 2006

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Dear Mr Rose

Response to FRC's consultation paper: "Choice in the UK audit market"

I am writing this as a response to the above discussion paper from FRC. I believe that the information I am providing in this response is relevant and important to the public debate that FRC has opened on the choice available within the UK audit market.

However, there is a need for participants in the debate to understand the reality of the "Big 4" market shares as well as other findings from relevant academic research.

Concentration in the market

Based on a sample of all UK listed companies after excluding financial companies (i.e., banks, trusts, insurance, services, etc) and on 2002-2003 data, the results show that the Big 4 firms undertake 70 percent of the audits in the sample, and receive 86 percent and 88 percent of the audit and non-audit fee respectively. Based on the most recent data (i.e., the 2005-06 data), the Big 4 firms audit 59 percent of the audits in the sample, and receive 95 percent and 96 percent of the audit and non-audit fee respectively.

Market entry

Recent research evidence (see Basioudis and Francis 2006) shows that office-level industry leadership drives the reputation for industry expertise in the UK market for audit services, and if this reputation is priced in the audit market, then accounting firms have economic incentives to become office-level industry leaders in city-specific audit markets and to actively market their "local" reputations for industry expertise. Non-Big 4 firms, therefore, may become a major challenge to the large audit firms, if they emphasise their local office reputations for industry expertise.

Are the Big 4 really the "Big 4"?

Audit firms develop industry specialisation to create economies of scale and differentiate their product from their competitors, among other things. Table 1 reports the 2002-03 sample distribution and industry market leaders for the 28 LSE industry codes, and Table 2 reports the 2002-03 sample distribution by cities and city market leadership in the UK based on the auditor's letterhead from the audit report. Audit firms are ranked number one, number two, number three or number four based on their percentages of audit fees in the industry (Table 1) or city (Table 2).

Table 1 reveals that the Big 4 firms are really the “Big 4” in only 13 out of 28 (46%) industry groupings. In other words, in more than 50% of the cases, non-Big 4 firms are one (or more) of the four main national industry leaders. A similar pattern occurs when the city leadership is examined. Based on Table 2, the Big 4 firms are really the “Big 4” in only 9 out of 24 (37.5%) city groupings.

Even if the industry sectors (i.e., financials) left out originally from the sample are to be included in the above analysis, my view is that the percentage of Big 4 firms being the “Big 4” will increase but will not change dramatically. Further, the above analysis of Big 4 firms is based on 2002-03 available data, but there is no reason to believe that the findings will be substantially different based on more recent data.

Audit pricing and industry specialisation

Basioudis and Francis (2006) and Basioudis and Xia (2006) report empirical evidence of a significant audit fee premium for auditor industry specialisation in the UK. This result is consistent with the findings in other countries, such as Australia, Canada, Hong Kong, Singapore, and the United States (Craswell et al. 1995; DeFond et al. 2000; Francis and Simon 1987; Chung and Lindsay 1988; Farger et al. 2002; Francis et al. 2004). Differential pricing implies a supply of a differential audit quality by specialists, and there is evidence (mainly from U.S. studies) that the earnings and financial statements of companies audited by specialists are, on average, of higher quality (Francis et al 2006).

If this is also the case in the UK, then there may be some policy implications. For example, it may be more effective if regulators place relatively more emphasis (monitoring and investigations) on companies that are not audited by industry specialists (at national or city-level) because it is possible that the earnings of such companies may have potential misstatements (Francis et al. 2006). Finally, the message for investors coming out from this stream of academic research is that earnings reports may be more credible and less likely to be materially misstated if audited by industry specialists, and this would affect the usefulness of earnings reports in assessing firm performance and the pricing of equity securities.

I hope the above would add some value to the debate.

Yours sincerely

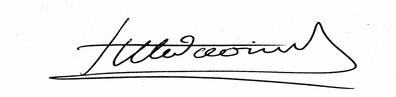

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Table 1: Descriptive statistics on <u>industry leaderships</u> based on 2002-03 UK audit fees

Data attrition, industry composition, audit fees per <u>industry</u> leader #1, #2, #3, & #4

