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ABSTRACT

Title: THE AUDIT INDUSTRY: WORLD'S WEAKEST OLIGOPOLY?

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The world's audit oligopoly is composed of four accounting firms: PricewaterhouseCoopers, KPMG, Ernst & Young, and Deloitte Touche Komatsu (the Big 4). These firms are in a strong position in that they audit the financial statements of nearly all the global public companies in the world and, arguably, are the only audit firms able to do so. They are huge, privately-owned, international networks with robust revenues, vast resources, and expertise. Yet they are heavily regulated by governments, and they are subject to massive lawsuits when investors and creditors suffer large losses due to fraud or error; these are their major weaknesses. Since the dual shocks of the collapse of Arthur Andersen (reducing the Big 5 to 4) and the enactment of stringent regulations by the U.S. Congress in 2002 in reaction to corporate accounting scandals, there is great concern in the financial community that another company in the oligopoly could be forced out of business, further reducing the choice of auditors for multinational corporations and causing disruptions in the marketplace.

This paper reviews the effects of concentration on competition in the market for audits of major multinational corporations, as well as the effects on audit fees, audit quality, and the regulatory environment. It observes that competition is far less intense than in earlier years and that regulatory authorities are reluctant to take severe disciplinary actions against audit firms, but that the industry remains vulnerable to legal challenge. Global public companies will continue to face limited choice of auditors until smaller competitors or new competitors can build viable networks and reputations for high quality audits. The paper examines barriers to market entry and comments on proposals to promote greater competition, including liability limitations. It also reports on anticompetitive practices of major accounting firms in the past and the need for regulatory authorities to maintain constant vigilance to avoid any recurrence. Finally, responding to the question posed in the title, the paper concludes that considering the industry's market dominance, the relaxation of punitive actions by regulatory authorities and the availability of some forms of liability limitation, the audit industry may not be the ideal candidate for weakest oligopoly in the world.

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Keywords: competition, oligopoly, antitrust, business organization, accounting firms, audit fees, corporate governance, corporate fraud, liability limitations, Sarbanes-Oxley compliance, capital markets, globalization, international accounting standards, international financial reporting standards, regulation, professional services, business schools

JEL Classifications:
D2 – Production and Organizations
D4 – Market Structure and Pricing
F2 – International Factor Movements and International Business
K2 – Regulation and Business Law
L1 – Market Structure, Firm Strategy, and Market Performance
L2 – Firm Objectives, Organization, and Behavior
L4 – Antitrust Policy
L8 – Industry Studies: Services

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# THE AUDIT INDUSTRY: WORLD'S WEAKEST OLIGOPOLY?

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## EXECUTIVE SUMMARY

Only four firms in the world are capable of preparing audits of the major global corporations. This oligopoly is less feared for its market dominance than for its small number of firms, which leaves clients with little choice in selecting an auditing company. Despite heavy government regulation in the United States, many fear that further concentration in the accounting industry through merger or business failure would result in chaos and loss of investor confidence in the financial community. Regulatory authorities appear to be inhibited in levying severe penalties on these firms. The firms are "too big to fail." At the same time, the Big 4 are vulnerable to massive lawsuits with multi-million-dollar claims that could bankrupt them.

A recent report by the U.S. Government Accountability Office (GAO) reviewed the situation and a wide range of proposals (including liability limitations), but made no recommendation for action at this time because each of the proposed solutions has distinct disadvantages.

This paper reviews the competitive effects of concentration in the audit industry, the problems that arise from concentration, the recent sharp increase in audit fees, the industry's vulnerability to mega law suits, and the proposed solutions, especially liability limitation. It concludes with some comments and concerns about the lack of greater choice and competition. The paper suggests that more work needs to be done to find ways of encouraging mid-size and smaller firms to develop the capacity and reputation to conduct multinational audits and to reduce impediments to the entry of new firms into the field.

**Part I** of the paper ("Four Are Too Few") introduces the problems and sets the stage for discussion of the issues. There is general agreement that the small number of audit firms limits the ability of global corporations to select or change auditors and that further decline in the number would create serious problems in the financial community. Can the level of competition be increased and, if so, how? How can the U.S. government regulate and discipline the audit industry effectively without further weakening it? Should the government enact legislation to limit the industry's liability? What can be done to remove barriers to the entry of additional global audit firms?

**Part II** ("The Cast of Characters") describes the nature of the oligopoly, its origins, size, and structure. The audit oligopoly consists of four giant accounting firms--- PricewaterhouseCoopers, Ernst & Young, KPMG, and Deloitte Touche Tohmatsu (The Big 4). These firms are the result of a series of mergers, along with the demise of Arthur Andersen (one of the Big 5). The audit industry is heavily concentrated, considering that the Big 4 accounting firms currently audit the vast majority of all U.S. public companies (78 percent based on the number of companies; 99 percent on the basis of total sales of public

companies). Collectively, the Big 4 earned almost $90 billion worldwide in 2007 and employed more than a half million persons. In addition to audits, revenues come from tax services and business consulting. Each of the Big 4 is not monolithic and centrally-operated, but rather a loose confederation of individual member companies--- privately-owned partnerships--- connected by a common brand and network of communications. Each firm has successfully projected the image of a global organization, rather than one tied to a particular nationality.

**Part III** ("The Effects of Concentration") discusses the effects of concentration on competition in the industry, the sharp rise in audit fees in recent years and reasons for the increase. The audit industry has been concentrated for many years, but since 2002 the market is shared by only four firms instead of eight, as in the 1970s. Competition is far less intense now than in earlier years and global public companies face a limited choice of audit firms. Audit fees, though much higher than before, reflect costs more fully and realistically. In its study of the Big 4, GAO found that there is "no clear, definitive link between accounting market structure and anticompetitive behavior." There appears to be general agreement that the higher fees are attributable more to new regulatory requirements than to industry concentration. Clients of the Big 4--- large, sophisticated multinational corporations with huge resources --- are complaining about the burden of regulatory requirements (which contribute to the cost of audits), but not the cost of the audits themselves. Small public firms complain about the requirements and the disproportionately high costs of audits. Actions by regulatory authorities are constrained by the fear of driving another major accounting firm out of business and thereby compounding the lack-of-choice problems of global public companies in selecting an audit firm. There appears to be no evidence of anticompetitive behavior in recent public literature and there are no cases reflecting antitrust violations by major accounting firms in the United States. However, in 2000, the then-Big 6 were fined for anticompetitive practices in Italy, which serves as a reminder for regulatory authorities to remain vigilant so that similar anticompetitive activities do not occur in the future. (Because of the fundamental underlying importance of accounting standards in the audit business, Part III takes note of the recent steps taken by the U.S. Securities & Exchange Commission to move toward adoption of international financial reporting standards and Appendix III-4 provides information on the development and status of international standards.)

**Part IV** ("Deep Pockets and Exposure to Liability") examines information on mega-lawsuits filed against the Big 4 and other large accounting firms. Detailed information on lawsuits is assembled in Appendixes IV-1 thru IV-4. The greatest weakness of the oligopoly appears to be its exposure to potentially ruinous legal challenges. Despite a dominant market position and a booming business, the oligopoly and its clients are in the anomalous situation of seeking government protection against massive lawsuits by disgruntled investors, creditors and others. Part IV describes government consideration of liability limitations and the extent to which such limitations already exist in the United States and other countries. It also addresses the need for audit quality to protect the public interest and to avoid litigation. Considering the liability limitations that currently exist and the potential for adoption of limitations by more jurisdictions, as well as the inherent difficulty of prosecuting legal challenges, the level of exposure of audit firms to massive lawsuits--- the greatest weakness of the audit oligopoly--- may be on the verge of decline.

**Part V** ("Recounting the Remedies") discusses various proposals currently under consideration to reduce the risks of current and future audit market concentration, to increase competition, and to improve audit quality and independence. Each has disadvantages. Proposals to set monetary caps on liability, for example, could eliminate a useful incentive for auditors to be perspicacious in detecting corporate fraud and wrongdoing and would deprive injured parties of a mechanism to obtain adequate relief. In

the United States some limitations already exist in the form of proportionate liability and contractual agreements. The European Commission recently recommended that its 27 member states adopt measures to limit liability, consistent with their own legal systems. Five member states already have monetary caps on liability and five others allow audit firms to limit liability through contractual agreements. Proposals to break up the Big 4 or to require one or more of them to spin off a portion of their operations to create additional firms with the capacity to audit large public companies would have disruptive consequences for existing audit firms and their employees. Proposals to remove market barriers may be costly and ineffective, but offer the most pragmatic approach. Removal of restrictions on outside ownership of accounting firms, however, could help to attract new, well financed entrepreneurs with management expertise to acquire and combine smaller companies into larger networks and enhance their reputations. Safeguards would be necessary to avoid conflicts of interest with other businesses owned by the entrepreneurs. Proposals to improve the quality of audits include education and training programs, strict licensing and certification requirements, continuing education to keep accountants up to date on new developments, creation of coordination and communication programs with participation of mid-tier and smaller audit firms. These also may prove to be costly and ineffective. Radical proposals, such as nationalization or third-party (e.g., insurance company) payment, are well intentioned and may remove a basic conflict of interest in the current system by which audit firms are paid, but they raise questions concerning operation, cost and efficiency of the system and how the drastic change would affect the business community.

**Part VI** ("Making the World Safe for Auditing Multinational Corporations") analyzes the available information and presents conclusions, partly through responses to questions posed in the introduction to this paper. The situation with respect to the small number of audit firms remains precarious. The need for monetary caps on liability for audit firms in the United States, however, may be lessened by already existing limitations in the form of proportionate liability and contractual agreements. Competition has practically slowed to a crawl, but could be increased over the long term by removing barriers to entry of new firms and growth of mid-tier and smaller audit firms. Because the process of barrier removal requires long lead time, the paper suggests that steps need to be taken soon to build more capacity and avoid a future crisis. Appendix VI-1 provides ideas for a pro-competitive program to develop additional audit firms capable of conducting audits of global public companies. In the meantime, regulatory authorities need to remain vigilant to avoid repetition of anticompetitive practices of the past. Finally, responding to the facetious question in the title, the paper concludes that the audit industry may not be the ideal candidate for weakest oligopoly in the world.

# THE AUDIT INDUSTRY: WORLD'S WEAKEST OLIGOPOLY?

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## Preface

Recent corporate scandals and turmoil in the accounting sector inspired this paper. It is a story that is still unfolding as companies and auditors adjust to new regulatory conditions, imposed mainly as a reaction to those scandals. Audit firms and large public companies also face a world of globalization, where competition for listings among new and existing stock markets is mounting and new standards for international financial reporting are becoming more acceptable. It is a world filled with financial innovations (some of which gave rise to the corporate scandals) amidst growing technical complexity, which is little understood by the vast majority of individual investors. Although competition in international capital markets and adoption of international accounting standards go beyond the scope of this paper, they continue to underlie the competition in a highly concentrated audit industry, an oligopoly which is the subject of this paper.

The world's largest corporations essentially depend upon four privately-held accounting firms to supply their annual audits which are required by law. The audit industry is heavily regulated by governments and is susceptible to massive lawsuits when their clients are involved in fraudulent activities or suffer severe financial losses. Auditors are expected to detect fraud or questionable practices in reviewing financial statements. One major accounting firm was driven from business because of corporate scandal and there is great fear that the industry may shrink further through government or private legal action. Because of the history of multimillion-dollar litigation, the industry is unable to obtain liability insurance. The situation is so serious that the four remaining major audit firms and their clients are petitioning governments to impose monetary limits on liability. Is this the world's weakest oligopoly?

Virtually all of the information in this paper comes from published sources. The author wishes to acknowledge those who assisted in identifying and suggesting pertinent sources of information for this report, particularly Orrice Williams of the General Accountability Office, Virgil Webb of the American Institute of Certified Public Accountants, Louise Haberman of the National Council of State Boards of Accounting, Professor Roy Suddaby, Department of Strategic Management & Organization, Alberta School of Business, and Richard Larm. The author also appreciates the comments and suggestions received from members of the Advisory Board of the American Antitrust Institute (AAI), especially Lawrence J. White, Professor of Economics, Stern School of Business, New York University. Any mistakes or misjudgments, however, are the sole responsibility of the author and the opinions expressed in the paper may not necessarily reflect the views of the AAI.

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# PART I

## INTRODUCTION: FOUR ARE TOO FEW

Enacted during the Great Depression of the 1930s, U.S. laws require that financial statements of public companies must be audited by an independent public accountant. As public companies grew and expanded internationally, particularly in the second half of the 20th century, public accounting firms also grew and followed their clients to serve them in foreign markets.

Concentration has long been characteristic of the U.S. accounting industry. Even in the 1960s, the largest accounting firms controlled roughly 75-80 percent of the audits of public companies. At that time, though, eight firms shared the business. Over the years, through mergers and consolidations, the firms grew far larger, but the number of firms shrank to five and, with the closure of Arthur Andersen in 2002, the "Big 5" became the "Big 4."

The Big 4 are giant organizations with substantial human resources, technical capabilities, huge earnings and market power. These four firms dominate the industry and conduct nearly all the audits of the world's largest corporations. The accounting business is currently booming, revenues are surging, and audit fees are rising. Paradoxically, despite this enviable position, the audit oligopoly suffers the weakness of vulnerability to massive lawsuits and fears that court cases could cause the collapse of another big accounting firm.

Large public companies are now concerned about the short supply of firms available for auditing, particularly if they desire to change, or if one of the Big 4 were to go out of business. Regulators in the United States and other countries also are concerned about the lack of additional competitors and the possible failure of another big firm as a consequence of regulatory actions or massive lawsuits.

As an integral part of the global financial system, which depends upon integrity in financial reporting and investor confidence, accounting firms are now the focus of several studies on ways to facilitate the operation of capital markets and to regulate the industry without stifling it. For example, a recent report by the U.S. Government Accountability Office (GAO) reviewed the situation and a wide range of proposals (including liability limitations), but made no recommendation for action at this time because each of the proposed solutions has distinct disadvantages. See Appendix I-1 for a list of GAO studies and other studies.

While clients of the Big 4 audit firms are concerned about their lack of choice, they are also concerned that major lawsuits could bring about failures of individual audit firms. This concern is shared by regulatory authorities. The short supply of accounting firms capable of auditing major multinational corporations appears to be inhibiting disciplinary actions by regulatory authorities.

This paper assembles and organizes information on the status of the audit industry with emphasis on the effects of concentration on audit fees, competition, regulation, and audit quality as well as the vulnerability of accounting firms to massive lawsuits. In addressing the current competitive situation, the paper seeks answers to four basic questions: (1) Can the level of competition be increased and, if

so, how? (2) How can the U.S. government regulate and discipline the audit industry effectively without further weakening it? (3) Should the government enact legislation to limit the industry's liability? (4) What can be done to remove barriers to the entry of additional global audit firms?

The paper is organized as follows. Following this introduction, Part II describes the nature of the oligopoly and the Big 4 accounting firms. Part III focuses on the effects of concentration on limited choice of auditors, audit fees, competition, and regulation. Part IV examines the threat of mega-lawsuits filed against large accounting firms and the quality of audits. Part V explores the various proposals to resolve the situation. Part VI attempts to answer the four questions posed above in this introduction.

# PART II

# THE CAST OF CHARACTERS, SIZE AND STRUCTURE OF THE OLIGOPOLY

## Oligopoly Size and Scope

The audit oligopoly is composed of four accounting firms (the Big 4) --- PricewaterhouseCoopers (PwC), Ernst & Young (EY), KPMG, and Deloitte Touche Komatsu (DT). Each of these firms generates hefty annual revenues of about $20 billion or more, roughly the size of Costa Rica's gross domestic product ($22 billion). The oligopoly is global in reach and has grown rapidly in recent years. Each firm has a presence in more than 140 countries, backed by extensive communication networks, technical knowledge and industry expertise, and each employs over 100,000 employees worldwide.

Collectively, the Big 4 earned almost $90 billion in 2007 and employed more than a half million persons, equivalent to the entire population of New Orleans (2000 Census). The International Federation of Accountants (IFAC) estimates a world population of over 2.5 million accountants.[1]

Worldwide revenues, employees, and number of countries of operation for each firm in 2007 are shown below. (Ancestry of the Big 4 firms goes back to the 1800s or early 1900s. Appendix II-1 presents a brief history, tracing the evolution of each of the firms.)

| **Firm (2007 FY data)** | **Revenues** | **Employees** | **Countries** |
|---|---|---|---|
| PricewaterhouseCoopers | $25.2bn | 146,700 | 150 |
| Deloitte Touche Tohmatsu | $23.1bn | 150,000 | 142 |
| Ernst & Young | $21.1bn | 130,000 | 140 |
| KPMG | $19.8bn | 123,000 | 145 |

Source: Wikipedia, Company Websites

### Market Share

From the revenue data shown above, it is clear that no single firm is dominant in the industry. The global market is shared almost equally by the Big 4. The market share percentages range from 22 to 28 percent based on 2007 revenues; two of the firms had almost equal shares of about 25 percent. Over the last five years, the spread has become more equalized as the share of PricewaterhouseCoopers (the

[1] IFAC is comprised of 157 members and associates in 123 countries and jurisdictions, representing over 2.5 million accountants. Accessed on IFAC website www.ifac.org August 16, 2008

largest in terms of revenue) declined from 34 percent in 2002 to 28 percent in 2007 and the share of KPMG (the smallest of the four) increased from 18 percent to 22 percent in the same period. Appendix II-2 contains a table on market share/concentration ratios for selected years in the period 1988-2005.

## Revenue by Geographic Region

Europe is the largest source of revenue for the Big 4, generating $41.4 billion or 46 percent of total revenue in 2007, about 19 percent more than the previous year. For KPMG, Europe produces more than half its revenue. In the same period, revenue from the Americas increased by only 10 percent to $36.7 billion or 41 percent of total revenue. Revenue from Asia (mostly China, India and Southeast Asia) grew the fastest, by 22 percent, but remained the smallest regional segment at 13 percent of total revenues.

## Structure of Global Organization (Global, But Not Monolithic)

As global organizations, the Big 4 vary in their levels of integration. Rather than centrally-operated and –controlled parent-subsidiary relationships, the major accounting and audit firms are organized as confederations of individual member companies connected by a common brand and network of communications. Generally, the member companies are separate and independent legal entities whose representatives participate in global committees that work to set and meet high quality operating standards and consistency of quality at all locations. In this respect, the organizations are similar to franchise operations. Some refer to these affiliations as "a collection of member firms" or "individual firms operating under an umbrella" or "a series of national partnerships" or (as in a recent document of the European Commission[2]) "'the Big 4' audit networks."

Of the major firms, EY appears to be well advanced in the process of integrating its regional organizations: 87 country practices in Western and Eastern Europe, the Middle East, India and Africa organized into a single area; a similar EY integration is underway among 700 partners in 15 countries in the Far East. [3] Along the same lines, PwC recently announced a reorganization to bring its national partnerships closer together and KPMG is in the process of merging some of its European practices. [4] The only true international partnership with strong central control over accounting standards and procedures was the now-defunct Arthur Andersen.[5]

The Big 4 have successfully projected their images as global companies, not tied to any individual country. The company names and reputations are recognized throughout the world. As an example, Steven G. Butler, Chairman of KPMG, in a public appearance in 2001, described his company as follows: "KPMG is a global professional services firm, and there are two elements that serve to define who we are... First, we're a knowledge business. .. Second, KPMG is a stateless organization. We practice in more than 150 countries around the world, employ more than 100,000 people… The membership of our

[2] EU Press Release IP/08/897 June 6, 2008, "Auditing: Commission issues Recommendation on limiting audit firms' liability" (see MEMO/08/366)

[3] Business Wire - Press Release, "Ernst & Young Announces Significant Globalization Moves," Forbes, April 21,2008

[4] Hughes, Jennifer, "PwC to shake up national partnership network," *Financial Times*, Aug. 19, 2008; Hughes, Jennifer, "For a single language, audit regulators must go global too," *Financial Times*, Aug. 20, 2008.

