AUDIT FIRMS: TOO FEW TO FAIL

by Albert A. Foer and Bernard Ascher[1]

New York's lawsuit against the accounting firm Ernst & Young for its role in the collapse of Lehman Brothers reminds us that an important function in the financial system was not addressed in U.S. financial reform legislation--- the role of auditors. E&Y allegedly helped its client, Lehman Brothers, by misleading investors about the financial health of the investmentbanking firm. Lehman's bankruptcy in September 2008 is said to be the largest in U.S. history.

Although there are thousands of accounting firms, very few have the resources and expertise to conduct audits of large multinational banks and corporations. The Big 4 accounting firms, Ernst & Young, together with PricewaterhouseCoopers, Deloitte Touche Tohmatsu, and KPMG, are huge privately owned international networks that employ over 600,000 worldwide. Each firm earns $20 billion a year or more. They audit the financial statements of nearly all of the world's public companies with annual sales over $250 million and, arguably, are the only audit firms able to do so.

The American Antitrust Institute (AAI) is concerned about concentration in the audit industry, has posted several working papers on its website (http://www.antitrustinstitute.org), and has expressed its concerns over audit industry concentration to Congressional committees in the United States and to the European Commission in its current investigation. Concentration began in the 1980s when the then-Big 8 became the Big 5 as a result of mergers and acquisitions. With the demise of the Arthur Andersen firm as a result of the Enron case in 2002, the Big 5 became the Big 4, raising fear among clients, investors and regulatory authorities that the world would lack adequate audit services if another member of the Big 4 were to close.

There is concern that the small number of large accounting firms already limits the choice of auditors available to large companies and that loss of another major firm could lead to increases in audit fees (which could be borne by clients and their shareholders or ultimately passed on to consumers in some form). Moreover, the possibility of another Andersen-like departure inhibits the enforcement options of regulators, who generally are reluctant to take dramatic action for fear of causing further shrinkage of the number of firms.

The challenge now facing governments is to find ways to bring more large firms into the market to compete for audits of global banking institutions and other public corporations. Numerous studies have been conducted on the audit industry and many recommendations have been offered for consideration. Inquiries are currently underway by regulatory authorities in the United Kingdom and by the European Commission.

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Recommendations in circulation include nationalization or breakup of the existing Big 4 firms, building up the second-tier, medium-sized firms through divestiture of Big 4 clients, award of government audit contracts to medium and small firms, steps to reduce the "perception bias" against non-Big 4 firms, and removal of restrictions on ownership of accounting firms and the partnership business model to encourage new firms to enter the business and to stimulate growth and consolidation of smaller firms.

Litigation costs of the major accounting firms are clearly substantial and could be regarded as a barrier to new entrants. In the Lehman Brothers bankruptcy case, for example, New York State is seeking $150 million in compensation plus damages from auditor Ernst & Young. The Big 4 and many of their clients have sought passage of liability limitation laws in recent years, pointing out the possibility that further shrinkage in the industry could occur from the cumulative effect of adverse decisions in massive lawsuits.

If liability limitations are to be considered, they should be linked to voluntary divestiture of clients by the Big 4 in negotiations with second tier firms or networks of smaller firms. Although mandatory divestiture may be considered a drastic action, it may be more palatable today in light of the government bailouts of major banks and financial institutions in the past several years, along with partial nationalization of General Motors.

In 2011, during this post-crisis recovery period, the next Congress has an opportunity to take a fresh look at the situation. This may be a good time to consider the various proposals and the public role of audit firms, including the possibility of establishing regulatory incentives for the Big 4 firms to divest a portion of their clients (and relevant accountants) to second-tier firms.

Expanding the audit field to six or eight qualified firms could help to calm fears about stability of the financial system and generate more investment and job growth. It might even bring back the days--- like the early 1980s--- when price competition was more intense and large public companies could cut costs by requesting bids from eight audit firms. This would surely heighten the competition and make it less likely that the firms which conduct audits of public companies will be deemed either too large or too few to fail.