SIC	LSE Industry Name	Number of observations per SIC	Audit Fee per SIC	Industry Leader #1 & market shares based on audit fee data		Industry Leader #2 & market shares based on audit fee data		Industry Leader #3 & market shares based on audit fee data		Industry Leader #4 & market shares based on audit fee data	
1	Farming	11	1,334.00	MS	(45.58%)	EY	(20.01%)	DT	(16.19%)	HY	(9.45%)
11	Mining	39	3,887.62	PwC	(43.24%)	EY	(20.89%)	KPMG	(9.63%)	DT	(8.76%)
15	Manufacturing - Food	29	9,218.00	KPMG	(79.02%)	EY	(8.27%)	PwC	(7.21%)	GT	(1.61%)
17	Manufacturing - Clothing	29	3,851.35	DT	(47.26%)	PwC	(21.40%)	BDO	(10.48%)	KPMG	(7.91%)
20	Manufacturing - Wood	9	2,179.00	KPMG	(37.45%)	PwC	(28.59%)	DT	(27.54%)	EY	(3.76%)
22	Printing & Publishing	37	6,241.11	DT	(47.11%)	PwC	(21.71%)	KPMG	(12.42%)	EY	(7.66%)
24	Chemicals	30	5,651.00	KPMG	(38.08%)	PwC	(31.87%)	DT	(18.42%)	RSM	(4.46%)
25	Manufacture - Plastics	14	2,107.09	KPMG	(39.77%)	PwC	(25.96%)	EY	(25.87%)	DT	(8.40%)
26	Manufacture - Ceramics	11	1,091.50	PwC	(67.89%)	KPMG	(15.67%)	EY	(12.83%)	GT	(2.38%)
27	Manufacture - Metals	74	9,307.13	KPMG	(30.39%)	PwC	(29.82%)	DT	(17.01%)	EY	(16.63%)
30	Manufacture - PC, TV,	21	2,003.78	KPMG	(29.64%)	DT	(29.44%)	PwC	(15.92%)	EY	(9.38%)
31	Electrical	34	5,642.28	DT	(25.56%)	PwC	(19.58%)	KPMG	(16.69%)	GT	(12.97%)
33	Manufacture - Medical instruments	31	3,345.00	PwC	(33.33%)	DT	(27.62%)	KPMG	(20.44%)	EY	(11.44%)
34	Manufacture - Transport	14	4,668.00	PwC	(57.20%)	DT	(13.97%)	KPMG	(13.24%)	EY	(12.85%)
36	Manufacture - Other	28	4,384.00	KPMG	(47.81%)	DT	(18.75%)	PwC	(15.11%)	EY	(11.38%)
40	Utility - Electricity	3	224.00	AK	(89.29%)	PwC	(8.48%)	CLB	(2.23%)		
41	Utility - Water	7	498.00	DT	(31.93%)	PwC	(28.11%)	KPMG	(18.07%)	SC	(15.46%)
45	Construction	47	10,084.00	KPMG	(45.30%)	PwC	(16.06%)	DT	(13.00%)	EY	(10.06%)
50	Wholesale	98	13,527.13	PwC	(28.25%)	KPMG	(27.92%)	DT	(18.48%)	EY	(8.17%)
52	Retail	61	5,943.38	PwC	(35.74%)	DT	(27.90%)	KPMG	(14.95%)	EY	(12.08%)
55	Leisure - Hotels, Restaurants	35	3,480.00	KPMG	(31.84%)	PwC	(28.74%)	BDO	(17.47%)	EY	(7.01%)
60	Transport	26	5,326.50	PwC	(40.29%)	KPMG	(22.27%)	BDO	(19.10%)	EY	(12.96%)
64	Utility - Telecommunications	14	994.00	DT	(44.16%)	PwC	(21.43%)	EY	(21.33%)	BDO	(4.93%)
71	Support activities - Advert, Rent	56	8,786.75	PwC	(45.19%)	KPMG	(33.96%)	DT	(8.84%)	GT	(4.51%)
72	Software publishing	84	7,716.06	EY	(26.85%)	PwC	(19.79%)	DT	(19.26%)	KPMG	(18.66%)
80	Education	3	149.75	P K F	(59.43%)	KPMG	(33.39%)	KS	(7.18%)		
83	Health activities	9	625.04	PwC	(79.67%)	EY	(4.80%)	BDO	(3.84%)	BA	(3.52%)
92	Media - TV, Radio, Sport Stadiums	53	3,642.43	KPMG	(36.78%)	DT	(18.61%)	PwC	(15.46%)	BDO	(6.48%)
	Total (Mean)	907	125,907.90		(45.14%)		(22.32%)		(14.94%)		(8.96%)