[5] Aharoni, Yair, "Coalitions and Competition: The Globalization of Professional Business Services," 1993, p. 139

executive team and our Board of Directors is comprised of a multinational mix of professionals who together symbolize the tremendous diversity within our firm." [6]

## Consolidation

The audit oligopoly existed in the 1970s and 1980s, but it consisted of eight firms at that time. Beginning in 1987, international accounting firms consolidated their resources through a series of mergers, creating the "Big 5" from the "Big 8," which had also resulted from several mergers. The "Big 5" came about through the following mergers:

- Peat Marwick and KMG became KPMG (1987);
- Ernst & Ernst and Arthur Young became Ernst & Young (1989);
- Deloitte Haskins & Sells and Touche Ross became Deloitte & Touche (1989);
- Price Waterhouse and Coopers & Lybrand became PricewaterhouseCoopers (1998).

Also, in 1998, a proposed merger between Ernst & Young and KPMG, which would have created an even larger firm, failed because of European regulatory and antitrust concerns in certain countries for some business sectors.[7] Arthur Andersen, the smallest of the Big 5 participated in several merger discussions with other firms, but was not involved in a merger during the period.

By combining resources, mergers enabled the firms to take advantage of greater economies of scale, to follow their clients around the world as they became globalized, and to invest in the latest computer, communication and information technology. In the 1980s, the major accounting firms had aspirations of becoming "professional service firms" or multidisciplinary practices--- global consulting firms, including legal services, with one-stop shopping. [8]

The Big 5 became the Big 4 in 2002 with the demise of Arthur Andersen. The firm was indicted for obstruction of justice for shredding documents related to the audit in the 2001 Enron scandal. The resulting conviction, since overturned, still effectively meant the end for Arthur Andersen. Most of its country practices around the world were sold to members of what is now the Big Four, notably Ernst & Young globally and Deloitte & Touche in the UK. [9] (See Part III for further details on competition for AA's former clients.)

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[6] Butler, Stephen G., Chairman of KPMG, speaking on April 23, 2001 at the International Honoree Luncheon in New York City. Butler received the Beta Gamma Sigma International Honoree Award, the Society's top honor, following his speech. Reported in Beta Gamma Sigma News, Summer 2001, page 1.

[7] "[T]here is evidence that Karel Van Miert, the EU competition commissioner, was indeed gearing up to stop, or at least seriously challenge, the KPMG and E&Y merger. In a confidential 18-page letter…Mr. Van Miert concludes of the KPMG and E&Y merger, on the basis of an initial inquiry, that 'there is strong likelihood that the notified operation will create or strengthen a dominant position, whether single or oligopolistic, in the market of audit and accounting services, within the EU.'" Kelly, Jim, "E&Y-KPMG: Rise and Decline of a Merger," *Financial Times*, Feb. 19, 1998.

[8] For example, in 1998, PwC expected to be one of the top six law firms in every country in which it operated, including America; Deloitte Touche Tohmatsu stated similar intentions; and Ernst & Young's stated aim was to have a global law firm with 4,000 staff by 2003 or 2004. *Economist*, Nov. 13, 2003. Also see: Ascher, Bernard, "The Threat to U.S. Lawyers from Competition by Multidisciplinary Practices (MDPs): Is It Gone?" American Antitrust Institute, Working Paper 06-06, November 29, 2006, available at http://antitrustinstitute.org/Archives/557.ashx

[9] Gullapalli, Diva, "Grant Thornton Battles Its Image; No. 5 Accounting Firm Struggles To Attract Major Audit Clients, Despite Misfortunes of Big Four," *Wall Street Journal.*, June 9, 2005. pg. C.1

## Second Tier and Smaller Firms

A second tier of mid-sized firms have multinational clients and networks with potential for international growth. With over 350 publicly traded companies as clients, BDO Seidman, LLP is the U.S. member firm of BDO International, the world's fifth largest accounting and consulting organization with over 621 member firm offices in 110 countries and approximately 30,000 partners and staff. In 2007, BDO International had revenues of $3.911 billion.[10] Another second tier firm, Grant Thornton, has international reach and expertise. Its international network operates in more than 100 countries, with recent revenues of $2.8 billion and total personnel (including partners) of over 25,000. More than 700 smaller firms also audit public companies in the United States, but they generally lack the staff, resources and expertise to audit major multinational corporations.

## Level of Concentration

The Big 4 accounting firms dominate the market for audits of large public companies. In 2006, they audited 98 percent of the 1500 largest public companies with annual revenues over $1 billion and 92 percent of public companies with annual revenues between $500 million and $1 billion. In 2002, they audited over 78 percent of all U.S. public companies (those listed on stock exchanges) and 99 percent of all public company sales, according to reports of the U.S. Government Accountability Office (GAO)[11].

The level of concentration is even more pronounced when considering the industry of the clients. In some industries, such as petroleum and coal, and security and commodity brokers, the level of concentration in 2002 by the top two auditing firms was about 94 percent (based on industry assets). Other industries in which the level s of concentration for the top two auditing firms were greater than 80 percent include metal and mining; general building contractors, air transportation, non-depository (loan and credit) institutions; oil and gas; and transportation equipment. Because public companies generally prefer auditors with established records of industry expertise and requisite capacity, their viable choices in these industries are even more limited than the Big 4.[12]

## Worldwide Dominance

The Big 4 accounting firms dominate internationally, with nearly $90 billion in total global net revenues for 2007[13], up from $47 billion in 2002.[14] As examples, the Big 4 audited:

- virtually all major listed companies in the **United Kingdom** in 2002[15] (all but one of the UK's biggest companies and 98 percent of the FTSE 350[16];

[10] Note that BDO Seidman is subject to a $521 million jury verdict. The case is under appeal. See Appendix IV-4 of this paper and Osterland, Andrew, "Jury's fraud penalty stuns auditor: $521 million judgment—seen as largest ever—could swamp BDO Seidman," *Financial Week*, Aug. 20, 2007.

[11] U.S. Government Accountability Office (GAO-03-864), "Public Accounting Firms: Mandated Study on Consolidation and Competition," Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services, July 2003.

[12] Ibid.

[13] Wikipedia, available at http://en.wikipedia.org/wiki/Big_Four_auditors, accessed August 16, 2008

[14] Ibid; February 2003 Public Accounting Report

[15] GAO, op. cit.., fn 11

[16] Jopson, Barney, "Top audit firms' dominance studied," *Financial Times*, Apr. 10, 2006; *Oligopoly Watch*,

- over 80 percent of all public companies in **Japan** in 2002;[17]
- at least 90 percent in the **Netherlands** in 2002;[18] and
- more than 80 percent of listed companies in **Italy** in 2001 (then-Big 5).[19]

### Audit and Other Revenues

While auditing is a key service which lies at the core of the business, it is not the only source of revenue for these firms. Other services include tax advice and business consulting services. The proportion of audit revenue to total revenue fluctuates. In the 1980s and 90s, the major accounting firms sought more consulting business, which was seen as more lucrative than auditing. In the late 1990s, however, the Big 4 faced harsh criticism for putting commercial interests ahead of the public interest. Facing strong pressures to spin off their consulting arms, three of the four firms split or sold their consulting arms by 2002; only Deloitte retained its consulting services. (For details of the spinoffs and subsequent revival see Appendixes II-3 and III-2.) Prior to the divestiture, audit revenue as a percentage of total revenue declined to considerably less than 50 percent ,[20] but after the spinoff of the consulting arms of major accounting firms in 1998 and the issuance of regulations under Sarbanes-Oxley legislation, the percentage increased to at least 51 percent.[21] However, more recently, the Big 4 have revived their consulting businesses[22] and one British study indicates that audit fees now represent only one-third of Big 4 income.[23] For further discussion of competition for non-audit business, see Part III and Appendix III-2.

## Nature of the Oligopoly: "Tight" with Significant Market Power

The audit industry is an oligopoly, that is, it consists of a small number of firms that controls the supply of audit services to major corporations. It also meets the definition of a "tight oligopoly," meaning that it is a market structure in which the top four providers control at least 60 percent of the market and other entities face significant barriers to entry into the market. In the large public company audit

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"The latest maneuvers of the new oligopolies and what they mean: Big Four auditors and divestment, Aug. 10, 2006.

[17] GAO, op. cit., fn 11

[18] Ibid.

[19] Ibid.

[20] "Audit fees declined from 70 percent of accounting firms' revenues in 1976 to just 31 percent in 1998, as consulting fees expanded." Stuart, Alix Nyberg, *CFO Magazine*, Oct. 1, 2002; also quoted in Futurecasts online magazine in review of Arthur Levitt's book, "Take on the Street," Vol. 5 No. 3, Mar. 1, 2003.

[21] A survey of 23 Dow Jones Industrials showed that audit fees in 2004 represented 65 percent of total fees of $821 million in 2004; prior, the audit fees were only 30 percent of the total." Gullapalli, Diva, "Audit Fees Are on Rise As Companies Pony Up; Payments for Consulting And Other Services Shrink, In Big Change From 2000," *Wall Street Journal,* Mar. 25, 2005. pg. C.3; Taub, Stephen, "Audit Fees Surged in 2004; With companies reportedly willing to pay up for top-notch auditing work, accounting firms are making hay," *CFO.com*, Mar. 28, 2005

[22] Hughes, Jennifer, "Audit firms once again making 'consulting hay'" *Financial Times*, Nov. 19, 2007. p. 4; Byrnes, Nanette, "Consulting Pays Off for Accountants Again; Deloitte & Touche resisted splitting with its consulting arm, and now the multibillion-dollar segment has inspired other audit firms to rebuild theirs, *Business Week*, Aug. 20, 2007

[23] Hughes, Jennifer, "Andersen's collapse results in a fee bonus for Big Four rivals," *Financial Times,* Apr. 29, 2008. p. 19

market, the Big 4 now audit over 99 percent of all public companies with sales over $250 million, and other firms face significant barriers to entry into the market. [24]

The audit industry also qualifies as a "tight oligopoly" by another measure--- the Herfindahl Hirschman (HHI) Index. "As a general rule, an HHI below 1,000 indicates a market predisposed to perform competitively and one that is unlikely to have adverse competitive effects. A 1,000-1,800 value generally indicates moderate concentration. Anything over 1,800 is regarded as a sign of acute concentration. An HHI above 1,800 indicates a highly concentrated market in which firms have a potential for significant market power--- the ability to profitably maintain prices above competitive levels for a significant period of time. From 1990 to 1997, the four-firm index was fairly steady and below the 1800 mark, but following the merger of Price Waterhouse and Coopers & Lybrand, the index jumped over the threshold and increased from 1998 to 2002 with the demise of Arthur Andersen, when the index hit 2566, well above the threshold for significant market power." [25] Numerous other markets in the United States qualify as tight oligopolies (see Appendix II-4).

*Thus, the result of consolidation through a series of mergers (and the dissolution of Arthur Andersen) is a more heavily concentrated audit industry, consisting of four huge firms with significant market power. Part III discusses the problems associated with concentration.*

[24] GAO, op. cit., fn 11
[25] Ibid.

# PART III

# EFFECTS OF CONCENTRATION

The most obvious and perhaps the most significant effect of concentration in the industry is the limited choice of audit suppliers for public companies. Concentration also affects audit fees, competition, audit quality, and the regulatory environment. Market power resulting from concentration sometimes leads to anticompetitive behavior. These subjects are addressed in turn in Part III.

## Limited Choice

Large public companies have fewer choices in selecting an audit firm. The Big 4 have few, if any, competitors among mid-tier firms in the market for large public company audits. GAO found that specialization, potential conflicts of interest, and independence rules can further limit audit choices. "The significant changes that have occurred in the profession may have implications for competition and public company choice, especially in certain industries, in the future," GAO reported. The great fear among large public companies is that choices could be further reduced if another of the Big 4 accounting firms goes out of business. [26] Large public companies are more concerned about availability of audit firms than about price. [27]

Even before the Big 5 shrank to the Big 4, there was concern about the small number of major audit firms. In 1998, one report stated that a reduction from five to four would not be tolerated and two Competition Commissioners of the European Union believed that five is the minimum required to ensure enough competition.[28] According to a variety of reports, now that there are only four firms, further shrinkage would "be a catastrophe for financial markets," "a global economic concern," "a threat to continued existence of the profession" and "could call into question viability of the survivors." Reduction to three firms "could cause paralysis in financial markets" and leave the industry "too small to maintain audit quality and independence." See Appendix III-1 for a compilation of comments and references on further concentration of the audit industry. The seriousness and complexity of the situation is highlighted by a statement of the outgoing Chairman of the U.S. Public Company Accounting Oversight Board, who said in 2005: "regulators do not have 'a clue' how to respond if one of the big four accounting firms were to collapse."[29]

[26] GAO, op. cit. fn 11

[27] *Financial Times*, March 29, 2008, op. cit. fn 20

[28] Guerrera, Francesco, and Spiegel, Peter, "Deloitte offer would face reluctant EU competition hurdle," *Financial Times*, March 12, 2002

[29] William McDonough, Chairman of the U.S. Public Company Accounting Oversight Board, expressing relief that the Department of Justice reached a settlement with KPMG over its sales of tax avoidance schemes to clients, quoted in Parker, Andrew, "US audit watchdog warns about industry," *Financial Times*, September 27, 2005

## Client Conflicts

Part of the problem with lack-of-auditor choice is the fear of possible misuse of company information---business strategies, secret recipes, and other trade secrets. If a client perceives the possibility of conflicts with a rival companies using a particular auditing firm it might rule out selecting that audit firm, thus reducing the number of practical choices. For example, Coca-Cola, fearing that company secrets would become vulnerable, made Ernst &Young drop Pepsi after Arthur Young merged with Ernst & Whinney in 1989. (PepsiCo had been an Arthur Young client since 1965; Coca-Cola had been an Ernst & Whinney client since 1924 and paid higher audit fees than PepsiCo.)[30] In February 1998, EY and KPMG cited client opposition as one of the reasons for abandoning merger plans (although there were a number of other reasons, e.g., antitrust issues, cost problems, and the difficulty of merging two diverse companies and cultures). [31] Along with fears that the relative lack of choice would encourage a rise in prices, there were fears among clients that the combined firms would make company secrets vulnerable to rivals using the same firm." [32]

On the other hand, each of the Big 4 has clients who compete in the same industry and there are few, if any, reported instances in which audit firm personnel may have revealed company secrets to another client. The accountants argue that they have a better record of keeping company secrets than, say, advertising men; they also say that in some industries experience is essential to navigate clients through special regulatory provisions, including tax rules.[33]

## Audit Fees

Audit fees are probably at historically high levels. The increase since 2002 is generally attributed to new regulatory requirements rather than to industry concentration. Audit clients are complaining about the high cost of compliance with the requirements of Sarbanes-Oxley legislation, not high audit fees. [34] Ironically, the legislation enacted as a backlash to corporate and accounting scandals has created a huge bonanza for audit firms. Business is booming to the extent that some of the overload is flowing from the Big 4 to smaller accounting firms[35] and to India through outsourcing. [36]

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[30] Hoover Profile: Ernst and Young Global Ltd., Last updated June 24, 2004, obtained online from Answers.com, access July 20, 2008

[31] Ibid. There were fears that the "merger would have furthered the consolidation of the major accounting firms into the Big Four, an outcome disturbing to many industry analysts. (See fn 7 supra.) Along with fears that the relative lack of choice would encourage a rise in prices, there were fears among clients that the combined firms would make company secrets vulnerable to rivals using the same firm."

[32] Ibid. "There was a conflict at the time of the merger over each firm's "cola" clients. A conflict of interest existed in that PepsiCo had been an Arthur Young client since 1965, while Coca-Cola had been an Ernst & Whinney client since 1924. Coca-Cola forced the firm to dump PepsiCo, as Ernst & Young noted that Coca-Cola had been a client for a longer time and that Coke's annual audit fee was $14 million, a much higher figure than Pepsi's $8.8 million audit fee."

[33] *Economist*, "Bean Counters Unite," Oct. 25, 1997

[34] Ciesielski, Jack T. and Weirich, Thomas R., "Ups and Downs of Audit Fees Since the Sarbanes-Oxley Act: A Closer Look at the Effects of Compliance, *CPA Journal*, Oct. 2006

[35] Reilly, David, "Outside Audit: Midtier Auditors Gain Traction In Quest for Large-Cap Clients," *Wall Street Journal*, Nov. 14, 2006, p.C3

[36] Bellman, Eric, "A Cost of Sarbanes-Oxley: Outsourcing to India," *Wall Street Journal*, July 14, 2005; "US accounting work for Indian BPOs, " *Rediff News*, July 14, 2005 http://www.rediff.com///money/2005/jul/14bpo.htm, accessed June 26, 2008.

Because accounting firms are not required to reveal information on rates charged to individual clients, determining the precise level of audit fees and the changes over time are difficult tasks. In the United States, however, public companies are now required to disclose the amount paid in audit fees. Fees vary among client firms depending upon the amount of work involved, which is affected by the size of the company and the extent of its business activities (including mergers and acquisitions).

Trade literature abounds with descriptions of the increase based on various studies. For example, according to the *CPA Journal* ,[37] between 2001 and 2004 audit and audit-related fees increased by 103 percent for 496 of the S&P 500. A report by the *Corporate Library* stated that the aggregate data presented some fairly outstanding figures -- with an average increase in audit fees of 756 percent between 2001 and 2006." [38] Other articles (based on various time periods and different groups of companies) indicate that audit fees: have tripled [39]; doubled[40]; and "skyrocketed[41]. The situation has been described as "a revolution in fees," and "a dramatic change in the market."[42]

Major corporations are spending tens of millions of dollars on audits. According to the *Wall Street Journal*, in 2004, based on proxy disclosures, 23 of the 30 Dow Jones Industrials paid a total of $533 million for audit fees. General Electric, for example, paid $78 million in 2004; United Technologies, $32 million; IBM, $22 million; and Johnson & Johnson, $20 million. [43] "Companies are willing to pay up for top-notch auditing work, and the accounting firms have milked the changing auditing environment by charging much higher fees.[44] According to Arthur Bowman, editor of Bowman's Accounting Report, the fees of smaller accounting firms were 35 to 40 percent lower than the Big 4's.[45] For further information on increases in audit fees, see Appendix III-3.

Audit fees are no longer (as they once were) a loss leader to attract consulting business; they reflect more realistically the actual cost of audits. Clients do not change audit firms often. "It is manifestly costly to change auditors, largely because changing auditors is a reportable event, and the market may be skeptical about the reasoning behind a change of auditors and discount the company's stock price. Auditors tend to be changed very infrequently. In the extreme, General Electric, for example, has used KPMG and its predecessors for over a hundred years." [46] Because switching costs are high, competitive

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[37] *CPA Journal*, Oct. 2006, , op. cit. fn 34

[38] *Corporate Library* Press Release, "Big Four Audit Firms Feel the Effects of Post SOX Inroads as Audit Fees Skyrocket," Posted Sept. 17, 2007

[39] Grant, Jeremy, "Piling on the pressure as Sarbanes costs hit," *Financial Times*, May 22, 2006. pg. 27

[40] Hughes, Jennifer, "Rising audit fees embolden critics of Big Four accountancy firms," *Financial Times*, Sep. 10, 2007. p.19; Hughes, Jennifer, "Rising audit fees embolden critics of Big Four accountancy firms," *Financial Times*, Sep. 10, 2007. p.19; Hughes, Jennifer, "Andersen's collapse results in a fee bonus for Big Four rivals," *Financial Times*, Apr 29, 2008, p.19; Countryman, Andrew, "Sarbanes-Oxley mandates send corporate audit expenses soaring," *Chicago Tribune*, June 5, 2005

[41] Wallison, Peter J., "The Sorcerer, the Apprentice, and the Broom: What to Do about Private Securities Class Actions," *AEI Online*, Posted: Thursday, Mar. 8, 2007, accessed July 20, 2008; *Corporate Library*, Sept. 17, 2007, op. cit. fn 34; *Chicago Tribune*, June 5, 2005, op. cit. fn 40

[42] *Corporate Library*, Sept. 17, 2007, op. cit. fn 38

[43] Gullapalli, Diva, Mar. 25, 2005, op. cit. fn 21; Taub, Stephen, Mar. 28, 2005, op. cit. fn 21

[44] Taub, Stephen, Mar. 28, 2005, op. cit. fn 21

[45] Stuart, Alix Nyberg, Oct. 1, 2002, op. cit. fn 20

[46] Brown, John Prather, "Are Four Big Auditing Firms Enough?," *Columbia Law and Economics Seminar*, March 6, 2006, p. 3

tendering seldom occurs these days, but some bargaining occurs during the reappointment process. [47] As noted by a trade journal, "Audit fees had to increase, to help minimize litigation through sturdier audits or to pay for litigation expenses when a sturdier audit wasn't enough." [48] "With fewer business opportunities at their existing audit clients, auditors seem to be devoting more time to the audit, and justifying their higher fees.... The evidence shows that accounting firms are being paid better for audit engagements than they used to be, and this may be a sufficient incentive to keep them focused on the task of auditing."[49] Many believe that the small number of firms and the lack of alternative suppliers underlie high fees and additional cost comes from the need for the big 4 to build reserves to defend against potentially ruinous lawsuits. [50]

With respect to causes for the increase in audit fees, the GAO found that there was "no clear, definitive link between accounting market structure and anticompetitive behavior." Moreover, GAO found (after "using various audit fee measures") that its research "did not provide conclusive evidence of any effects of consolidation." [51] Some evidence did suggest that audit fees were loss leaders during the 1980s and 1990s. GAO concluded, however that "2002 market structure was not necessarily inconsistent with a competitive environment." [52] Recent studies in the United Kingdom found a link between concentration and audit fees. [53]

## Competition

The market for auditing is a two-tier market: (1) the market for large public companies in which the Big 4 compete among themselves; and (2) the market for audits of all other companies in which the Big 4 compete along with all other auditing firms.

