



National Audit Office

Helping the nation spend wisely

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Our Reference
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Dear Julian

DISCUSSION PAPER: CHOICE IN THE UK AUDIT MARKET

The National Audit Office (NAO) is pleased to comment on the above discussion paper. The NAO, on behalf of the Comptroller and Auditor General, carries out the external audit of all UK central government departments and a wide range of other UK and international public bodies. In addition, we will in due course carry out the external audit of the Whole of Government Accounts, which the UK government intends to produce as a consolidation of the financial statements of all parts of the UK public sector.

At present the NAO contracts out about 25 per cent of its financial audit work, worth approximately £8.2 million in 2006-07 to firms drawn from the Big 4 and mid tier. In practice this means that we are directly concerned about the choice and availability of firms at the top end of the UK market and by the quality of their work.

Accordingly we welcome the work being undertaken by the FRC to highlight the importance of audit to the UK economy and to try and stimulate the competitive environment in the audit market. Our main concern is that increased competition and choice should not be achieved at the expense of audit quality. We agree that it will be important to look at what can be done by other stakeholders to enable other mid-tier firms to compete more effectively for listed company audit work and by extension, the audit of major public sector organisations.

We note that the study carried out by Oxera for the FRC focussed on marked structure and choice, but did not look at the specific reasons for choosing a particular firm of auditors or for the low switching rate between auditors. We feel that further work needs to be done in this area in conjunction with the work on increasing competition and choice, to make companies aware that there is a viable alternative to the Big 4 firms.

Our answers to the specific questions raised in the discussion paper are contained in Annex A to this letter.

If you wish to discuss our comments please contact Mandy Measures (telephone +44 (20) 7798 7739).

Yours sincerely



Martin Sinclair



Request for Specific Comments

Q1 Do you agree that the focus of the debate should be on the degree of choice in the market for audit services to large public companies, rather than other features of this market?

We agree that the focus of the debate should be on the degree of choice in the market, but are concerned that this should not be at the expense of audit quality. We believe that the reasons for appointing a particular firm of auditors should also be examined as part of the debate, which would identify barriers within the companies that would prevent mid tier firms from entering the market, and to examine in more detail why the Big 4 firms are perceived to be the auditors of choice.

Q2 What do you regard as the most important criteria for evaluating any opportunities for mitigating risks arising from the level of choice in the audit market?

We note that the concentration of expertise amongst the Big 4 firms exposes the market to risk should one of these firms leave the market for whatever reasons. However, it is unclear whether changes to the existing situation can be brought about without regulatory intervention. The market, as it exists in its current form, has evolved over the last 10 years or so due to various mergers amongst the top firms to create the current Big 4 firms that exist.

Q3 We invite views on how different groups, acting individually or collectively, could increase the propensity of non-Big Four or new firms to seek to be major players in the market for audits of large companies.

One of the main obstacles to other firms entering the market is cost. Significant investment will be needed on the part of many mid-tier firms to expand the volume of services and specialisations that they offer, and to provide an integrated international network so that they appeal to the larger companies and are able to compete effectively with the Big 4 firms.

There appears to be a great reluctance on the part of larger companies to appoint outside the Big 4, and the extent to which this is due to lack of choice needs to be assessed. If it is due to other factors such as the perceptions of directors, audit committees, shareholders, advisors, etc, then steps can be taken to change these, although this is likely to be a gradual process.

However, if there is a willingness on the part of larger companies to appoint from outside the Big 4, and this was not perceived to be an inferior choice, there may be more incentive for mid-tier firms to enter the market. Obviously such firms will have to be their own ambassadors and ensure that the work that they perform is of an excellent quality and that they meet all the needs of the client. The challenge for the mid-tier firms is to prove that bigger does not necessarily mean better.

Q4 We invite views on how the propensity of companies and their audit committees to purchase audit services from non-Big Four firms could be increased.

A lot can be done in this area to improve the perception amongst audit committees, company directors, investors and others that Big 4 is best and is the only option. Further comments are given in response to Q5 below.

Q5 We invite views on:

- a. The combination of steps that would be most likely to lead to increased choice.*
- b. Whether these steps could be taken forward by market participants, or whether existing laws and regulations may constrain or prevent this.*
- c. The costs of the steps relative to the risks arising from the existing or potential degree of concentration in the market.*

We do not believe that existing laws and regulations constrain the entry of new participants to the market, but the very nature of the market itself makes it difficult for new participants to enter. This can partly be removed by increasing the awareness of the market to other firms, and by other firms themselves promoting their strengths to the market.

One option would be for mid tier firms to specialise in particular niche market segments, so that they could sell themselves as experts in a particular field. We note for example the success of PKF, RSM Robson Rhodes and others in establishing themselves as major suppliers of extend audit services to the public sector. This would obviously require significant investment on the part of such firms to build up their expertise, which they would subsequently need to market heavily.

Q6 We invite views on steps that could be taken to mitigate the risk of unnecessary withdrawal of a firm from the market.

We believe that the Big 4 firms will have taken their own steps to assess and mitigate the risks that they face within their own markets and across their international networks. All firms in the UK are required to have appropriate professional indemnity insurance, and comply with Generally Accepted Accounting Standards, International Standard on Quality Control and the Ethical Standards, and these should minimise the risk that a firm would be forced to withdraw from the market, at least in the UK.

Q7 We invite views on steps that could be taken to mitigate the effects of a voluntary or involuntary withdrawal of a firm from the audit market.

We believe that the general increase in choice would mitigate such circumstances.