DT = Deloitte & Touche, EY = Ernst & Young, PWC = PricewaterhouseCoopers, P K F = Pannell Kerr Forster, MS = Moore Stephens, AK = A K & Co, HY = Hacker Young, BA = Blueprint Audit Ltd, GT = Grant Thornton, BDO = BDO Stoy Hayward, RSM = RSM Robson Rhodes, SC = Saffery Champness, KS = Kingston Smith

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Table 2: Descriptive statistics on city leaderships based on 2002-03 UK audit fees
Data attrition, city composition, and fees per city leader #1, #2, #3 & #4

City	Number of observations per city	Audit fee per city	City Leader (1)	% of audit fees of City Leader (1)	City Leader (2)	% of audit fees of City Leader (2)	City Leader (3)	% of audit fees of City Leader (3)	City Leader (4)	% of audit fees of City Leader (4)
Aberdeen	3	236	PwC	(50.8%)	EY	(42.4%)	DT	(6.8%)		(0.0%)
Belfast	4	498	PwC	(44.0%)	A K	(40.2%)	EY	(15.9%)		(0.0%)
Birmingham	71	7827.61	KPMG	(39.3%)	DT	(21.9%)	PwC	(19.6%)	EY	(8.6%)
Bristol	33	4117.76	PwC	(57.9%)	DT	(18.5%)	KPMG	(17.8%)	EY	(3.0%)
Cambridge	22	1453	DT	(38.7%)	PwC	(30.1%)	EY	(23.5%)	RSM	(5.2%)
Cardiff	11	961.75	KPMG	(46.8%)	DT	(42.8%)	PwC	(10.4%)		(0.0%)
Crawley, W Sussex	17	1273.01	KPMG	(61.3%)	DT	(33.9%)	GT	(4.9%)		(0.0%)
Dublin	6	436.12	KPMG	(46.3%)	RJK	(44.7%)	DT	(9.0%)		(0.0%)
Edinburgh	16	1615	PwC	(54.6%)	DT	(21.4%)	KPMG	(11.0%)	EY	(9.8%)
Glasgow	25	2604	EY	(34.3%)	PwC	(17.7%)	KPMG	(17.3%)	DT	(12.1%)
Leeds	70	8669	DT	(33.8%)	PwC	(25.9%)	KPMG	(19.8%)	EY	(15.0%)
Leicester	7	931.26	KPMG	(61.7%)	GT	(23.4%)	PwC	(14.8%)		(0.0%)
Liverpool	11	1111	PwC	(49.1%)	KPMG	(37.9%)	EY	(6.6%)	HLB	(3.2%)
London	351	69581.17	KPMG	(37.1%)	PwC	(25.2%)	DT	(12.1%)	BDO	(5.2%)
Luton	7	803	EY	(100.0%)		(0.0%)		(0.0%)		(0.0%)
Manchester	59	7839.9	DT	(43.1%)	PwC	(30.3%)	KPMG	(10.5%)	EY	(8.1%)
Newcastle	24	1619	PwC	(34.5%)	KPMG	(25.4%)	DT	(23.2%)	EY	(16.9%)
Nottingham	29	2596.5	PwC	(35.5%)	DT	(26.2%)	KPMG	(21.7%)	EY	(8.6%)
Oxford	7	447	GT	(90.6%)	KPMG	(9.4%)		(0.0%)		(0.0%)
Reading	20	3238	DT	(37.6%)	PwC	(27.0%)	EY	(24.4%)	KPMG	(11.1%)
Sheffield	6	597	PwC	(62.8%)	HAWSONS	(27.1%)	GT	(10.1%)		(0.0%)
Southampton	25	2425.45	PwC	(45.2%)	EY	(23.6%)	KPMG	(14.6%)	GT	(9.7%)
Surrey	8	449.26	BDO	(56.6%)	KPMG	(30.3%)	NH	(6.7%)	Menzies	(4.2%)
Various small towns	75	4578.1	PwC	(37.4%)	KPMG	(14.1%)	DT	(11.2%)	GT	(6.9%)
Total (Mean)	907	125,907.9		(50.0%)		(26.6%)		(13.0%)		(5.3%)

DT = Deloitte & Touche, EY = Ernst & Young, PWC = PricewaterhouseCoopers, GT = Grant Thornton, BDO = BDO Stoy Hayward, AK = A K & Co, RSM = RSM Robson Rhodes, RJK = Robert J Kidney & Co, NH = Nunn Hayward, HLB = HLB Kidsons