### Barriers to Entry

GAO found that mid-tier and smaller accounting firms face significant barriers to entering the large public company audit market. These include lack of adequate staff, technical expertise, access to capital and global reach. The GAO report itemizes the barriers as follows: "reputation, size/capacity constraints, limited access to capital, litigation risks, lack of expertise, lack of global networks and

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[47] "Competition and Choice in the UK Audit Market," *Oxera Consulting Ltd.*, April 2006, available at http://www.oxera.com, accessed July 13, 2008. Bargaining power between audit firm and client is reasonably symmetrical. High switching costs make a client reluctant to change firms. At the same time, loss of a major client can be harmful not only to revenue but to reputation and can cause substantial internal shakeups at the audit firm, which account managers have a strong interest in avoiding.

[48] *CPA Journal*, Oct. 2006, , op. cit. fn 34

[49] Ibid.

[50] Ibid.

[51] GAO, op. cit., fn 11

[52] Ibid

[53] A recent study by the *London School of Economics* for the accounting firm BDO found a link (although there was no link prior to collapse of AA in 2002) between concentration and audit fees, maintaining that the impact is quantifiable. Also a study in 2006 by Oxera Consulting Ltd. found a link between concentration and audit fees:"Competition and Choice in the UK Audit Market," prepared by *Oxera Consulting Ltd*. For the UK Department of Trade & Industry and Financial Reporting Council, April 2006, available at: http://www.oxera.com, accessed July 13, 2008.

alliances, varying state licensing requirements and other regulations, Sarbanes-Oxley and independence requirements. As a result, in the short run, the mid-tier and smaller firms are not expected to reach the size of the large accounting firms. The barriers are discussed further in the sections below and in Part V of this paper.

## Competition Among the Major Firms

Competition among the major accounting firms was much keener in years prior to consolidation of the industry into four firms. In the early 1980s, audit firms came under tremendous pressure to lower their audit fees. Clients actively played the eight major audit firms against one another to lower their audit fees in bidding wars. As a result, audit fees became a "loss leader" and were not self-supporting. [54] A *Wall Street Journal* article at that time cited two reasons for the increased competition among certified public accounting firms. First, "more big companies are requesting multiple bids for their outside audits to cut costs," and second, the "larger CPA firms, in an effort to expand, are competing more aggressively with smaller accounting firms for the business of midsized and closely held companies." [55] Arthur W. Bowman, editor of the Public Accounting Report, pointed out that a "recent rash of [corporate] mergers is spurring audit-fee competition as new parent companies drop the auditors of one of the merged concerns." Fees were being discounted to 70% of the base fees and, in some cases, 50 percent, compared to 80-90% two years prior.[56]

According to Yale University professor Shyam Sunder, the auditors responded to competitive pressures "by lowering their audit fees, lowering the quality of audit services they provided, and by turning to more lucrative consulting services." Audits became a tool for attracting clients' business for management consulting, information technology, tax advice and other services. [57] It was not uncommon for the major accounting firms to underprice ("lowball") their audit services to gain other business from clients. [58]

This fierce competition could have contributed to consolidation of the industry. "…[A]ccounting is turning into an intensely competitive and not too genteel business in which computers are cutting costs, clients are raided and an increasing share of revenues comes from such non-auditing services as management consulting and tax planning," observed *Business* Week magazine. "To compete PW and DH&S are preparing to try the first merger among Big Eight firms."[59] Between 1991 and 1997, KPMG lost approximately 60 audit clients in the US to E&Y. As stated in a *Washington Post* report, "price competition for corporate audits is hurting accounting firms so much that they are seeking new sources of revenue and in some cases merger partners." [60]

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[54] Berton, Lee, "Audit Fees Fall As CPA Firms Jockey for Bids," *Wall Street Journal*, Jan 28, 1985, p.1
[55] Ibid.
[56] Ibid.
[57] Collapse of Accounting: Causes and Cures, Shyam Sunder, Yale University, PowerPoint slides accessed May 31, 2008
[58] Bazerman, Max H., Morgan, Kimberly P. and Loewenstein, George F., "The Impossibility of Auditor Independence," Vol. 38, No. 4, *Sloan Management Review*, Massachusetts Institute of Technology, Summer 1997
[59] *Business Week*, "The Big Eight Could Soon Be the Big Seven," Sept. 24, 1984, p. 37
[60] Ross, Nancy, "Competition Stinging Big Accountants," *Washington Post*, Sept. 1, 1984, p. D9

## Competition for Arthur Andersen Clients

In competing for Arthur Andersen's former clients in 2002, the Big 4 garnered 87 percent of the business.[61] Andersen had reviewed the books of 1,300 public companies. [62] E&Y merged with many ex AA practices around the world, but not in the United States, United Kingdom, and Netherlands. Deloitte absorbed the UK business of AA.[63]

Interestingly, not all of the Big 4 gained market share when Arthur Andersen went out of the audit business. From 1988 to 2005, based on sales revenue audited, Ernst & Young gained 7 percent market share; Deloitte Touche also gained 7 percent; KPMG gained 3.6 percent. PricewaterhouseCoopers lost 3.8 percent. Arthur Andersen had accounted for 14 percent in 1988. See Appendix II-2.

## A Milder Form of Competition

Now that there are essentially only four major suppliers, the nature of competition is quite different. Competition still exists, but it is far less vigorous. In addition to industry concentration, however, a number of other factors have changed. Beginning in the late 1980s, the major firms were pressured into divesting themselves of their management consulting activities because of the possibility of conflict of interest with audit business. Moreover, the enactment of new regulatory requirements in the Sarbanes-Oxley Act of 2002 made audits more complicated and burdensome. In effect, since 2002, an audit is a different "product" than an audit in prior years. Also, audit firms no longer are permitted to provide consulting services to their audit clients (although they can provide such services to non-audit clients). They can provide tax services to audit clients (subject to certain restrictions) and to non-audit clients. [64]

Thus, it is difficult to conclude that industry concentration by itself is responsible for less vigorous competition since 2002. In fact, the GAO concluded that "the 2002 market structure was not necessarily inconsistent with a competitive environment." [65] Although GAO found no empirical evidence of impaired competition to date," it observed that "the increased degree of concentration coupled with restrictions on the provision of non-audit services to audit clients may have implications for competition or exercise of market power in the future." [66]

Price competition is a secondary consideration. Big 4 audit clients are sophisticated companies with great resources and expertise, unlike purchasers of consumer products who lack such knowledge and can be hurt more by price-fixing and other anti-competitive behavior. Even though audit costs can run into millions of dollars in absolute terms, the price effects are small in relation to stock market value and in terms of the costs of the products sold to ultimate consumers. Other factors considered by audit clients in selecting an audit firm are reputation (see discussion below), sector-specific skills, international coverage, and quality of staff.

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[61] Gullapalli, Diya, "Grant Thornton Battles Its Image; No. 5 Accounting Firm Struggles To Attract Major Audit Clients, Despite Misfortunes of Big Four," *Wall Street Journal*, Jun 9, 2005. p. C1
[62] *Economist*, Nov. 13, 2003; and Ascher, op. cit. fn 6
[63] Gullapalli, op. cit., fn 21
[64] Byrnes, Aug. 20, 2007, op. cit. fn 22
[65] GAO 2003, op. cit. fn 11
[66] Ibid.

## Mid-Tier and Smaller Audit Firms

The Big 4 audit firms continue to dominate the market for audits of major multinational corporations, although mid-tier firms, such as Grant Thornton and BDO have tried to make inroads in that market. Grant Thornton's CEO, Edward E. Nussbaum, in Congressional testimony and in speeches, has asserted that there already are more than four firms capable of performing international audits. He contends that Grant is an excellent fifth choice, has offices in a number of countries, and can devote more attention to clients than the Big 4. Grant embarked on a campaign, advocating "right sizing." Back in 2001, Grant even "stole a Big Five employee to help it win Big Five business: Ed Russ, whom Grant executives came to know as he researched a possible acquisition of Grant by his employer, PricewaterhouseCoopers."[67]

Grant Thornton and BDO are growing, but they have a long way to go to join the ranks of the Big 4. For example, the revenue of Ernst & Young is 23 times that of Grant Thornton, the fifth largest firm. Even if the number 5 through 8 firms were rolled into one, "there would not be enough business to match the capabilities of the Big 4." [68]

As a result of the work generated by Sarbanes-Oxley requirements, the Big 4 are overloaded; they have become more selective in accepting clients and have let some of the smaller clients go. Mid-tier and smaller audit firms have gained from the overload. [69] In the years 2003 to 2005, 4,000 companies (one third of all public companies) switched to Non-Big 4 auditors[70] and the proportion of smaller companies using Big 4 auditors fell by half between 2002 and 2006.[71] Another survey of 3,140 companies showed that the number of non-Big 4 audit firms servicing these companies increased from none in 2001 to 91 in 2006 (an increase of 1,000 percent). In addition, the non-Big 4 firms more than doubled their market share over this period. This growth may in part be due to the enormous increase in revenue opportunities for audit services. [72]

Indeed, concentration in the small and mid-size public company audit market has eased during the past five years. The Big 4 share in auditing small public companies with annual revenues under $100 million has declined from 44 percent in 2002 to 22 percent in 2006; and in auditing mid-size public companies with annual revenue between $100 million and $500 million from 90 percent in 2002 to 71 percent in 2006, according to the GAO. [73]

GAO found that the market for smaller public company audits was much more competitive than the overall or large company market.[74] Smaller public companies are changing auditors more frequently. Apparently, the stigma of using a non-Big 4 auditor is fading. While GAO recognized that smaller

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[67] Gullapalli, June 9, 2005, op. cit. fn 61

[68] McDonough, William, Chairman Public Company Accounting Oversight Board, quoted in *Accounting Observer* Website (accessed May 14, 1998}, "Nice Work If You Can Get It, Part II," posted by Jack Ciesielski, Sept. 29, 2005.

[69] Reilly, Nov. 14, 2006, op. cit. fn 34

[70] Ibid.

[71] Chasen, Emily, "US watchdog says 'Big 4' audit firms enough for now," *Reuters*, Jan. 10, 2008

[72] *Corporate Library* Press Release, Sept. 17, 2007, op. cit. fn 38

[73] U.S. General Accountability Office, (GAO-08-163): "Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action," Report to Congressional Addressees, Jan. 2008

[74] Ibid.

companies see more choices of audit firms, its survey nevertheless found that 82 percent of large public companies see their choice of auditors limited to three firms.[75]

## Reputation

Reputation is an important factor in competition. Banks recommend the Big 4 to large borrower companies. In addition to reputation, strengths of the Big 4 include expertise, communication networks capital and human resources, geographic reach, and deep pockets to withstand large lawsuits. Investors often question why a small public accounting firm has been selected to perform audits, but readily accept a Big 4 firm without question. [76]

"The American Assembly, an influential public policy forum (associated with Columbia University), noted the effect of a more diffuse snobbery in a report last May that said a 'patina of authority and confidence' surrounded the big four: 'Analysts and investment bankers are often concerned that the presence of a mid-tier firm as auditor will negatively impact a company's marketability, either by creating the perception that the company was shed by a big four because of high risk, or raising a spectre of doubt about the validity of its financial statements'."[77] Mid-tier and smaller audit firms have attempted to refute this "perception bias" in Congressional testimony and public appearances, especially Edward Nussbaum, CEO of Grant Thornton. [78]

Mid-tier firms believe the situation has changed since the accounting scandals of the past decade. There is no longer a stigma associated with auditor changes, as pointed out by Cono Fusco, managing partner for strategic relationships at Grant Thornton. "Based on the inquiries we would have gotten in the past," he said, "there was some level of concern among companies that the market placed a higher value on having one of the Big Four. But today, changing from one of the four large firms is not seen as a sell signal." [79]

Switching from a Big 4 to a smaller audit firm may no longer be seen as a "sell signal" and banks may no longer be placing higher value on a Big 4 audit.[80] A study commissioned by BDO found that 244 public companies which dropped a Big 4 auditor had no effect on stock prices.[81]

## Other Networks

In October 2006, Baker Tilly, one of the biggest accounting firms in the United Kingdom, created Baker Tilly USA, a network of 22 mid-sized US accounting firms to compete with the Big 4.[82] At present, the Baker Tilly International Network has 144 member firms around the world.[83] Three other accounting

[75] Ibid. and Chasen, Sept. 17, 2007, op. cit. fn 71
[76] Jopson, Barney, "The stranglehold of leading auditors has prompted calls for radical measures to reduce concentration. But there are limits to what the UK can achieve alone," *Financial Times*, Mar 27, 2006, p.15
[77] Ibid.
[78] Ibid.
[79] Reilly, Nov. 14, 2006, op. cit. fn 34
[80] Ibid.
[81] Ibid.
[82] Vault, "High times for accountants," *Vault.com*, accessed Apr. 20, 2008
[83] Virchow, Krause & Co., the largest U.S. member of the Baker Tilly International Network, is seeking to change its name to Baker Tilly LLP. The 77-year-old accounting firm is in discussions with the Baker Tilly international group

firm networks --- Moores Rowland North America, the Leading Edge Alliance and Moore Stephens North America--- are hoping to create demand for their respective services by combining accounting firms to rival the power of the Big 4.[84]

This is clearly in response to the consolidation of the accounting profession in recent years, which has narrowed the choice of auditors and accountants for corporate America. These networks recognize the market opportunities for audit services. As stated by Geoff Barnes, Chief Executive and President of Baker Tilly International, "We are at a time when the business market is crying out for alternatives to the Big 4, and we believe that our structure can fill that void". [85]

**Other Competition**

In competition for business and tax advisory services (non-audit services), the Big 4 compete--- not only against each other--- but against their former subsidiaries, such as Accenture and BearingPoint, as well as law firms and other business consulting firms, such as McKinsey & Company and Booz Allen. They also compete with each other in recruiting top accounting graduates from leading universities, and in government lobbying. Non-audit competition is described further in Appendix III-2, showing revenues for consulting services for each of the Big 4 in 2006--- a combined total of over $20 billion.

## Regulatory Environment: Soft

Until 2002, the audit industry in the United States was self-regulated through its trade association, the American Institute of Certified Public Accountants (AICPA), subject to oversight by the Securities & Exchange Commission (SEC), an independent agency of the U.S. government with about 3,400 employees. In 2002, the Sarbanes-Oxley Act created the Public Company Accounting Oversight Board (PCAOB), a private, nonprofit corporation, to oversee the auditors of public companies.[86] The PCAOB was created to protect investors and the public interest by promoting informative, fair, and independent audit reports. (The audit industry also is subject to laws and regulations of state governments.)

The PCAOB Board consists of five members who are appointed by the Securities and Exchange Commission. Although the PCAOB is a private sector entity, the Act gives the SEC oversight authority

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about becoming the flagship firm in the U.S. and is also pursuing approval from state regulators in the four Midwestern states where it operates, as well as from their state boards of accountancy. Under the proposal, all of the other U.S. firms in the network would remain independent member firms with the same ability to use the brand name as they now use it, but only Virchow, Krause would use Baker Tilly as its firm name. Over 60 of Baker Tilly's 144 member firms across the globe have Baker Tilly as part of their name. Virchow Krause has offices in Chicago, Detroit, Minneapolis and Wisconsin, and a staff of over 1,300. The firm hopes to gain regulatory approval around the end of 2008. "Virchow Krause Wants Baker Tilly Naming Rights," WebCPA website (accessed Aug. 21, 2008)

[84] Vault, op. cit. fn 82

[85] Baker Tilly website: www.bakertillyinternational.com, accessed July 16, 2008

[86] Recently, a three-judge panel on the U.S. Appeals Court for the District of Columbia Circuit ruled in a 2-1 decision that the makeup of the PCAOB under the Sarbanes-Oxley Act does not violate the appointments clause and separation of powers in the Constitution. The plaintiffs, the Free Enterprise Fund and audit firm Beckstead & Watts, may appeal, either to the full appeals court or even the U.S. Supreme Court. Cohn, Michael, "How Would the Supreme Court Rule on the PCAOB?" WebCPA, Aug. 27, 2008 (accessed Aug. 28, 2008)

over the Board. In addition to appointing members of the Board, the SEC, among other things, must approve the PCAOB's budget and rules, including auditing standards, and may review appeals of adverse Board inspection reports and disciplinary actions against registered firms. With a staff of about 500, PCAOB has a budget of roughly $140 million (financed by fees from issuers of stock).

The Act gives the PCAOB four primary responsibilities: registration of accounting firms that audit public companies trading in U.S. securities markets; inspections of registered public accounting firms; establishment of auditing and related attestation, quality control, ethics, and independence standards for registered public accounting firms; and investigation and discipline of registered public accounting firms and their associated persons for violations of specified laws or professional standards.[87]

PCAOB conducts periodic inspections of audit firms and releases part of the information to the public, subject to limitations of confidentiality. Critics contend that the public reports "are too vague and released one year too late to tell the public what kind of job the large audit firms are doing."[88] PCAOB spokesmen indicate that the inspection reports are intended to be a dialog between PCAOB and the firm and that the reports serve as a constructive tool to improve audit quality.[89]

Many believe that regulatory authorities are reluctant to take action against major accounting firms for fear that another of the Big 4 might collapse and throw the financial world into turmoil. [90] Noting the mild SEC punishment handed out to audit firms for their roles in accounting scandals, in 2003, a major business publication raised the question: "Are the Big 4 accounting firms now too few to be allowed to fail—and effectively beyond regulators' reach? Regulators face a conundrum. They must carry a big stick but not use it to drive any of the remaining big players out of business."[91] Regulators feel constrained to sanction the Big 4 when it comes to new evidence of unprofessional behavior. After Andersen, no one wants to be blamed for causing another firm to collapse. [92] More recently, a *New York Times* article observed that "…the appetite for prosecuting accounting firms has diminished since Arthur Andersen was convicted of obstruction of justice as part of the Enron investigation, according to analysts… With only four large accounting firms left, the government is unlikely to push any of them too hard, experts say. [93]

[87] PCAOB Strategic Plan, 2008–2013, Mar. 31, 2008; pcaob.com (accessed July 20,2008; sec.gov (accessed July 20, 2008) In addition, note that combating securities and commodities frauds is also a priority for the FBI's White Collar Crime Program. These frauds, however, are much broader in scope because they include pyramid and Ponzi schemes, market manipulation, broker embezzlement and foreign exchange fraud and not simply wrongdoing in preparation of corporate financial reports and audits. FBI website, (accessed July 20, 2008).

[88] Johnson, Sarah, "Why the Big 4 Are Still a Big Mystery," *CFO.com*, Jan. 26, 2007. See also: Johnson, Sarah, "PCAOB Finds Slip-ups in E&Y Audits," *CFO.com*, May 3, 2007; "PCAOB: Deloitte Fails on Fair-value Testing," *CFO.com*, June 18, 2007; Allen Rappeport, "PCAOB Cites 'Deficiencies' at PwC," *CFO.com*, July 1, 2008; Kim, Jim, "PCAOB Takes PwC to Task," *CFO.com*, July 3, 2008; Leone, Marie, "Failing Grades for E&Y, KPMG," *CFO.com*, Jan 12, 2007.

**[89]** Johnson, Sarah, "Q&A: The PCAOB's Charles Niemeier," *CFO.com*, Jan. 26, 2007

[90] Cray, Charlie, and Drutman, Lee, "Corporations and the Public Purpose: Restoring the Balance," *Seattle Journal for Social Justice*, Fall/Winter 2005 Issue: Volume 4, Issue 1

[91] Dwyer, Paula, "The Big Four: Too Few to Fail?," *Business Week*, Sept. 1, 2003, p. 30

[92] Cray, Fall/Winter 2005, op. cit., fn 90

[93] Bajaj, Vikas, and Creswell, Julie, "A Lender Failed. Did Its Auditor?," *New York Times*, Apr 13, 2008

## International Accounting Standards

While the issues associated with international accounting standards and capital markets extend beyond the scope of this paper, it is appropriate to note the significance of convergence of national accounting standards into harmonized international standards, especially in view of the steps recently taken by the U.S. Securities & Exchange Commission to move toward adoption of such standards in the coming years.[94]

Due to increasing economic integration and changes in industrial structure, the world has outgrown the existing system of varying national accounting standards. Universally acceptable accounting standards are important to investors and to companies engaged in cross-border transactions, including cross-border stock offerings and listings of company shares on stock exchanges outside their home countries. Adoption of global standards will relieve large companies of the need to keep separate accounts according to differing standards or the need to reconcile their financial statements to the standards of another country. It will make it easier to compare financial results of reporting companies from different countries. Thus, the development of global standards will lower administrative costs and costs of raising capital for large companies. Initially, however, it may raise the cost of audits because of the added time needed to convert from one standard to another, at least for some period of time.[95]

The world's largest accounting firms have been intimately engaged in the development and promotion of international financial reporting standards and, through their advanced knowledge and expertise, will gain an advantage over smaller accounting firms through adoption of these standards internationally. In effect, smaller audit firms without up-to-date knowledge of the IFRS system could be faced with another barrier to competition for large public company audits.[96] For further details on the status of IFRS, see Appendix III-4.

## Audit Quality and Independence

In competition for clients, quality and reputation are strong points of the Big 4 audit firms. Despite the numerous, highly publicized accounting scandals, the Big 4 perform thousands more successful audits. Based on their resources, their expertise, and their track records, the Big 4 can command a premium for their audit fees, as previously stated. Quality and independence, therefore, can be counted as strengths of the oligopoly. At the same time, however, in view of the liability risks and the nature of the system (particularly the conflict between the public interest and the interest of the paying client), quality and independence can also be regarded as weaknesses. This is discussed further in Part IV of this paper.

## Anticompetitive Behavior

In March 1977 (prior to consolidation of the eight major accounting firms), the Federal Trade Commission (FTC) opened an investigation of restrictions on competition in accountancy. The

[94] "SEC Proposes Roadmap Toward Global Accounting Standards to Help Investors Compare Financial Information More Easily," Press Release 2008-184, Aug. 27, 2008

[95] Hughes, Jennifer, "Far-reaching changes for US," Financial Times, Aug. 27, 2008

[96] Johnson, Sarah, and Leone, Marie, "Big Four: Get a Head Start on IFRS: The SEC's proposed timeline gives credence to a call by auditors for companies to start paying attention to international accounting rules," CFO.com, Aug. 28, 2008 (accessed Aug. 31, 2008).

Commission was to study the effects of state restrictions on advertising by accountants (all states except Nevada); prohibitions on those in other occupations (e.g., lawyers, real estate agents) also practicing as accountants (46 states); and prohibitions on accountants bidding competitively for accounting engagements (19 states, including Massachusetts, Michigan, Pennsylvania and Ohio). The study also was to include "the degree of possible control by major accounting firms over the accounting industry, the reasons for such dominance, and its possible effects." [97] The investigation was prompted by collapse of the Penn Central Railroad, the Equity Corporation of America scandal, and a Senate subcommittee staff report charging that "big accounting firms tend to serve their corporate clients rather than the investing public." [98]

At about the same time, the DOJ challenged Texas regulations that prohibited competitive bidding by accountants in the state. If successful the decision could apply in other states.[99] In 1978, a U.S. District Court in Texas ruled that Texas' regulations constituted a violation of the Sherman Act with the purpose or effect of suppressing or eliminating price competition and that the state board of accountancy was not immune from federal antitrust law. [100] This overturned the prevailing doctrine that price competition was unethical, undermined professional integrity and would not deliver the desired type and quality of services to the customer. The decision was affirmed, but modified, in 1979 by the U.S. Court of Appeals. [101]

Subsequently, in 1980, the FTC closed its case because the Commission found that many of the restraints had been dropped voluntarily and that since the case was opened, Supreme Court decisions favoring competition among professionals had caused "a significant number of states and associations to cancel or reduce accounting restrictions." [102] The FTC was to continue monitoring the situation, including state rules against "encroachment," the practice of one accounting firm soliciting another firm's clients. [103]

These and various other court decisions in the United States helped to unleash vigorous price competition among the major accounting firms in the 1980s and 1990s, especially as audit fees became used as loss leaders to attract more lucrative consulting business.

More recently, the Italian government took action against anticompetitive behavior of accounting companies. In 2000, the Italian government levied fines on the Italian Association of Public Accountants (ASSIREVI) and its members, the Big 6 global accounting firms. At the time. the six firms--- Arthur Andersen, Coopers & Lybrand, Deloitte & Touche, KPMG, Price Waterhouse, and Reconta Ernst & Young--- handled roughly 90 percent of the business of those entities in Italy which are required to have outside accountants. The firms violated Italian antitrust law by concluding agreements that covered virtually every aspect of competition between the auditing firms. The violations were of two distinct

[97] *Wall Street Journal*, "FTC to Study State Accountancy Boards, Groups for Possible Curbs on Competition," Mar. 25, 1977, p. 7
[98] Ibid.
[99] Ibid.
[100] United States v. Texas State Board of Public Accountancy, U.S. District Court, Western District of Texas, Austin Division. Civil No. A-76-CA-219, filed May 5, 1978; Commerce Clearing House Trade Regulation Reports, 62039
[101] United States v. Texas State Board of Public Accountancy, U.S. Court of Appeals, Fifth Circuit No. 78-2205, dated Apr. 9, 1979; Commerce Clearing House Trade Regulation Reports, 62,546
[102] *Wall Street Journal*, "FTC Closes Probe of Accounting Rules Limiting Competition," Sept. 17, 1980, p.4
[103] Ibid.

types: setting prices for the services offered on the market by the members of ASSIREVI; and, more generally, coordinating competitive behavior. [104]

The agreements set the fees for auditing based on circulation of "an annual benchmark audit fee and working-hours table according to the size and the sector of activity of the client firms. The agreement also laid down rules to be followed when acquiring new clients in order to protect the market positions of each firm. In particular these rules prohibited any form of competition in relation to each audit firm's 'client portfolio.' By applying these rules, the auditing firms were able to agree, for example, on how to respond to requests for discounts from client companies, and to establish in advance the firm that would be awarded auditing contracts, in many cases making competitive tendering a mere formality."[105]

"In view of the serious nature of these offenses, the Authority imposed fines on the six firms totaling 4.5 billion lire (about $2.3 million): 1.223 million ($0.63 million) on Arthur Andersen, 840 million ($0.43 million) on Coopers & Lybrand, 788 million ($0.41 million) on Reconta Ernst & Young, 687 million ($0.35 million) on KPMG, 539 million ($0.28 million) on Price Waterhouse and 470 million ($0.24 million) on Deloitte & Touche." )[106] The fines were equivalent to between 1.15 percent and 1.4 percent of their revenues from auditing services.[107]

In its 2003 report on concentration in the audit industry, the U.S. General Accountability Office found, with respect to audit fees, there is "no clear definitive link between accounting market structure and anticompetitive behavior."[108]

## In Short

Since 2002 the Big 4 accounting firms have been engaged in a milder form of competition for audit clients than occurred in the 1980s and 1990s. Mid-tier and smaller accounting firms face formidable barriers to entry in the market for audits of global public companies, although they are gaining market share in the audits of smaller companies. Audit fees are much higher than before, reflecting costs more fully and realistically. In its study of the Big 4, GAO found that there is "no clear, definitive link between accounting market structure and anticompetitive behavior." There appears to be general agreement that the higher fees are attributable more to new regulatory requirements than to industry concentration. Clients of the Big 4--- large, sophisticated multinational corporations with huge resources --- are complaining about the burden of regulatory requirements (which contribute to the cost of audits), but not the cost of the audits themselves. Small public firms complain about the requirements and the disproportionately high costs of audits. Actions by regulatory authorities are constrained by the fear of driving another major accounting firm out of business and thereby compounding the lack-of-choice problems of global public companies in selecting an audit firm. There appears to be no evidence of anticompetitive behavior in recent public literature and there are no cases reflecting antitrust violations by major accounting firms in the United States. Nevertheless, recalling the

[104] Italian Authority Press Release, Proceeding Reference 1266, Number 4, February 21, 2000; also Proceeding Reference 97, November 25, 1998
[105] Ibid.
[106] Ibid.
[107] OECD Annual Report on Competition Policy Developments in Italy, 1999, pars. 72-73
[108] GAO, op. cit. fn 11

example of the industry's anticompetitive practices in Italy in recent years, regulatory authorities would be well advised to remain vigilant so that similar anticompetitive activities do not occur in the future.

*Parts II and III have focused on the strengths of the oligopoly. Part IV focuses on its weaknesses, especially its exposure to massive lawsuits. Moreover, it focuses on the issue of liability limitations and questions on how to maintain consistent high quality audits in the light of conflicts of interest built into the audit system.*

# PART IV

# DEEP POCKETS AND EXPOSURE TO LIABILITY

The greatest weakness of the audit oligopoly appears to be its exposure to potentially ruinous legal challenges. Despite a dominant market position and a booming business, the oligopoly and its clients are in the anomalous situation of seeking government protection against massive law suits by disgruntled investors, creditors and others.

## Massive Lawsuits

Massive lawsuits are ever-present risks and sources of weakness for each of the major audit and accounting firms. This is not a new phenomenon, but the claims have grown in size through the years, while the industry has consolidated into four huge firms. During a 5-year period in the 1980s, the cost of settlements to major audit firms amounted to less than $200 million;[109] whereas in 1998-2006, the Big 4 audit firms faced dozens of claims in excess of $1 billion.[110]

Audit firms are vulnerable, partly because they have deep pockets and partly because of the nature of the business. When corporations suddenly fail or suffer severe declines in stock prices, disgruntled investors, creditors and employees are prone to sue the auditors as well as the corporate management. Claims against the auditors are based on allegations of fraud or failure to identify errors or wrongdoings that led to massive losses. With pending claims totaling billions of dollars, the Big 4 audit firms face serious threats to their survival.

Appendix IV-1 traces the growth of lawsuit claims from 1967 to the present through reports that appeared in the popular press and trade journals.[111] Appendix IV-2 lists the largest settlements in 1980-85; Appendix IV-3 lists the top ten cases in 1999-2004; and Appendix IV-4 provides an extensive (but not exhaustive) list of cases from 1992 to present, involving each of the Big 4. Because media reports often combine the value of the claims against the client with those against the auditors, the magnitude of the claims as they apply to the Big 4 may be somewhat overstated. Also, the amount under consideration may change over time and out-of-court settlements may be agreed on a confidential (undisclosed) basis. Legal challenges are complex, take years before reaching court or settlement, and are usually settled for smaller amounts than those originally sought.[112]

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[109] House Subcommittee on Oversight and Investigations; cited in "Small CPA Firms' Liability Rates Soar --- Plight Tied to Malpractice Suits Against Big Eight," Burton, Lee, *Wall Street Journal*, Nov 19, 1985. pg. 1

[110] Holstein, William J., What If One of The Big Four Fails? Trying to avoid an Arthur Andersen-type disruption, *Directorship*, Sept. 2006

[111] Publications are identified in footnotes in Appendix IV-1.

[112] Buck, Tobias, "Brussels suggests legal shield for big audit firms," *Financial Times*, Jan. 18, 2007

Auditors, in some instances, actually win cases (as in the Equitable Life case in the United Kingdom). [113] While the body of information on settlements by the Big 4 is extensive, it should be recognized that the number of cases in which the auditors perform their tasks well are hardly reported and publicized; they are far more numerous and certainly not as newsworthy as the scandals.

## Lawsuits in Other Countries

Lawsuits against the Big 4 are not limited to the United States. Examples of other countries' cases include Italy (Parmalat), United Kingdom (Equitable Life), Canada (Philip Services), Ireland (SmartForce) and Japan (Kanebo). These cases are included in the list in Appendix IV-4. National laws apply in each country. The European Union considered limits for audit firm liability and recently issued recommendations for its 27 member countries rather than imposing European-wide regulations (see below).

## Availability of Insurance

In the 1980s, the then-Big 6 audit firms were covered by liability insurance, mainly from Lloyd's of London. In 1993, however, Lloyd's sharply raised deductibles, or portions of negligence settlements the firm must pay before getting any coverage. Likewise, other insurers had raised premium rates and imposed deductibles of $10 million and limited coverage to $100 million. Lloyd's limited coverage to $50 million for all annual settlements, rather than $50 million per negligence award. [114] Because of their inability to obtain liability insurance for catastrophic cases, the major accounting firms to a large extent are now self-insured. [115]

The American Institute for Certified Public Accountants (AICPA) offers an insurance program through CNA and Aon Insurance Services for firms billing in excess of $10 million, but not for the Big 4. The program affords CPA firms extensive resources and experience, including tailored risk management services and highly responsive claims management. The Big 4 audit firms are specifically excluded. [116]

## Effect on Small Audit Firms

As liability insurance became more expensive or unavailable, small audit firms faced difficulties deciding whether to continue auditing public companies. Several severely curtailed or abandoned the business of auditing public companies, focusing instead on private clients, taxes, consulting, and other kinds of work that face fewer government restrictions. Many of the dropped clients were the smallest public companies, often the least lucrative clients who could not afford or had been rejected by the Big 4. [117]

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[113] In the Equitable Life case in the United Kingdom, Equitable sued for $4.77 billion, but later cut that amount to about $1.5 billion, then dropped the case in September 2005, and paid for the legal costs incurred by Ernst & Young. "Ernst & Young," Jun. 9, 2007, *Wikipedia.com*, accessed July 20, 2008; *BBC News*, "Equitable slashes auditor claim, July 18, 2005

[114] Lochner, Philip R Jr., "Black Days for Accounting Firms," *Wall Street Journal*, May 22, 1992, p. A10

[115] Weil, Jonathan, and Spurgeon, Devon, "Arthur Andersen Insurer Is Rendered Insolvent --- Funds From Bermuda Firm Were Going to Be Used To Settle Host of Claims," *Wall Street Journal*, Apr 1, 2002, p. C1

[116] See AICPA Professional Liability Insurance Plan for Regional Firms at http://www.cpai.com/business-insurance/professional-liability/lgfirm.isp, accessed May 21, 2008

[117] Johnson, Carrie, "Effect on Small Audit Firms: See Small Accounting Firms Exit Auditing," *Washington Post*, Aug 27, 2003, p. E01

## Lawsuits as a Barrier to New Entrants

Exposure to massive claims in lawsuits is also an important element in audit industry competition. Fears of bankruptcy due to costs of court cases are real and, to a certain extent, threaten to reduce further the number of global audit firms. Although it has not happened thus far for a major firm,[118] the possibility weighs heavily on the audit industry. Because liability insurance has become virtually unobtainable, the Big 4 firms must set aside reserves to self-insure against potential catastrophic claims. This is a heavy burden that can be borne better by the Big 4 than by smaller audit firms. Indeed, the risk of massive lawsuits tends to discourage market entry of new audit firms and constitutes a formidable barrier to competition (see Part V). Ironically, exposure to litigation is somewhat of a double-edged sword for the Big 4. It is a threat to their survival, but at the same time it helps to solidify their market position by discouraging competitors from entering the market.

## Campaign for Liability Limits

The unavailability of liability insurance and the threat of ruinous lawsuits drive the audit firms and their clients to press governments for liability limitations. With billions of dollars of claims pending, the "liability exposure substantially exceeds the combined partner capital of the Big 4 firms."[119] Thus, the major audit firms and their clients contend that liability limits are necessary to prevent the loss of another Big 4 firm, "which would throw the global financial system into chaos."[120]

The disappearance of any one of the Big 4 firms would be a true catastrophe for financial markets as well as for public companies worldwide. Collapse of another Big 4 firm could cause "paralysis in financial markets."[121] The choice of auditors would be substantially reduced, and the requirements for auditor independence might make it impossible for some companies to find a sufficiently skilled independent auditor.[122] "…[I]t could leave international businesses struggling to find an auditor to sign off on their accounts.[123] In addition, "accounting and auditing costs, already sky high, would become an even more costly burden on public companies, reducing profits and driving smaller companies--which bear a disproportionate share of the costs--to privatization."[124] "The prospect of losing another major accounting firm—and the negative spiraling effect that would occur across the other firms and in our financial markets— must be recognized as a global economic concern."[125]

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[118] In 1990, Laventhol & Horwath, at the time the seventh largest auditing firm in the United States, filed for bankruptcy protection due in part to a failure in the provision of non-audit services, and subsequent class action litigation, loss of reputation, and inability to attract and retain clients. See: Cunningham, Lawrence A., "Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels, *Boston College Law School Faculty Papers*, Year 2006 Paper 165

[119] Wallison, Mar. 8, 2007, op. cit. fn 41

[120] Committee on Capital Markets Regulation, *Interim Report*, 87, cited in Wallison, op. cit. fn 41

[121] Cray, Fall/Winter 2005, op. cit, fn 90

[122] Wallison, op. cit. fn 41

[123] Buck, Tobias, Jan. 18, 2007, op. cit. fn 112

[124] Wallison , Mar. 8, 2007, op. cit. fn 41

[125] Ernst & Young CEO James S. Turley in a speech in December 2005, cited in Holstein, Sept. 2006, op. cit. fn 110

Three recent reports on the condition of the U.S. capital markets recognized "that any one of the four global accounting and auditing firms…could be destroyed at any time by a large jury award in a private securities class action."[126]

One of the Big 4 CEOs called for the government to cap the liability of major accounting firms, suggesting a cap of $100 to $200 million. "Some level of accountability in the courts is good for us," he said. "But when you start talking about ... having billions of dollars in liability on a single audit ... it just doesn't make sense."[127]

## Opposition to Liability Limits

Opponents of liability limitations point out that the global financial system operates largely on trust. Credibility is essential to maintaining confidence in the system. Certified public accountants serve in the public interest and are expected to spot and uncover irregularities in the corporate books when they occur. Too often auditors tend to protect their clients or their firm rather than the public. Along with regulation and enforcement, lawsuits serve as a deterrent to improper accounting, thus protecting the public interest. At the same time, they help to redress harm to investors caused by inappropriate corporate governance and questionable accounting practices.

Some claim that securities laws in the United States afford auditors with ample protection, mainly through the Private Securities Litigation Reform Act of 1995, which limits liability to proportionate fault, imposes litigation requirements that make it less likely for auditors to be sued, and weeds out frivolous cases. [128] (Under proportionate liability, an auditor is liable only for the part of the claim for which it is responsible, taking into account the fault of other parties. For example, if the audit firm is responsible for 20 percent of the damage, it would pay only that portion of the damages. In cases of joint and several claims, audit firms have been responsible for the entire amount when the client is bankrupt or otherwise unable to pay.)

Auditor liability is also limited by contractual arrangements with clients (although this won't protect the auditor against clients' shareholders); and by punitive damage waivers in audit client contracts. As

[126] The three groups are: the U.S. Chamber of Commerce; a group of academics and market professionals called the Committee on Capital Markets Regulation; and New York City mayor Michael Bloomberg and Senator Charles Schumer (D-N.Y.), cited in Wallison, Peter J., "Hostages to Fortune: A Change in the Audit Certification Can Reduce Auditors' Risks," Posted: Apr. 6, 2007, AEI Online, accessed July 20, 2008. Committee on Capital Markets Regulation, Interim Report, Nov. 30, 2006, 14, available at www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (accessed Mar. 5, 2007); and Michael R. Bloomberg and Charles E. Schumer, "Sustaining New York's and the US' Global Services Leadership," Jan. 22, 2007, 102, available at www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf (accessed March 5, 2007).

[127] Deloitte CEO James Copeland, cited in Solomon, Caleb and Berton, Lee, "Deloitte Is Hit By Jury Award of $77 Million --- Punitive Damage Is Levied In Case of Tax Returns For Cattle Partnership," *Wall Street Journal,* Nov. 11, 1993, p. A4

[128] Coffee, John P., "Trouble with a cap on liability: Protecting auditors weakens corporate accountability," *Pensions & Investments*, May 12, 2008

Limited Liability Companies (a relatively new business structure), the individual partners in audit firms are not responsible for the liabilities of other partners.[129]

Some contend that claims of catastrophic liability exposure are exaggerated and that auditors have paid only a small portion of what major public companies have paid.[130] Legal challenges are complex, take years before reaching court or settlement, and are usually settled for smaller amounts than those originally sought.[131] With regulators reluctant to take strong actions against the four remaining accounting firms (as noted in Part III of this paper), civil lawsuits are left as the most effective discipline for auditing firms.[132]

"The issue is simply one of trust. Under the law, we have a duty to assure that public auditors and accountants uphold the public trust inherent in their permit...Public auditors have a duty to protect the public. When they fail in that duty, the public must be protected from the auditors."[133]

## Liability Limits in Other Countries

Currently, in the European Union, liability caps exist in only five member states: Germany, Austria, Belgium, Greece and Slovenia. In Germany, auditor exposure is capped at 4 million Euros (about $6 million).[134] In Greece, the limits are based on a multiple of fees secured by an accounting firm with an audit client.[135] Britain, meanwhile, is introducing the concept of "proportionate liability." Australia already has a proportionate liability regime. Denmark, Netherlands, Luxembourg, Spain, and the United Kingdom[136] allow audit firms to limit liability through contractual agreements with clients (as in the United States).

In 2003, in a speech in London, Frits Bolkestein, EU Commissioner of Internal Market and Taxation, expressed opposition to liability limits. "The Commission considers auditor liability primarily as a driver of audit quality and does not believe that harmonisation or capping of auditor liability in general is necessary," he said and went on to add that there are four clear reasons for not limiting auditor liability.[137] In June 2008, however, the European Commission formally recommended that the member

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[129] The Big 4 accounting firms are Limited Liability Companies (LLCs), a relatively new business structure in the United States, allowed by state statute. "LLCs are popular because, similar to a corporation, owners have limited personal liability for the debts and actions of the LLC. Other features of LLCs are more like a partnership, providing management flexibility and the benefit of pass-through taxation." These entities offer a business the limited liability of a corporation but are generally treated as partnerships for tax purposes (that is, there is no tax at the entity level and therefore no "double taxation"). IRS website, www.irs.gov accessed Aug. 20, 2008

[130] Coffee, May 12, 2008, op. cit. fn 128

[131] Buck, Tobias, Jan. 18, 2007, op. cit. fn 112

[132] Bajaj, Apr. 13, 2008, op.cit. fn 93

[133] Connecticut Attorney General Richard Blumenthal , announcing an investigation of the role of Arthur Andersen in the Enron scandal, Press Release, January 17, 2002

[134] *Economist*, "The future of auditing: Called to account," Nov. 18, 2004

[135] Michaels, Adrina and Parker, Andrew, "Governments are considering ways to shelter accounting firms from ruinous lawsuits but lawyers specialising in class-action suit," *Financial Times*, May 21, 2004

[136] Heaton, Nicholas, "One Size Fits All? The many different approaches to auditors' liability among the EU's 27 member states make harmonisation a thorny subject," *Accountancy Age*, Feb. 22, 2007

[137] Bolkestein, Frits, "Auditor Liability: An EU Perspective," Address at The London Underwriting Centre, Mar 24, 2003; (http://europa.eu.int/rapid/pressReleasesAction.do?reference=SPEECH/03/151&format=HTML&aged=0&language=EN&guiLanguage=en) For excerpts from the speech, see Appendix Iv-5 of this paper.

states enact their own liability limitations, pointing out that the combination of unlimited liability and insufficient insurance coverage makes the current situation no longer tenable (see further details below).

In 2004, Britain's Office of Fair Trading had considered and rejected auditor caps, stating that it found little evidence that caps encouraged competition or would do anything to reduce the risk of the collapse of a Big 4 firm. "Indeed, caps might make concentration worse, since they would help the Big 4, who are already most exposed, more than smaller outfits…"[138]

Also in 2004, it appeared that Britain was leaning toward adoption of proportionate liability. As stated by Peter Montagnon, head of investment affairs at the Association of British Insurers, "Investors have been ready to support a properly elaborated regime for proportionate liability because this makes the auditors clearly responsible for their own mistakes but absolves them from responsibility for the failings of others. But investors have always been highly skeptical of any other form of liability cap because they perceive a serious risk to quality and confidence in the audit."[139]

In 2005, William McDonough, then Chairman of the Public Company Accounting Oversight Board, told the *Financial Times* that auditors could not expect lawmakers in the United States to consider providing them with liability protection until they had won back public confidence.[140]

## European Union Considerations

In 2006, the European Commission issued a report and initiated a consultation on auditors' liability. The report offered four ways to improve protection for the audit industry: (1) impose a fixed monetary cap for auditor liability at European level through EU legislation; (2) introduce a cap based on the market capitalization of the audited company; (3) propose a cap based on a multiple of the audit fees charged by the auditor to the client; or (4) introduce the principle of "proportionate liability", meaning that auditors would only be liable to pay damages that were caused by their own mistakes, but not their clients'.[141] Following consultations with EU member states, regulators and the private sector, in June 2008 the EU Commission issued recommendations for action.

## EU Recommendations for Member States

In its recommendations, the European Commission endorsed the concept of liability limitations, but avoided adoption of a single method of limitation for all Member States. Instead, Member States may choose a method that best suits their legal environment, but is in line with certain principles. Its aim is to protect European capital markets by ensuring that audit firms remain available to carry out audits on companies listed in the EU. Limitations can also be adopted for audits of unlisted companies. Three methods--- caps, proportionate liability, or a contractual limitation--- are offered as possible examples, but any other equivalent method might be used. Limitation must be consistent with the following principles: (1) the limitation of liability should not apply in the case of intentional misconduct on the part

[138] *Economist*, Nov. 18, 2004 op. cit. fn 134
[139] Ibid.
[140] Parker, Andrew, "Accounting head warns on capping liabilities," *Financial Times*, Sept. 24, 2005
[141] EU Press Release IP/08/897 June 6, 2008, "Auditing: Commission issues Recommendation on limiting audit firms' liability" (see MEMO/08/366) available at http://ec.europa.eu/internal_market/auditing/liability/index_en.htm

of the auditor; (2) a limitation would be inefficient if it does not also cover third parties; and (3) damaged parties have the right to be fairly compensated.

Upon introduction of the EU recommendations, Internal Market and Services Commissioner Charlie McCreevy said: "After in-depth research and extensive consultation, we have concluded that unlimited liability combined with insufficient insurance cover is no longer tenable. It is a potentially huge problem for our capital markets and for auditors working on an international scale. The current conditions are not only preventing the entry of new players in the international audit market, but are also threatening existing firms. In a context of high concentration and limited choice of audit firms, this situation could lead to damaging consequences for European capital markets." [142]

The major audit networks will not receive immunity from their audit failure and they will continue to pay compensation to damaged parties, but claims against them will not be unlimited. Damaged parties will retain the right to be fairly compensated for injury, but subject to the limits of the method chosen by their Member States. A liability limitation should benefit new market entrants and especially mid-tier audit firms, as these firms may not have the same ability to establish self-insurance, which was established by the Big 4 more than a decade ago. Lower liability risks would provide stronger incentive for new investment into mid-tier audit firms, which could help them compete with the major audit networks.[143]

The recommendations were welcomed by some audit firms and their trade associations.[144] Some of the member states already have limitations in effect. Now, it is a matter of time before the other states will decide what, if any, limitations to adopt. The European actions may well encourage countries in other regions to follow their examples.

## Audit Quality and Independence

The investing public at large depends on the audit system operating with complete integrity. Auditing critics contend that declining quality of audits is a cause of lawsuits and that consistently high quality audits would eliminate the risk of liability exposure.[145] The rising number of liability lawsuits is a result of the series of highly publicized accounting scandals in recent decades. Even though these scandals may involve a relatively small number of cases, there is great public concern regarding the potential for corporate fraud and abuse. There is even skepticism over the quality of audits and the ability of auditors to detect errors and inaccuracies in financial statements.

U.S. laws require that financial statements of public companies must be audited by an independent public accountant. In attesting to financial statements, therefore, the auditor is expected to play the

[142] Ibid., Press Release
[143] Ibid., Q&A
[144] For example, see Deloitte Press Release, Jun 13, 2008, IAS PLUS Monthly News, www.iasplus.com, accessed Aug. 20, 2008; Heaphy, S, Institute of Chartered Accountants in Ireland, "ICAI welcomes EU Commission recommendation on Auditor Liability," ICAI website, www.accountingnet.ie, Jun. 15, 2008 accessed Aug 20, 2008; Institute of Chartered Accountants in England and Wales, "Auditor Liability Limitation," undated ICAEW website, www.icaew.com, accessed Aug. 20, 2008
[145] For example, see Bolkestein, op. cit., fn 137. "Unlimited auditor liability is a quality driver. If the auditor delivers permanently high quality he has no liability exposure. There is no more effective liability risk management than delivering high quality audits."

role of a public watchdog. The American Institute of Certified Public Accountants (AICPA) states in its Code of Professional Ethics: "In the performance of any professional service, a member shall maintain integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others. . . . Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism."[146]

## Conflicts of Interest

Conflicts of interest, however, are built into the system as audit firms are paid by the corporations whose books they review. This conflict was addressed in a Supreme Court case in 1984.[147] "The Court held…that by certifying the public reports that depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client and owes ultimate allegiance to the corporation's creditors and stockholders and to the investing public."[148] In the decision, Chief Justice Warren Burger wrote: "This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."[149]

"The fact that audit fees are paid by the company audited poses a basic conflict of interest built into the Securities Acts," as one accountancy professor noted.[150] According to billionaire investor Warren Buffett, "auditors tend to kowtow to the managers who choose them and dole out their pay."[151] In the past these conflicts could be managed better. However, in more recent years, the audit has lost its stature and is no longer the primary focus of accounting firms.[152] Audits became commoditized products and clients were paying more for consulting than for audits.[153] " As accounting firms 'shifted to something more akin to marketing organizations' obsessed with cross-selling [additional] services to audit clients, the conflict between serving corporate managers and protecting the public interest was magnified. "[154]

Some observers even submit that complete impartiality and objectivity may be "psychologically impossible" because of subconscious personal biases of which individual auditors may be unaware. "Psychological research points to an inescapable conclusion: such impartiality is impossible under current institutional arrangements…Despite the auditors' best efforts to place the external users' interests above the client's and to maintain objectivity, they may be unable to overcome cognitive or

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[146] Quoted in Bazerman, Summer 1997, op. cit. fn 58

[147] U.S. Supreme Court: 1984, United States v. Arthur Young & Co., U.S. Supreme Court Reports, 26 April 1984

[148] Steinberg, William, "Cooked Books: Shoddy and in some cases sharp practices by the Big Six accounting firms are the hidden element linking the financial scandals of the 1980s and 1990s," *Atlantic Monthly*, Jan. 1992

[149] W. Burger, U.S. Supreme Court: 1984, United States v. Arthur Young & Co., U.S. Supreme Court Reports, 26 April 1984, 79 L Ed 2d, 826-838.

[150] Andrew D. Bailey Jr., the Ernst & Young professor of accountancy at the University of Illinois at Urbana-Champaign, quoted in Reutter, Mark, "Accounting: Change in auditing firms' duties gave rise to conflicts of interest," University of Illinois at Urbana-Champaign News Bureau, May 1, 2002

[151] Quoted in Hilzenrath, David S., "After Enron, New Doubts About Auditors," *Washington Post*, Dec. 5, 2001, p. A01

[152] Reutter, May 1, 2002, op. cit. fn 150

[153] Weil, Jonathan, "Missing Numbers -- Behind Wave of Corporate Fraud: A Change in How Auditors Work; 'Risk Based' Model Narrowed Focus of Their Procedures, Leaving Room for Trouble; A $239 Million Sticky Note," *Wall Street Journal*, Mar. 25, 2004, p.A1

[154] Reutter, May 1, 2002, op. cit. fn 150

psychological biases that make them arrive at marginal decisions in the client's favor…The larger problem facing society is that there is good reason to believe that auditors will unknowingly misrepresent facts and will unknowingly subordinate their judgment due to cognitive limitations."[155]

''No change to the law on financial liability could protect one of an auditor's greatest assets, its reputation,'' said Patricia Hewitt, Britain's secretary of state for trade and industry. ''That responsibility rests with the professionalism of auditors themselves.'' [156]

Some critics contend that fierce price competition contributed to the decline in audit quality. After the federal government ruled that bans on advertising, uninvited solicitations, and participation in bidding contests are anticompetitive, bidding wars ensued. [157] In order to cut costs, audit firms put fewer resources into audits, using junior or inexperienced staff or skimping on record checks.[158] Reduced hours on the job tended to discourage auditors from looking for fraud. One of the shortcuts used by the major accounting firms was adoption of a risk-based approach, which focused on risky clients and risky areas of company financial reports, those prone to error or fraud. Only cursory reviews were made of the more stable, low-risk items, such as cash on the balance sheet. Rather than checking all components of the financial statement--- a details-oriented approach, the auditors tried to identify areas in which misstatements were most likely to occur.[159]

## Efforts to Improve Audit Quality

The Big 4 accounting firms have spent tens of millions of dollars to improve their auditing techniques. "KPMG's investigative division has doubled to 280 its force of forensic specialists, some hailing from the Federal Bureau of Investigation. PricewaterhouseCoopers LLP auditors attend seminars run by former Central Intelligence Agency operatives on how to spot deceitful managers by scrutinizing body language and verbal cues. Role-playing exercises teach how to stand up to a company's management."[160]

Additional efforts to improve audit quality include the establishment of a Center for Audit Quality and a think tank, The Deloitte Forensic Center, to focus on issues facing auditors in a time of growing financial complexity and market globalization. In January 2007, the AICPA and eight public company accounting firms established The Center for Audit Quality, an autonomous, nonpartisan, nonprofit group affiliated with the AICPA and based in Washington, D.C. The Center's mission is "to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust." The Center for Audit Quality aims to become an expert resource and catalyst for public education and discussion.[161] In June 2007, Deloitte established a think tank ("Deloitte Forensic Center") to explore approaches for mitigating

[155] Bazerman, Summer 1997, op. cit. fn 58
[156] Norris, Floyd, "Britain Refuses to Put Cap On Liability of Big Auditors," *New York Times*, Sep. 9, 2004, p. W1
[157] Weil, Mar. 25, 2004, op. cit. fn 153
[158] Hilzenrath, Dec. 5, 2001, op. cit. fn 151
[159] Weil, Mar. 25, 2004, op. cit. fn 153
[160] Ibid.
[161] CAQ Press Release, Jan. 30, 2007. The eight public company accounting firms are: BDO Seidman LLP, Crowe Chizek and Company LLC, Deloitte & Touche USA LLP, Ernst &Young LLP, Grant Thornton LLP, KPMG LLP, McGladrey & Pullen LLP, and PricewaterhouseCoopers LLP. Membership is open to all U.S. public company auditing firms registered with the Public Company Accounting Oversight Board. Associate membership is available for U.S. accounting firms not registered with the PCAOB.

costs, risks and effects of corporate fraud and corruption. The think tank will focus on the use of technology to detect and prevent fraud.[162]

In developing its recommendations to member states on liability limitation, the European Commission was mindful that audit quality is fundamental and that investors should have full confidence in the auditor. In a memo accompanying the recommendations, the Commission emphasized that the limitations should not apply in case of intentional breach of auditor duties, such as collusive behavior with management in committing fraud. The limitation should apply only in case of negligent behavior by the auditor. Also, the Commission pointed out that, during the public consultation period, respondents from countries where a liability cap already exists (e.g., Germany, Austria, Belgium), did not believe that their domestic cap had had adverse effects on audit quality. [163]

Maintaining consistent high quality audits can minimize the risk of massive lawsuits.

## In Short

To summarize, Part IV identifies exposure to potentially ruinous legal challenges as the greatest weakness of the audit oligopoly. Despite a dominant market position and a booming business, the oligopoly and its clients are in the anomalous situation of seeking government protection against massive law suits by disgruntled investors, creditors and others. Liability limitations already exist to some extent in the United States, particularly in the form of proportionate liability. Liability caps exist in a few European countries, but can be expected to spread to others in light of the recent recommendations by the European Commission. The pursuit or threat of lawsuits can still serve as a deterrent to fraudulent behavior and as a spur to audit quality and can bring compensation to investors and creditors when injury occurs because of fraud or negligence. However, legal challenges generally are complex and difficult to prove, take years before reaching court or settlement, and are usually settled for smaller amounts than those originally sought. Audit quality and independence are a fundamental concern of the global financial system. The public interest needs to be protected from conflicts of interest which are built into the system, particularly payment to the auditor by the client whose books are audited. Considering the liability limitations that currently exist and the potential trend toward the spread of limitations to additional jurisdictions, as well as the inherent difficulty of prosecuting legal challenges, the level of exposure to massive lawsuits--- the greatest weakness of the audit oligopoly--- may be on the verge of decline.

[162] SmartPros, "Deloitte Forms Think Tank Forensic Center," June 22, 2007 accessed Aug. 13, 2008
[163] EU Press Release IP/08/897 June 6, 2008, op. cit. fn 2

# Part V

# RECOUNTING THE REMEDIES

There is no shortage of proposals to remedy the problems associated with audit industry concentration. The proposals are centered mainly on three objectives: (1) prevent further concentration; (2) promote increased competition; and (3) improve audit quality and independence.

## Prevent Further Concentration

Large public companies already are faced with a limited choice of audit firms and further concentration---- through merger or business failure--- would exacerbate the situation. In the case of a merger of two Big 4 firms, U.S. antitrust and securities regulators surely would review the proposal carefully in view of the current short supply of audit firms. Business failure of a Big 4 firm is not likely to occur, given the financial health of these firms, except for the possibility of ruinous lawsuits.

### Risk Reduction

Reduction of the risk of litigation (discussed in detail in Part IV) can be accomplished by maintaining consistent high quality audits (see below) or through statutory limits on audit firm liability. There is great public controversy over setting statutory limitations. The level of a monetary cap on liability can also be a factor. For example, a limit in the range of tens of millions of dollars would, in many cases, deny investors and lenders from receiving adequate compensation where audit firms are at fault; a limit of one hundred million dollars, in some cases, might also be unfair to shareholders and creditors, while being regarded as an insufficient safeguard by public companies and audit firms. Opponents of liability caps are not interested in providing security for the audit oligopoly and its corporate clients. They object outright to any statutory limit on grounds that it would eliminate a useful incentive for auditors to be perspicacious in detecting corporate fraud and wrongdoing and would deprive injured parties of a mechanism to obtain adequate relief.

## Promote Increased Competition

Audit firms and the entire financial community are still adjusting to the requirements of Sarbanes-Oxley legislation. Price competition (as noted in Part III) is a secondary consideration for large public companies in selecting an audit firm. Other considerations include reputation, sector-specific skills, international coverage, and quality of staff. However, at some future time, when compliance with the new regulations becomes more routine, corporations may again seek to reduce audit costs aggressively, as they did in the 1980s. This would generate more competition among the Big 4 audit firms.

## Many Proposals

Proposals to create a larger field of competitors and increase the choices available to large public companies include: requiring divestment of auditors by one or more of the Big 4; remove barriers to growth of mid-tier and smaller audit firms and to new entrants; allow outside ownership of audit firms; build additional networks and reputations; and change the "perception bias" against the non-Big 4 firms.

## Divestiture

The most radical of these proposals is divestiture--- breaking up one or more of the Big 4 into smaller pieces to create a larger number of firms for audit selection. The problems with this approach are many: deciding which firm(s) to split up, how to split them, how to finance them, who will manage them; avoiding disruption of annual audits of client companies; and avoiding violation of the legal rights of the owners (partners) of the Big 4 firms. Breaking up the four firms into smaller, more competitive units is regarded as an extreme measure, which in itself could be disruptive and might even dilute the resources necessary for audit firms to defend against massive lawsuits. Similar proposals include forcing Big 4 firms to divest some of their large public company clients, a proposal that was under consideration in Britain, but later was dismissed. [164] Incidentally, it is not inconceivable that disaffected partners in a Big 4 firm could leave that firm and bring their clients with them, forming the nucleus of a new competitive audit firm. It is doubtful that governments could devise effective measures to encourage partners to do so, even if this were determined to be desirable.

## Barrier Removal

The most pragmatic approach is to find ways to remove the barriers to growth of mid-tier and smaller firms and to new entrants. Mergers among these firms could be encouraged. It will take a long time, though, to develop firms or networks to reach the size and capabilities of the Big 4. Some networks already are at work to build expertise and reputations internationally (see Part III). Also, some work is underway to publicize the capabilities of mid-tier firms and to change the stigma attached to the use of non-Big 4 audit firms by large public companies. Government purchasing power could be used as well to encourage hiring mid-tier or smaller firms through contracts for audits of government agencies or programs.

## Outside Ownership of Accounting Firms

One of the barriers, whose removal could show promising results, is the limitation on outside ownership of audit firms. At present, the United States and other countries require that accounting firms be owned entirely, or by a majority of, certified public accountants. If this requirement were removed or modified, it could perhaps attract entrepreneurs with ample financial resources and talented management, who recognize the opportunities in this field and are willing to take on the challenge of building new audit entities. Such entrepreneurs could include corporate conglomerates or private equity firms, not only with capital, but with management talent and experience in consolidating small firms and building larger businesses. The new entities could be created by acquiring existing small firms and combining them into large national and international firms. An entrepreneur with an internationally recognized brand name would be helpful in establishing a reputation for quality work. The new entities

[164] Jopson, Feb. 5, 2007, op. cit. fn 16

probably would have to start with small company clients and demonstrate their capabilities over several years before they could attract global corporations--- even if they offer lower audit fees. The new entities would not have to cope with the risk of mega-lawsuits until they actually solicit the audit business of global corporations.

Opponents of outside ownership are concerned that "without CPAs as majority owners, external shareholders might make business decisions in a firm's economic interests that compromise its independence for purposes of performing audits." Appropriate safeguards would be needed to ensure independence and audit quality. [165] Another problem for new entities could be a shortage of qualified accountants in the labor market, which some companies indicated may be more of an impediment to growth than limited access to capital.[166]

## Improve Audit Quality

As noted earlier, consistent high quality audits could minimize the need for liability limitations. Improvements in audit quality would help to sustain the Big 4 and reduce the threat of further shrinkage of the number of firms capable of auditing large public global companies. A draft report by the U.S. Treasury's Advisory Committee on the Auditing Profession (May 5, 2008) recommends a series of proposals to improve the quality of audits through education and training programs, strict licensing and certification requirements, continuing education to keep accountants up to date on new developments, creation of coordination and communication programs with participation of mid-tier and smaller audit firms.

Quality control, ethics, and independence standards for registered public accounting firms already are responsibilities of the PCAOB (see Part III). Regulatory authorities should be wary of recommendations that would duplicate existing programs at the cost of governments and taxpayers. The audit industry and individual Big 4 firms have also taken steps to improve the ability of auditors to detect fraud and misstatements.

Some radical proposals would directly address the inherent conflict of interest in the system, where auditors are paid by the companies whose books they audit. These proposals include changing the audit payment system by nationalizing the audit industry or the process of auditor selection, or by creating a new entity to hire and pay the auditors--- for example, insurance companies.

### Nationalization

For decades public companies have paid accounting firms to audit their books. For those who believe this system is basically flawed, a direct solution would mean that someone other than the audited public company should pay for the audit. If the government conducted audits, according to this theory, auditor independence and hence audit quality would be improved. This is not a new idea. President Franklin D. Roosevelt thought of it following the market crash of 1929, when he considered having the Federal Trade Commission audit publicly traded companies. After vigorous lobbying from the accounting profession, Roosevelt and Congress allowed the industry to regulate itself. [167]

[165] GAO (2003), op. cit. fn 11
[166] Ibid.
[167] Pizzo, Stephen P., "Making Accounting Add Up," *Forbes.com*, Feb. 26, 2002

The idea arose again in 2002 in the midst of corporate scandals, when Representative Dennis Kucinich introduced legislation ("The Shareholder and Employee Protection Act of 2002")[168] to create a Federal Bureau of Audits (FBA) within the Securities and Exchange Commission "to protect the American shareholder from corporate criminals."[169] Under this approach, the role of the FBA would be to assign government-employed accountants to perform audits for public companies, in effect nationalizing the audit industry. The proposal raised many questions. For example, what would happen to the major accounting firms whose revenues consist of tens of millions of dollars of audit fees annually? Would all the certified public accountants, who conduct annual audits of some 17,000 public companies, become government employees? How would the transition be managed? Could the government conduct the service free of political influence and more efficiently than the private sector? Would the government be able to attract high quality accountants to serve as auditors? The cost of the program could be neutral if it were funded by audit fees. The bill did not advance, but it called attention to the inherent conflict of interest built into the audit system and It serves as a reminder that in extreme circumstances, Congress could change the system.

## An Insurance Solution

At about the same time, a Princeton University professor proposed a system whereby publicly traded companies would be required to purchase "audit insurance."[170] The same companies that provide directors and officer liability insurance could provide these policies. Each public firm would be free to buy (or not buy) any amount of financial misrepresentation insurance, and indicate the amount of coverage bought in its report. The insurer would examine the financial reports and charge a premium. Under this proposal, the insurance company would be responsible for monitoring audit quality and would bear the financial liability for proper audits. This would be a private enterprise solution rather than nationalization, but some of the same questions remain regarding management of the transition, the fate of the audit firms and their employees, and the effectiveness of the program. Problems also could arise in setting the rates inasmuch as audit firms and their clients would have little leverage in negotiating for lower rates. [171]

A professor of accounting at NYU[172] makes a strong case for financial statement insurance under which insurance carriers would appoint and pay auditors instead of the companies being audited. This would align the interests of the auditor with investors rather than the companies. Companies would purchase financial statement insurance to cover investors' losses arising from misrepresentation or omission in financial reports. The premium (to be determined by risk assessors) would cover both the insurance and the audit. The amount of coverage and the premium would be made public to provide incentives to improve the quality of financial statements. The system is intended as a free market approach with no legislation required, but a temporary regulatory initiative may be necessary to get the system started.

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[168] HR 3795, 107th Congress 2d Session H.R. 3795 February 26, 2002

[169] "Congress to Consider Federal Takeover of External Auditing," *CAE Bulletin*, Institute of Internal Auditors, Feb. 28, 2002

[170] Ibid. Dan Palmon, the Chairman of the Accounting Department at Rutgers University

[171] Pizzo, Feb.26, 2002, op. cit. fn 156; *CAE Bulletin*, Feb. 28, 2002, op. cit. fn 167

[172] Joshua Ronen, Research Professor of Accounting at the Stern School of Business, New York University.

The SEC could mandate minimum coverage for a federal insurer, who would collect the premiums. In time, market institutions would replace the government as the required infrastructure is established. This approach would require special initiative and coordination between the private sector and the government in the startup period. Complete replacement of the current audit system without a government mandate would require the market to operate in such a way that companies eagerly switch from hiring auditors to buying financial statement insurance because they clearly recognize the economic and corporate governance benefits of the new system.[173]

## In Short

Various proposals are under consideration to reduce the risks of current and future audit market concentration. Each proposal has disadvantages. Proposals to prevent further concentration include setting monetary caps on liability to reduce the risk of litigation, a highly controversial measure. Opponents object to monetary limits on grounds that it would eliminate a useful incentive for auditors to be perspicacious in detecting corporate fraud and wrongdoing and would deprive injured parties of a mechanism to obtain adequate relief. Moreover, in the United States some limitations already exist in the form of proportionate liability and contractual agreements on liability and, in Europe, five countries already have monetary caps on liability. Proposals to promote greater competition include breaking up the Big 4 or requiring one or more of them to spin off a portion of their operations to create additional firms with the capacity to audit large public companies. These proposals raise questions regarding the consequences for existing audit firms and their employees, as well as major disruptions for the business community. Other proposals to promote greater competition include removing barriers to new entrants and to growth of mid-tier and smaller firms. Removal of restrictions on outside ownership of accounting firms could help to attract new, well financed, management-talented entrepreneurs to acquire and combine smaller companies into larger networks, but safeguards would be necessary to avoid conflicts of interest with other businesses owned by the entrepreneurs. Proposals to improve the quality of audits include education and training programs, strict licensing and certification requirements, continuing education to keep accountants up to date on new developments, creation of coordination and communication programs with participation of mid-tier and smaller audit firms. Other proposals include measures designed to remove a basic conflict of interest by changing the audit system so that auditors get paid by the government (nationalization) or by a third party (e.g., an insurance company) rather than the client whose books are being reviewed. These measures, considered quite radical, raise questions about the consequences for existing companies and their employees and disruptive conditions for the business community in the transition.

[173] Ronen, Joshua, "Post-Enron Reform: Financial-Statement Insurance and GAAP Revisited," Stanford Journal of Law, Business & Finance, Autumn 2002, Volume 8 Number 1, pp. 39-68. Ronen, Joshua, "Financial Statement Insurance Will Best Ensure Auditor Independence," Guest Column, Dow Jones Newsletter, Aug. 18, 2004. "Dole Asks SEC to Require 'Financial Statement insurance'," Corporate Financing Week.com, Feb. 9, 2003 (accessed Aug. 31, 2008).

# PART VI

## MAKING THE WORLD SAFE FOR AUDITING MULTINATIONAL CORPORATIONS

Auditing is an important element in the world financial system. Investors depend on the reliability of corporate financial statements. The power of the audit oligopoly is demonstrated by the fact that its four firms are practically the only ones in the world that are capable of auditing large multinational corporations. Although this market is shared fairly evenly among the four major accounting firms, the situation is viewed as precarious by large audit clients, not so much because of high audit fees, but because of lack of choice in selecting an audit firm. The small number of choices also presents a problem for regulatory authorities, who appear to be inhibited from taking strong disciplinary action for fear that it could put another audit company out of business and create chaos in the financial markets.

### Strengths and Weaknesses

The strength of the oligopoly is offset somewhat by exposure to massive lawsuits. Fearful that a series of multi-million dollar lawsuits could sink another major auditing firm, the client companies are advocating legislation to limit the liability of audit firms. It is anomalous that the client companies would be seeking to make the oligopoly even more powerful by reducing the threat of lawsuits, rather than seeking relief from high audit fees. However, regulatory requirements (namely compliance with the Sarbanes-Oxley law) are seen as the cause of high audit fees, not the lack of competition. Client companies are indeed seeking removal or relaxation of certain of these requirements.

Price competition has virtually slowed to a crawl as compared to the 1980s and 90s, prior to consolidation of the industry into four firms instead of eight. In those earlier years, price competition was important to the client companies, which sought to reduce costs by generating bidding wars among the eight firms. Audit fees are probably at record highs. At the moment, however, the prime concerns of public companies are the heavy burden of regulatory requirements, the lack of choice of auditor firms, and the threat of further concentration.

In the form of four huge firms, the audit oligopoly now has survived for six years since the demise of Arthur Andersen and the enactment of Sarbanes-Oxley legislation. In spite of mortgage and credit crises, the world's financial audit and reporting system appears to be on even keel, raising the inevitable question: does the level of concentration matter? The answer is a resounding: YES. Outward appearances can be deceptive. Limited availability of major audit firms remains a problem. The system is in very delicate balance or fragile at best. The threat of failure of another major audit firm is still an important factor in capital markets and in regulation of securities.

## Four Questions

The introduction to this paper poses four questions:

(1) Can the level of competition be increased and, if so, how?
(2) How can the U.S. government regulate and discipline the audit industry effectively without further weakening it?
(3) Should the government enact legislation to limit the industry's liability?
(4) What can be done to remove barriers to the entry of additional global audit firms?

## Competition

With respect to the first question, the level of competition can be increased by encouraging new large firms to enter the market. This, of course, cannot be done overnight. As noted in Part III, mid-tier firms are striving to gain new global clients--- a slow process--- and smaller audit firms have joined international networks, which could help build their capabilities of serving global corporations--- also a slow process. As noted in Part V, it might be helpful to attract new, cash-rich, management-talented entrepreneurs to the industry to acquire mid-tier and smaller firms and combine them into international networks with capabilities of auditing large global public companies. To do so, barriers to market entry would have to be removed or relaxed, such as requirements in the United States and other countries that accounting companies must be owned entirely, or by a majority of, certified public accountants. Safeguards also may have to be installed to avoid conflicts of interest with other businesses of the entrepreneur. As discussed in Part V, many proposals have been offered, but none would provide an immediate solution. While some opportunity currently exists for greater competition, steps need to be taken soon to create additional incentives for more firms to build capacity to audit multinational corporations so as to avoid a future crisis.

## Regulation

With respect to the second question, the U.S. Government will have to walk a fine line in disciplining audit firms in cases of fraud or wrongdoing. Prosecuting individual accountants rather than their firm appears to be an appropriate measure, although some critics contend that limiting enforcement in this way denies regulatory authorities of an important disciplinary tool. For the time being, however, it may be necessary for regulators to limit their enforcement actions to maintain the present number of audit firms for global corporations. Continued monitoring and surveillance must be used as a deterrent to improper actions. Recalling the experience of Italy in 2000 (with audit fee price-fixing, client allocation and other anticompetitive practices of the then-Big 6), authorities must remain vigilant of possible anticompetitive practices by the oligopoly as well as fraudulent auditing. The vast majority of accountants are strictly professional and ethical. Yet, it is the few accountants involved in high profile fraud cases who arouse negative publicity, taint the industry image and prompt the need for disciplinary actions.

## Monetary Limits

With regard to the third question, although the threat of lawsuits is an important check on misconduct by corporate executives and their auditors, some of the settlements have been exceptionally large.

With liability insurance largely unavailable to audit firms, the threat poses an economic concern to the Big 4, who must set aside reserves to protect themselves against massive lawsuits. As discussed in Part IV, some measures have already been adopted to limit liability of audit firms in the United States, such as proportionate liability and allowing contractual agreements with clients. The European Union recently recommended to its member states adoption of some forms of liability limitation, subject to certain conditions. Five member states already have monetary limits on liability and five others permit audit firms to limit liability by contractual arrangement. To some extent, the lack of liability limitations acts as a barrier to new entrants as well as to growth of mid-tier and smaller firms. Smaller firms are reluctant to enter the global market because of the risks of liability. While the threat is not so imminent and dangerous as to require immediate government action, consideration of liability limits in the near future cannot be summarily dismissed. Enactment of such a measure might be found to be desirable as part of a program to encourage and develop additional audit firms with capabilities suitable for global corporations. Ideas for a pro-competitive action plan are shown in Appendix VI-1.

## Barriers

With regard to the fourth question, removing barriers to entry offers a promising, but slow, solution to attracting new firms into the business. As noted above, the lack of liability limitations acts as a deterrent for new and existing firms to enter the market for global clients. A pro-competitive program to remove barriers to entry and growth could include some liability limitations as part of an action plan (see Appendix VI-1). Under this program, in return for the benefits of monetary caps on liability, the audit industry would be required to establish and fund an education center for accountants. With the expected conversion to international financial reporting standards, education will assume an even more vital role in the health and standing of audit firms and for the accounting profession.

As discussed in Part V, the removal or relaxation of ownership restrictions could help to attract new entrepreneurs with access to capital and management knowhow, who could work toward building networks capable of serving global public companies. Through education programs and greater communication and coordination within the audit industry, participation by mid-tier and smaller firms can enhance their expertise and reputations so as to dispel perceptions in the financial community that create a bias against non-Big 4 audit firms in the global market. U.S. Treasury's Advisory Committee on the Auditing Profession recommends a series of education and training programs to improve audit quality.

## In Short

The small number of audit firms capable of performing international audits for large public companies remains a precarious situation. As concluded by the GAO, none of the proposed solutions appear to be justified at present. It took many years for the industry to consolidate into four major firms. It will take many years for the industry to gain new entrants. Some proposals to develop greater competition by mid-size and smaller firms may help to build more audit capacity (although the GAO reported that "market participants generally saw these proposals as having limited effectiveness, feasibility and benefit"). The proposals include allowing outside ownership of accounting firms in order to provide capital to expand their operations, creating a group of accounting and auditing experts to provide needed expertise to smaller auditing firms, and establishing a profession-wide accreditation program to help these firms overcome some of the name recognition and reputation challenges they face. While some opportunity currently exists for greater competition, considering the long lead time needed, steps

need to be taken soon to create additional incentives for more firms to build capacity to audit multinational corporations so as to avoid a future crisis.

With respect to the risks of liability, the need for monetary caps may be less than originally expected, considering that some forms of protection already have been adopted to limit liability of audit firms in the United States (through laws for proportionate liability and for allowing contractual agreements with clients). The 27-nation European Union has recommended that its member states adopt some form of liability limitation. Five member states already have monetary limits and five others permit audit firms to limit liability through contractual agreements. With regard to regulation and discipline of the audit industry, limiting enforcement actions to responsible partners or other employees rather than the firm as a whole would deny regulatory authorities of an important discipline. For the time being, however, it may be necessary for regulators to limit their enforcement actions to maintain the present number of audit firms for global corporations. Continued monitoring and surveillance must be used as a deterrent to improper actions. Recalling the experience of Italy in 2000 (with audit fee price-fixing, client allocation and other anticompetitive practices of the then-Big 6), authorities must remain vigilant of possible anticompetitive practices by the oligopoly as well as fraudulent auditing.

## Final Words

Finally, it is time to respond to the question posed in the title of the paper: Is the audit industry the world's weakest oligopoly? Considering the industry's market dominance, the high level of audit fees, the booming audit business of recent years, the relaxation of punitive actions by regulatory authorities, and the availability of some forms of liability limitation, the audit industry may not be the ideal candidate for weakest oligopoly in the world. A facetious question deserves a facetious answer.

# Appendix I-1

## AUDIT INDUSTRY - SELECTED STUDIES

**United States Government Accountability Office**

(GAO-03-864), "Public Accounting Firms: Mandated Study on Consolidation and Competition," Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services, July 2003

(GAO-03-1158), "Accounting Firm Consolidation," Selected Large Public Company Views on Audit Fees, Quality, Independence, and Choice," Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services, September 2003

(GAO-04-216), "Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation," Report , November 21, 2003.

(GAO-04-217), "Mandatory Audit Firm Rotation Study: Study Questionnaires, Responses, and Summary of Respondents' Comments," Report February 26, 2004.

(GAO-06-361), " Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies," Report May 8, 2006.

(GAO-08-163): "Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action," Report to Congressional Addressees, January 2008

U.S. Chamber of Commerce, Committee on the Regulation of the U.S. Capital Markets in the 21st Century, Report and Recommendations, March 2007, 170-72, available at www.uschamber.com/publications/reports/0703capmarketscomm.htm (accessed April 2, 2007).

Committee on Capital Markets Regulation, Interim Report, November 30, 2006, 14, available at www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (accessed March 5, 2007); and Michael R. Bloomberg and Charles E. Schumer, Sustaining New York's and the US' Global Services Leadership, January 22, 2007, 102, available at www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf (accessed March 5, 2007).

The 103rd American Assembly, The Future of the Accounting Profession (New York: Columbia University, November 2003), 8, available at www.americanassembly.org/programs.dir/prog_display_ind_pg.php?this_filename_prefix=accounting&this_ind_prog_pg_filename=report (accessed April 2, 2007).

EU Press Release IP/08/897 June 6, 2008, "Auditing: Commission issues Recommendation on limiting audit firms' liability" (see MEMO/08/366) available at http://ec.europa.eu/internal_market/auditing/liability/index_en.htm

For additional studies and other references, see List of Selected References

## Appendix II-1

## BRIEF HISTORIES OF THE BIG 4 ACCOUNTING FIRMS

**PricewaterhouseCoopers (PwC)**. Samuel Lowell Price, an accountant, started his practice in London in 1849. In 1865 Price went into partnership with William Hopkins Holyland and Edwin Waterhouse. After Holyland left the firm, it became known as Price, Waterhouse & Co in 1874. Price Waterhouse opened an office in New York in 1890. In 1854 William Cooper established his own practice in London, which became Cooper Brothers seven years later when his three brothers joined. Meanwhile in the United States, in 1898, Robert H. Montgomery, William M. Lybrand, Adam A. Ross Jr. and his brother T. Edward Ross formed Lybrand, Ross Brothers and Montgomery. Coopers & Lybrand is the result of a merger in 1957 among Cooper Brothers & Co; Lybrand, Ross Bros & Montgomery and a Canadian firm McDonald, Currie and Co. In 1998, Coopers & Lybrand merged with Price Waterhouse to form PricewaterhouseCoopers.

**Ernst & Young (E&Y).** Arthur Young, born in Glasgow, Scotland, moved to the United States to pursue his career in accounting, and formed an accounting firm, Arthur Young & Company, with his brother Stanley in 1906. Alwin C Ernst, born in Cleveland, started a small public accounting firm with his brother in 1903. In 1989, the two firms were combined to form Ernst & Young.

**KPMG**. K stands for Klynveld, an accounting firm (Klynveld Kraayenhof & Co.) founded by Piet Klynveld in Amsterdam in 1917. P is for Peat, from the accounting firm William Barclay Peat & Co., which was founded in London in 1870. M stands for Marwick. James Marwick, together with Roger Mitchell founded the accounting firm Marwick, Mitchell & Co. in New York City in 1897. G is for Goerdeler. Dr. Reinhard Goerdeler was for many years chairman of the German Deutsche Treuhand-Gesellschaft (DTG) and later chairman of KPMG. He is credited with laying much of the groundwork for the KMG merger. KMG and Peat Marwick became KPMG in 1987.

**Deloitte Touche Tomatsu (Deloitte).** In 1845 William Welch Deloitte opened an office in London and was the first person to be appointed an independent auditor of a public company. In 1880, he opened an office in New York. In 1895 Charles Waldo Haskins and Eijah Watt Sells formed Haskins & Sells in New York. In 1898 George Touche established an office in London and then in 1900 joined John Ballantine Niven in establishing the firm of Touche Niven in New York. After several name changes from 1947 to 1960, the firm emerged as Touche Ross in 1969. Meanwhile, in 1952, Deloitte merged with Haskins & Sells to form Deloitte, Haskins & Sells and in 1968, NobuzoTohmatsu formed Tohmatsu Awoki & Co, a firm based in Japan that was to become part of the Touche Ross network in 1975. In 1989, Touche Ross merged with Deloitte Haskins Sells to form Deloitte & Touche. The international firm was renamed Deloitte Touche Tohmatsu in 1993 to reflect the contribution from the Japanese firm.

## APPENDIX II-2

## MARKET SHARES OF MAJOR ACCOUNTING FIRMS BASED ON REVENUES, SELECTED YEARS, IN PERCENT

| | 1988 | 2002 | 2004 | 2005 |
|---|---|---|---|---|
| PW & CL | 35.0 | | | |
| PWC | | 34.0 | 31.4 | 31.2 |
| EW & AY | 18.0 | | | |
| EY | | 23.0 | 25.1 | 25.3 |
| DHS & TR | 17.0 | | | |
| DT | | 24.0 | 24.1 | 24.3 |
| KPMG | 14.0 | 18.0 | 17.5 | 17.6 |
| AA | 14.0 | | | |
| Other | 2.0 | 1.0 | 1.9 | 1.5 |

PW&CL= Price Waterhouse LLP and Coopers & Lybrand LLP
PWC= PricewaterhouseCoopers LLP
EW&EY= Ernst & Whinney LLP and Arthur Young LLP
EY= Ernst & Young LLP
DHS&TR= Deloitte Haskins & Sells LLP and Touche Ross LLP
DT= Deloitte Touche LLP
KPMG= KPMG Peat Marwick LLP (prior to February 1995)
AA= Arthur Andersen LLP

Source: GAO 2003 Report: Concentration Ratios, Public Company Revenues (Sales) Audited, 1988 and 2002, updated to 2004 and 2005

## Appendix II-3

## Audit Firm Spinoffs and Sales of Consulting Arms

March 2000:
**Ernst & Young** sold its consulting operation to Paris-based Cap Gemini for $11 billion.

February 2001
**KPMG**'s North American operation, KPMG Consulting (subsequently re-branded as BearingPoint) split from its parent company and floated on the New York Stock Exchange.

July 2001
**Arthur Andersen**'s Andersen Consulting split from its parent company, having changed its name to Accenture.

October 2002
**PwC** sold PwC Consulting to IBM for $3.5 billion.

March 2003
**Deloitte Consulting**, on the other hand, abandoned its planned spinoff (to be named "Braxton," originally announced in February 2002) and decided to maintain its consulting arm, assuring the regulators and the public that it would comply with rules to avoid conflicts of interest. [174]

[174] In response to criticism over perceived conflicts of interest, Deloitte insisted it "will continue to fully comply with the form and substance of the Sarbanes-Oxley Act and the Securities Exchange Commission's independence rules in the United States and with all regulatory and legislative requirements in other countries". James Copeland, chief executive of Deloitte Touche Tohmatsu, said: "We really already have focused our Deloitte Consulting practice on the 75% of the market that we don't already audit." Zea, Adriana, "Deloitte in consultancy U-turn," *Accountancy Age*, Mar. 31, 2003

## Appendix II-4

## LIST OF SELECTED TIGHT OLIGOPOLIES

| | |
|---|---|
| Cereals: | Kellogg, General Mills, General Foods |
| Beer: | Anheuser-Busch, Miller, Coors |
| Airlines: | American, United, Northwest, Delta, USAir |
| Garbage disposal: | Waste-Management, Browning-Ferris |
| Automobiles: | General Motors, Ford, Chrysler, Toyota |
| Locomotives: | General Electric, General Motors |
| Carbonated drinks: | Coca-Cola, PepsiCo |
| Recordings: | Warner, Sony, BMG, Polygram, EMI, MCA |
| Express delivery: | Federal Express, UPS, Airborne Freight |
| Soaps and detergents: | Procter & Gamble, Colgate, Lever |
| Meat packing: | Iowa Beef Packers, Cargill, ConAgra |
| Automobile rentals: | Hertz (Ford), Avis, Budget (Ford), Alamo, National (GM) |
| Athletic shoes: | Nike, Reebok, Adidas |
| Toys: | Mattel, Hasbro |

Source: W. Shepherd, *The Economics of Industrial Organization*, 4th ed. (London: Prentice-Hall, 1997) cited in Table 2, GAO Report 2003: List of Selected Tight Oligopolies, as of 1996, Market Leading companies

Notes: This list includes a variety of tight oligopolies, and it does not attempt to compare or infer similarities aside from market concentration. It includes leading companies from the U.S. market perspective. The companies in certain markets may have also changed since 1996.

Additional Note: While there is industry specialization by the Big 4 firms (see "Level of Concentration" in Part II of this paper (p. 12)), there is no clear pattern of concentration by audit firms in the "tight oligopolies" listed above. For example, in cereals, PwC audits Kellogg's and KPMG audits General Mills; in automobiles; Deloitte audits General Motors; PwC audits Ford and Toyota, and KPMG audits Chrysler; in locomotives, Deloitte audits General Motors and KPMG audits General Electric; and in carbonated beverages, EY audits Coca-Cola and KPMG audits PepsiCo. In these cases, none of the Big 4 has a monopoly in auditing all the companies in the "tight oligopoly." Quite to the contrary, it appears that competing companies consciously select different auditors in order to safeguard company secrets and strategies. In the case of carbonated beverages, when Ernst & Whinney merged with Arthur Young, Coca-Cola forced the combined firm to dump PepsiCo as a client (see "Client Conflicts" in Part III of this paper (page 12 and especially footnotes 27 and 28).

## Appendix III – 1

## COMMENTS ON THE RISKS OF FURTHER CONCENTRATION

Even before the Big 5 shrank to the Big 4, there was concern about the small number of major audit firms. In 1998, one report stated that a reduction from five to four would not be tolerated.

--- "Lessons from the Accountancy Mergers," Lexecon Ltd., CRA Competition Memo: Sept. 1998

In 2002, EU Competition Commissioner Karel van Miert expressed his opinion that "five is the minimum required to ensure enough competition," a view shared by his predecessor, Mario Monte.

---"Deloitte offer would face reluctant EU competition hurdle," Guerrera, Francesco, and Spiegel, Peter, *Financial Times*, March 12, 2002

"The current degree of concentration in the profession raises the specter that the collapse of a Big Four firm would be a threat to the continued existence of the profession. An audit environment with only three large firms may be too small a number to maintain audit quality and independence, and any event that causes another firm's collapse would automatically call into question the viability of the survivors."

---American Assembly report (2005) *The Future of the Accounting Profession: Auditor Concentration*

"The concentration of the accounting industry has raised concerns that the collapse of another 'Big Four' firm could cause 'paralysis in financial markets'… in the event that only three big accounting firms remained, it would be difficult for the client companies to juggle the relationships necessary to comply with conflict of interest rules. "

--- "Corporations and the Public Purpose: Restoring the Balance," Charlie Cray and Lee Drutman, Seattle Journal for Social Justice, Fall/Winter 2005 Issue: Volume 4, Issue 1

"Few industry observers believe that any of the next-largest firms could handle the kind of giant, multi-national accounts that the global accounting firms are equipped to service."

---The Future of Auditing: Called to Account, *The* Economist, Nov. 20, 2004, quoted in "Corporations and the Public Purpose: Restoring the Balance," Charlie Cray and Lee Drutman, Seattle Journal for Social Justice, Fall/Winter 2005 Issue: Volume 4, Issue 1

Because of the inter-connectedness of international markets, the loss of another big firm also is a global economic concern. "The prospect of losing another major accounting firm—and the negative spiraling effect that would occur across the other firms and in our financial markets— must be recognized as a global economic concern."

---Ernst & Young CEO James S. Turley speech, December 2005, quoted in "What If One of The Big Four Fails? Trying to avoid an Arthur Andersen-type disruption," Holstein, William J., *Directorship,* September 2006

"The disappearance of any one of the Big Four firms would be a true catastrophe for financial markets as well as for public companies worldwide. The choice of auditors would be substantially reduced, and the requirements for auditor independence might make it impossible for some companies to find a sufficiently skilled independent auditor. In addition, accounting and auditing costs, already sky high, would become an even more costly burden on public companies, reducing profits and driving smaller companies--which bear a disproportionate share of the costs--to privatization. "

---"The Sorcerer, the Apprentice, and the Broom, What to Do about Private Securities Class Actions," Wallison, Peter J., *American Enterprise Institute Online*, Posted: Thursday, March 8, 2007

A further reduction in the number of firms with global reach is seen as problematic because it could leave international businesses struggling to find an auditor to sign off on their accounts.

---"Brussels suggests legal shield for big audit firms," Buck, Tobias, *Financial Times*, January 18, 2007, FT.com site.

"In some cases, because of geographic demands or industry specialization, a company may even have only one realistic choice."

--- Christopher Cox, Chairman of the Securities and Exchange Commission, quoted in "Number crunch: why the dominance of the big four is alarming regulators," Jopson, Barney, *Financial Times*. Mar 27, 2006. p. 15.

The complexity and seriousness of the situation are further illustrated by a statement of the Chairman of the U.S. Public Company Accounting Oversight Board, who said in 2005: "Regulators do not have 'a clue' how to respond if one of the big four accounting firms were to collapse."

--- William McDonough, Chairman of the U.S. Public Company Accounting Oversight Board, expressing relief that the Department of Justice reached a settlement with KPMG over its sales of tax avoidance schemes to clients; quoted in Parker, Andrew, "US audit watchdog warns about industry," *Financial Times*, Sep 27, 2005

## Appendix III-2

## Non-audit Competition

During that 1980s, the "Big 5" boldly announced their plans to become integrated professional service firms by expanding their legal services and other consulting services. Through their consulting affiliates, they began to fill clients' needs for management advice, information technology systems, tax and legal advice. In fact, these business services—particularly information technology-- became more profitable than the basic audit business and auditing was seen as a "foot in the door"--- a means of gaining more non-audit business. [175]

The marketing of consulting services to audit clients during the 1980s and 1990s gave rise to complaints about potential conflicts of interest. Regulators, lawmakers and shareholder activists alleged that a firm offering both consultancy and audit services to the same client could lead to questionable accounting practices.[176] Harshly criticized for putting commercial interests ahead of their role as independent auditors safeguarding the public interest, accounting firms faced strong pressures to spin off their consulting arms.

The Sarbanes-Oxley Act of 2002 banned accounting firms from providing consulting services to audit clients.[177] Under Sarbanes-Oxley specified non-audit services cannot be provided to audit clients, including financial information systems design and implementation; investment, management, and securities services; and legal and expert services unrelated to the audit. Tax services may be provided. [178]

Between 2000 and 2002, three of the Big 4 split or sold off their consulting arms. Thus, even prior to enactment of the Sarbanes-Oxley law, some of the "Big 5" had already divested their consulting arms. Only one of the major accounting firms (Deloitte) retained its consulting arm, assuring regulators and the public that it would comply with rules to avoid conflicts of interest.[179] For further details of spinoffs, see Appendix II-3.

In 2007, the non-compete agreements related to the spinoff sales have all passed, and according to Accountancy Age, all of the Big 4 are back in the top 10 of UK consulting fee earners. The returnees posted exceptional growth: 25 per cent, 14 per cent and 11 per cent respectively at PwC, E&Y and

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[175] For example, in 1998, PwC expected to be one of the top six law firms in every country in which it operated, including America; Deloitte Touche Tohmatsu stated similar intentions; and Ernst & Young's stated aim was to have a global law firm with 4,000 staff by 2003 or 2004. *Economist*, Nov. 13, 2003. Also see: Ascher, Bernard, "The Threat to U.S. Lawyers from Competition by Multidisciplinary Practices (MDPs): Is It Gone?" American Antitrust Institute, Working Paper 06-06, November 29, 2006, available at http://antitrustinstitute.org/Archives/557.ashx

[176] Zea, Adriana, "Deloitte in consultancy u-turn," Accountancy Age Mar. 31, 2003

[177] President George W. Bush signed the Sarbanes-Oxley Act of 2002 (Public Law 107-204) on Tuesday, July 30, 2002. Congress presented the act to the President on July 26, 2002, after passage in the Senate by a 99-0 vote and in the House by a 423-3 margin.

[178] Benston, George J., "Sarbanes-Oxley: A Benefits-Cost Analysis," May 5, 2004, available online at www.aei.org/docLib/20040505_Benston.pdf, accessed July 20, 2008

[179] Ibid.

KPMG, and 10 per cent for Deloitte. The growth picture is little different worldwide; this has been a bumper year for their consulting arms.[180]

The newer consulting work, however, is no longer focused on information systems (which is now considered "low-margin, commodity work," but rather on combining a variety of services to provide advice on business strategies. "Now we're working with our clients to figure out what is the best business solution for them," says Aidan Brennan, head of the advisory business at KPMG Europe. "The market is saying we want advice independent of the solution - there's been a real demand for us to provide that." [181] All of the Big 4 are now engaged in consulting and advisory services, as well as in auditing. To be consistent with the limitations of the Sarbanes-Oxley law, these services generally are performed for non-audit clients only. Deloitte uses a team approach so that auditors are not paid directly for non-audit work; they share a pool of profits with tax experts and consultants.[182]

In 2006, revenues for consulting services of the Big 4 amounted to $20.3 billion, of which Deloitte earned $8.9 billion; KPMG, $5.3 billion; PwC, $3.7 billion; and E&Y $2.4 billion.[183]

[180] Accountancy Age, *AccountancyAge*.com, Jan. 5, 2005; Hughes, Jennifer, "Audit firms once again making 'consulting hay'" *Financial Times*, November 19, 2007. p. 4; Byrnes, Nanette, "Consulting Pays Off for Accountants Again; Deloitte & Touche resisted splitting with its consulting arm, and now the multibillion-dollar segment has inspired other audit firms to rebuild theirs," *Business Week*, Aug. 20, 2007
[181] Ibid.
[182] Byrnes, Aug. 20, 2007, op. cit. fn 180
[183] Ibid.

## Appendix III-3

## AUDIT FEE INCREASES - LARGEST COMPANIES IN ILLINOIS

Overall, audit fees paid in 2004 by the 25 largest companies in Illinois rose a whopping 64 percent in their most recent fiscal year, to more than $220 million, or an average of nearly $9 million, according to a Chicago Tribune analysis of the audit fees. Since 2001, the year before Sarbanes-Oxley came into existence, audit fees for those companies have more than doubled, from an average of $3.8 million.

| COMPANY | AUDIT FEES 2003 | AUDIT FEES 2004 | PCT.CHANGE |
|---|---|---|---|
| Boeing | $16,300,000 | $30,900,000 | 89.6% |
| Caterpillar | $10,200,000 | $18,700,000 | 83.3% |
| Aon | $10,000,000 | $15,300,000 | 53.0% |
| Kraft Foods | $10,700,000 | $14,500,000 | 35.5% |
| Motorola | $7,300,000 | $13,900,000 | 90.4% |
| CNA Financial | $8,000,000 | $12,300,000 | 53.8% |
| Baxter International | $5,585,000 | $11,713,000 | 109.7% |
| Abbott Laboratories | $6,725,000 | $11,257,000 | 67.4% |
| R.R. Donnelley* | $1,469,855 | $11,047,926 | 651.6% |
| Sara Lee | $8,900,000 | $9,500,000 | 6.7% |

*Increase in R.R. Donnelley fees came in part from expenses associated with Moore Wallace merger.

Source: Chicago Tribune, June 5, 2005

A study by professors at the University of Nebraska at Omaha of 633 companies in the Fortune 1000 showed their audit fees rose, on average, nearly 64 percent, a total increase of more than $1.4 billion.

Source: Chicago Tribune, June 5, 2005

## Appendix III-4

## DEVELOPMENT AND STATUS OF

## INTERNATIONAL FINANCIAL REPORTING STANDARDS

Each nation has its own standards for reporting the financial conditions of public companies. These are rules and principles to guide accountants and to provide a consistent method by which companies keep their books and report their income, profits and losses. For example, the standards help determine the manner in which accountants treat the value of tangible and intangible assets, including the value of buildings and real estate, good will, intellectual property rights, pension liabilities, and derivatives.

Financial reports of U.S. companies currently are prepared in accordance with national standards--- the Generally Accepted Accounting Principles (GAAP), formulated by the Financial Accounting Standards Board (FASB), a privately-funded, non-profit organization.

Efforts to establish international accounting standards go back at least as far as 1967. The London-based International Accounting Standards Committee (IASC) began developing and issuing standards in conjunction with experts from the public and private sectors and organizations, such as the International Federation of Accountants (IFAC) and the International Organization of Securities Commissions (IOSCO). In 2000, the IASC was restructured into the IASB (International Accounting Standards Board), a private, non-profit organization, which issues international standards that complement or replace those of the IASC. Trustees are headed by Paul Volker, former Chairman of the U.S. Federal Reserve Board.

In April 2001, the IASB adopted all IAS and continued their development, calling the new standards International Financial Reporting Standards (IFRS). In 2002, the European Union announced plans to adopt IFRS for all EU companies beginning in 2005. The IASB and the FASB, its U.S. counterpart, issued the "Norwalk Agreement," (named for Norwalk, Connecticut) pledging to coordinate work to converge IFRS and US GAAP. Australia, New Zealand and Hong Kong committed to adopting IFRS in 2003. Significantly, IFRS became effective in all member states of the EU in 2005. The following year, China adopted accounting standards broadly in line with IFRS and IASB. Also in 2006, IASB and FASB worked out detailed plans to converge IFRS and US GAAP. In 2007, Canada, India, Japan and Korea agreed on plans to adopt or converge accounting standards with IFRS. Also in that year, the U.S. SEC allowed foreign users of IFRS to stop reconciling their accounts to US GAAP, as previously required --- seen as a strong signal that the regulator was planning to allow US companies to report in IFRS.

The standards are in use by more than 12,000 companies in about 100 countries. Australia issued its equivalent of IFRS in June 2006, replacing the previous Australian generally accepted accounting principles since June 2006. The Accounting Standards Board of Japan plans convergence with IFRS by 2011. Canada will require the use of IFRS in 2011 for Canadian publicly accountable profit-oriented enterprises. Russia has been implementing a program to harmonize its national accounting standards with IFRS since 1998. Despite these efforts, essential differences between the national standards and IFRS remain. Since 2004 all commercial banks have been obliged to prepare financial statements in accordance with both and international standards. Full transition to IFRS is thus delayed and is expected to take place beginning in 2011. In Turkey, since 2006 Turkish companies listed in Istanbul Stock

Exchange are required to prepare IFRS reports. In Singapore, reporting standards are closely modeled on IFRS, with appropriate changes made to suit the Singapore context. As mentioned above, the 27 member states of the EU have been required to use IFRS since 2005. The United States is the last major country to commit to the international standards.

Considering that thousands of U.S. companies are engaged in business in foreign countries which have adopted international standards and two-thirds of U.S. investors currently own securities of foreign companies, in August 2008, the SEC announced an eight-year plan to adopt IFRS. The plan remains subject to review. Public comments have been requested. Some larger companies could choose to begin using IFRS to report financial results starting in 2010. The SEC estimates at least 110 U.S. companies would qualify based on their market capitalization, among other factors. The SEC will decide in 2011 whether to require all of its registrants to use IFRS. The expected deadlines for mandatory use are: 2014 for large companies and 2016 for all U.S. publicly traded companies.

The major accounting firms have broadly endorsed the move, saying that the United States should not isolate itself as most countries move to international standards.

Conversion to IFRS will be a costly, time-consuming process, affecting not only the bookkeeping of public companies, but many of their management and control systems as well. It will require broad changes in the education of accountants with current textbooks based almost entirely on US GAAP and with US GAAP firmly etched in the minds of practicing accountants. The IFRS diverges distinctly from GAAP and will bring different results to profit and loss statements. US accounting rules, guidance and official interpretations total some 25,000 pages. IFRS, which has tried to rely on principles and has avoided adding much interpretation, is more on the order of 2,500 pages. Conversion will require years of great effort to make the necessary changes, but ultimately adoption of the international standards should cut operational costs for companies and make it easier to accomplish cross-border investing.

Source: Compiled by the author from SEC Press Release, Wikipedia, and various newspapers and business publications

# Appendix IV-1

## Growth of Lawsuits Against Audit Firms (1967-Present)

Audit firms have long been targets of lawsuits. This is not a new phenomenon. In 1967, for example, Forbes Magazine reported that fifty lawsuits were pending against public accounting firms.[184] In 1992, Time Magazine reported that accountants face 4,000 liability lawsuits, double the number in 1985, covering more than $15 billion in damages; in 1991, the Big 6 paid $300 million to settle lawsuits. [185] In 1995, the Economist Magazine reported that the then-Big 6 "forked out over $3 billion to settle negligence claims since 1990."[186] The same report indicated that outstanding legal claims against the firms in America totaled about $30 billion and that in London, a claim for $11 billion was pending against PwC and E&Y over the audit of Bank of Credit and Commerce International. [187] At that time, Philip Laskawy, the chairman of Ernst & Young, estimated that "legal costs now swallow a fifth of the Big Six's revenue from audit and tax work." [188]

Audit firms have long been targets of lawsuits, partly because they have deep pockets and partly because of the nature of the business. When corporations suddenly fail or suffer severe declines in stock prices, disaffected investors, creditors and employees are prone to sue the auditors as well as the corporate management. Claims against the auditors are based on allegations of fraud or failure to identify errors or wrongdoings that lead to massive losses.

### Growth of Litigation

The number and size of lawsuits against audit firms have grown in recent years. In 1998-2006, the Big 4 audit firms faced dozens of claims in excess of $1 billion,[189] whereas in 1980-85, for example, the cost of out-of-court settlements for malpractice by the Big 8 amounted to less than $180 million, of which $137 million was paid by now-defunct Arthur Andersen. [190] The 1980-85 cases are listed in Appendix IV-2.

Between 1999 and 2004, five cases brought settlements in excess of $100 million. E&Y was involved in the largest payout, $335 million, in the Cendant case. Now-defunct Arthur Andersen was involved in two cases: Baptist Funds of Arizona ($217 million) and Sunbeam ($110 million). KPMG was involved in

[184] *Forbes.com*, "What Are Earnings? The Growing Credibility Gap, May 15, 1967
[185] McCarroll, Thomas, "Accounting Who's Counting?" *Time*, Apr. 13, 1992
[186] *Economist*, "Accountancy firms: A glimmer of hope," Apr. 1, 1995, p. 62
[187] Ibid.
[188] Ibid.
[189] Holstein, William J., "What If One of The Big Four Fails? Trying to avoid an Arthur Andersen-type disruption," *Directorship*, Sept. 2006
[190] House Subcommittee on Oversight and Investigations, cited in Berton, Lee, "Small CPA Firms' Liability Rates Soar --- Plight Tied to Malpractice Suits Against Big Eight," *Wall Street Journal*, Nov 19, 1985, p.1

the other two cases: Rite Aid ($125 million) and Lernout & Hauspie ($115 million).[191] Appendix IV-3 lists the top ten cases in that period.

As of 2004, federal agencies had "collected $2 billion from accountants, lawyers and other professionals from the S.& L. debacle -- half from four big accounting firms. ..And the program is still young, a Government spokesman said, with hope. The payments are funneled to institutions made insolvent by the S& L crisis."[192]

Big pension funds and law firms are now pressing cases more aggressively when corporations lose money or when stock prices drop, causing harm to pension fund portfolios. Audit firms get drawn into the cases on grounds that they should have spotted the problems.[193] Thus, dozens of billion-dollar lawsuits were pending against the Big 4 from 1998 to 2006.[194] In 2006, the European Commission reported that "audit firms faced five claims worth more than $1bn and 11 claims in the range of $250m to $1bn in Europe alone"[195]and in 2007, according to the Committee on Capital Markets Regulation, more than three dozen suits were pending, "involving tens of billions of dollars of claimed potential damages."[196]

In May 2007, Tyco International and PwC agreed to pay a total of $3.2 billion to settle a class-action lawsuit brought by Tyco's shareholders over a multi-billion-dollar accounting fraud that ended with Tyco's top executives going to prison (CEO L. Dennis Kozlowski and CFO Mark H. Swartz). Of the total, PwC paid $225 million and Tyco paid $2.975 billion to conclude a four-year legal battle.[197] See Appendix IV-4 for detailed list of cases.

In April 2008, PwC reported an increase in federal class action shareholder lawsuits with 163 cases filed (compared to 163 in 2006; 169 in 2005; 206 in 2004) Of these, accounting-related cases fell in proportion to total cases to 50% in 2007 (compared to 61% in 2006).[198] "The Federal Bureau of Investigation has … 17 continuing investigations of possible corporate and accounting fraud related to subprime lending. That number, the F.B.I has said, is likely to increase."[199]

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[191] *Economist*, "Called to Account," Nov. 18, 2004

[192] Flaherty, Francis, "Business Diary," *New York Times*, Aug 14, 1994, p. A2

[193] Holstein, William J., What If One of The Big Four Fails? Trying to avoid an Arthur Andersen-type disruption, *Directorship*, Sept. 2006

[194] Ibid.

[195] Buck, Tobias, "Brussels suggests legal shield for big audit firms," *Financial Times*, Jan. 18, 2007

[196] Wallison, Peter J., "The Sorcerer, the Apprentice, and the Broom: What to Do about Private Securities Class Actions," *AEI Online*, Posted: Thursday, Mar. 8, 2007, accessed July 20, 2008

[197] *International Herald Tribune,* "Lawyers get 14.5 percent in Tyco case, $29 million in expenses," *Associated Press*, Dec. 20, 2007

[198] The full fallout of subprime-related cases is expected to be seen in 2008. "PwC Sees Securities Litigation on the Rise," *WebCPA*, New York, April 11, 2008

[199] Bajaj, Vikas, and Creswell, Julie, "A Lender Failed. Did Its Auditor?" *New York Times*, Apr 13, 2008

## Cases on the Horizon

Several potentially high-value cases are currently pending. Examples include: a shareholder suit against New Century Financial and its auditor KPMG; several lawsuits against Bear Stearns, its auditor (Deloitte) and its purchaser (JPMorgan Chase); and a lawsuit by shareholders against Dell and its auditor, PwC (a case which was expanded to include Intel's alleged 'secret' rebate program of $1 billion per year to Dell).. "The decline of $19 billion in Bear Stearns's market capitalization since January 2007 is one gauge of the potential losses investors may try to recoup."[200]

[200] Gerstein, Josh, "Amid Bear Stearns Rubble, Lawyers Swoop In," *New York Sun*, Mar. 18, 2008, http://www.nysun.com/business/amid-bear-stearns-rubble-lawyers-swoop/73076/ accessed Aug. 13, 2008

## Appendix IV-2

## Out-of-court Settlements by Big Eight Accounting Firms

## Malpractice Lawsuits (1980-85)

| Firm | Amount Paid |
|---|---|
| Arthur Andersen | $137,089,359 |
| Peat Marwick Mitchell | 19,400,000 |
| Ernst & Whinney | 6,020,500 |
| Deloitte Haskins & Sells | 4,997,585 |
| Coopers & Lybrand | 4,375,850 |
| Price Waterhouse | 3,500,000 |
| Touche Ross | 2,250,000 |
| Arthur Young | 1,490,000 |

Source: House Subcommittee on Oversight and Investigations; cited in "Small CPA Firms' Liability Rates Soar --- Plight Tied to Malpractice Suits Against Big Eight," Burton, Lee, *Wall Street Journal*, Nov 19, 1985. pg. 1

## Appendix IV-3

## Top Ten Shareholder Settlements by Accounting Firms (1997-2004)

| Auditor | Company | Settlement ($millions) | Date |
|---|---|---|---|
| E&Y | Cendant | 335 | Dec 1999 |
| Andersen | Baptist Funds of Arizona | 217 | Mar 2002 |
| KPMG | Rite Aid | 125 | Mar 2003 |
| KPMG | Lernout & Hauspie | 115 | Oct 2004 |
| Andersen | Sunbeam | 110 | May 2001 |
| Andersen | Colonial Realty | 90 | Jul 1997 |
| KPMG | Oxford Health Plans | 75 | Mar 2003 |
| Andersen | Waste Management | 75 | Dec 1998 |
| PwC | Micro Strategy | 55 | May 2001 |
| E&Y | Informix | 34 | Jun 1999 |

Source: Public Accounting Report, cited in "The future of auditing: called to account," *The Economist*, Nov. 18, 2004

## Appendix IV-4

## Cases Against Accounting Firms
## Settlements, Fines, Pending Cases (1992-Present)

This list of cases is intended to be illustrative and not exhaustive. Sometimes different reports of the same claim vary in the amounts cited. In some cases, the figures include not only the portion of the suit against the auditor, but damage claims against the entire audited corporation. Thus, media reports may overstate the magnitude of the cases against the auditors. Also, the amount under consideration may change over time and out-of-court settlement may be agreed on a confidential (undisclosed) basis.

| Auditor | Client | $Millions | Date | Comments |
|---|---|---|---|---|
| Deloitte | | | | |
| | (Financial Institutions) | 312. | Mar 1994 | |
| | Umbrella settlement w/fed'l gov't for allegedly faulty audits of collapsed financial institutions during the past decade | | | |
| | Fortress Re | 2000. | Nov 2004 | |
| | Delphi | 38.25 | Feb 2008 | |
| | Philip Services (Canada) | 50.5 | Mar 2007 | |
| | Parmalat (Italy) | 149. | Jan 2007, Apr 2007? | (originally sought $!0 billion) |
| | Adelphia Communications | 167.5 | Aug 2007 | |
| | (paid $50m to settle Adelphia 4/26/05; paid $167.5m to Adelphia August 2007) | | | |
| | Ligand | N/A | Dec 2007 | |
| | (PCAOB fine $1 million, PCAOB Release 105-2007-005 - 12/10/07 | | | |
| | Koger Properties (FL) | 81.3 | N/A | |
| | Bear Stearns | 1000. | April 2008 | |
| | United Companies Financial | N/A | N/A | |
| | Navistar | N/A | July 2005 | |
| | General Motors | 26 | Aug 2008 | |
| | (Total $303m: GM paid $277m, $200m reportedly covered by GM's insurance carrier; case filed Sept. 2005) | | | |
| PwC | | | | |
| | Miniscribe | 95 | 1993 | C&L |
| | American Mutual | 24 | 1996 | C&L Court rejected $3.75 million |
| | Micro Strategy | 55 | May 2001 | |
| | Safety-Kleen | 87.5 | Jan 2005 | |
| | Raytheon | 50 | May 2004 | |
| | Amerco Inc. (U-Haul Int'l) | 50 | N/A | (sued for $2.5 bn) |
| | Texarkana (travel) | 54.5 | N/A | |
| | Refco | 2000 | Aug 2007 | (PwC/E&Y/Grant Thornton) |
| | Tyco | 225 | May 2007 | |
| | BCCI (BankCredit/Commerce) | 200 | 1995 | (sought $11 bn) |
| | MiniScribe | 92 | Feb 1992 | (200m jury 2/5/92 – C&L) |
| | Maxwell | N/A | 1996 | (C&L) |
| | AHERF (Allegheny Health Education and Research Foundation) | | | (C&L 2001) |
| | AIG | N/A | 2007 | |
| | Dell | 1,000. | Jan 2007 | Amount not yet specified |
| | OAO Yukos | 0.48 | Mar 2007 | |

## KPMG

| | | | |
|---|---|---|---|
| BankAmerica Corp. | 75 | Dec 1992 | Peat Marwick |
| (Financial Institutions) | 186.5 | 1994 | (Paid to US Gov't Failed S&L) |
| Orange County | 75 | May 1998 | Original claim $3 billion filed Sept. 2005 |
| Rite Aid | 125 | Mar 2003 | |
| Columbia/HCA | 9 | Oct 2001 | filed in 1999 |
| Lernout & Hauspie Speech | 115 | Oct 2004 | |
| Oxford Health Plans | 75 | Mar 2003 | |
| Xerox | 22.4 | April 2005 | (paid to SEC) |
| (Tax Shelters) | 456 | Aug 2005 | (paid to DOJ) |
| Gemstar-TV Guide | 25 | N/A | (plus 10m fine 11/05) |
| Tenet Healthcare | N/A | Mar 2006 | |
| Fannie May | 2.000 | Dec 2006 | |

## E&Y

| | | | |
|---|---|---|---|
| (Failed Savings & Loans) | 400 | 1992 | (Paid to US Government) |
| Cendant | 335 | Dec 1999 | |
| Informix | 34 | Jun 1999 | |
| Bank of New England | 84 | 1998 | (collected $44m) |
| Equitable Life (UK) | 4.770 | Sep 2005 | |
| (cut to 750m BP, then dropped in Sep 2005; Equitable paid EY's legal costs) | | | |
| MerryGoRound | 4.000 | 1997 | |
| Charles Keating S&L | 63 | 1993 | (paid largely by insurance) |
| SmartForce (Ireland) | 0.725 | N/A | |
| HealthSouth | 445. | Feb 2006 | (HSouth pd, suing EY) |
| Refco | 2.000 | Aug 2007 | (PwC/E&Y/Grant Thornton) |
| AOL Time Warner | N/A | N/A | |
| Banque Cantonale de Geneve | N/A | N/A | |
| JDS Uniphase | N/A | N/A | |
| Superior Bank | N/A | N/A | |
| PNC | 9 | Apr 2007 | |

## Grant Thornton

| | | | |
|---|---|---|---|
| Refco | 2000 | Aug 2007 | (PwC/E&Y/Grant Thornton) |
| Carnegie | N/A | N/A | |

## BDO Seidman

| | | | |
|---|---|---|---|
| Bankest (FL) | 521 | June 2007 | (Under appeal) |
| (Florida jury verdict: $170 million compensatory damages, $351 million punitive damages) | | | |

## Andersen

| | | | |
|---|---|---|---|
| (Financial Institutions) | 65 | Dec 1993 | Umbrella settlement USG |
| Baptist Funds of Arizona | 217 | Mar 2002 | |
| World Com | 6100. | Sep 2005 | |
| Qwest Communication Int'l | N/A | Oct 2004 | |
| Global Crossing Ltd. | N/A | Nov 2005 | |
| Dynegy | 1 | N/A | |
| Sunbeam | 110 | May 2001 | |
| Colonial Realty | 90 | Jul 1997 | |
| Waste Management | 75 | Dec 1998 | |
| Peregrine Systems | N/A | N/A | |
| Enron | 300 | Apr 2002 | |

Source: Compiled by the author from various publications. (N/A = not available prior to publication)
Last update: 8/31/08

## Appendix IV-5

## EU Commissioner Frits Bolkestein
## Four Reasons for Not Limiting Liability

Following are excerpts from a speech in London by Frits Bolkestein, EU Commissioner of Internal Market and Taxation, on March 24, 2003.

"The Commission considers auditor liability primarily as a driver of audit quality and does not believe that harmonisation or capping of auditor liability in general is necessary… There are four clear reasons for not limiting auditor liability.

"Unlimited auditor liability is a quality driver. If the auditor delivers permanently high quality he has no liability exposure. There is no more effective liability risk management than delivering high quality audits.

"Liability systems exist for the protection of the persons who suffered damage not for the convenience of those who may be at fault. Therefore, the "deep pocket" approach is principally sound because someone who has suffered damage should not have to shoulder the burden of suing separately all parties which have a partial responsibility for proper financial statements. In any case, all Member States have the concept of joint and several liability as a fundamental element in their civil liability systems.

"Increased auditor liability is partly a self-created problem. Here, there are two considerations.

The growth of audit firms and the branding of one name one firm world-wide has significantly increased the potential damage to the whole network in case of a potential audit failure committed by one of the local firms. This drives the willingness of networks of audit firms to settle for higher amounts. Trends in liability claims should not be considered in absolute terms but relative to the increased turnover and profit of audit firms, figures that are not easily available worldwide.

Claims from potential audit failures have been settled too easily out of Court. As a consequence there is very little case law clarifying the boundaries of auditor liability. An unanswered question for me is whether out of Court settlements are initiated by the audit firms' desire to limit the damage to the brand name or by the risk judgement of insurance companies.

Audit is by its very nature a function which is carried out in the public interest. This implies that 3rd parties should be able to rely on the correctness of companies' financial statements and be in a position to claim damages in case of fraudulent financial reporting. EU company law specifically recognises the protection of third parties such as creditors as one of its major objectives. In this context the Commission is somewhat concerned about the recent modification to some UK audit reports which seem, in response to the ruling in the Bannerman case, to try to limit auditor liability to third parties via wording in the audit report."

Source: Bolkestein, Frits, "Auditor Liability: An EU Perspective," Address at The London Underwriting Centre, Mar. 24, 2003; (http://europa.eu.int/rapid/pressReleasesAction.do?reference=SPEECH/03/151&format=HTML&aged=0&language=EN&guiLanguage=en)

# Appendix VI-1

## Increasing the Supply of Global Audit Firms

**A Pro-Competitive Action Plan**

The various proposals discussed in Part V are basically long-term solutions to the needs for greater competition and greater choice of auditors for multinational clients. For those who are anxious to move more quickly and decisively, it would be prudent to give serious consideration to a plan to prevent further shrinkage and further concentration of the audit industry. The most pragmatic approach is to focus on removing barriers to new entrants and the growth of existing firms. Some of the barriers identified by GAO (see Part III) consist of shortcomings of the firms due to their lack of size, i.e., reputation, capacity, lack of expertise and global networks. These shortcomings can only be overcome with time and by the firm itself, but actions on other barriers could facilitate and accelerate the process. Barriers, such as lack of access to capital, litigation risks, and state regulations, can be dealt with through government action.

- Litigation risks could be addressed by adopting limits on liability. Perhaps, a cap could be placed on punitive damages (but not compensatory damages) against auditors based on a multiple of the auditor's fee. For instance, if the fee is $10million and the cap is five times the fee, the auditor would be liable for a maximum of $50 million. Such a limit should be contingent on the audit industry's willingness to contribute to the development of a larger number of competitors for the audits of multinational clients. As a quid pro quo for this benefit, the audit industry would be required to establish and fund an education center to help keep accountants from smaller companies up to date on accounting regulations and especially on the international financial reporting standards which are expected to become effective worldwide in a few years. College students in accounting and business management courses could also have access to such a facility or group of facilities, which would benefit all audit firms.

- Lack of access to capital could be addressed through removal of state restrictions on outside ownership of accounting firms. This, of course, would require amendments to state laws, which could perhaps be stimulated by some federal umbrella legislation. Safeguards would need to be built into such legislation to assure against conflicts of interest where new audit firm owners may be engaged in other enterprises. State laws are especially sensitive for local firms which may not wish to attract new competitors or new owners. So it will be necessary to build a consensus and rally supporters for such changes.

While this plan may appear overly ambitious, it does provide some ideas for consideration. The cost of the plan, of course, must be weighed against the cost of inaction.

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