

**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS  
COMPETITION COMMITTEE**

**Working Party No. 2 on Competition and Regulation**

**ROUNDTABLE ON COMPETITION AND REGULATION IN AUDITING AND RELATED  
PROFESSIONS**

-- United States --

**8 June 2009**

*The attached document is submitted to Working Party No. 2 of the Competition Committee FOR DISCUSSION under item III of the agenda at its forthcoming meeting on 8 June 2009.*

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**JT03265757**



## 1. Overview

1. Prior to 1989, there were eight major accounting firms in the U.S.<sup>1</sup>. These firms provided few services other than auditing. Beginning with the 1989 merger of Ernst & Whinney with Arthur Young to form Ernst & Young and the merger of Deloitte, Haskins & Sells with Touche Ross to form Deloitte & Touche that same year, the industry experienced a period of substantial consolidation. In 1998, Price Waterhouse joined forces with Coopers & Lybrand to form Pricewaterhouse Coopers. Finally, in 2002, Arthur Andersen was dissolved in the wake of the accounting scandal at the heart of the collapse of Enron, leaving the U.S. accounting industry with four major firms (known informally as the “Big Four,” or, somewhat more creatively, as the “Final Four.”): Ernst & Young, KPMG, Pricewaterhouse Coopers, and Deloitte Touche. Together, in 2003, the Big Four audited over 78% of all U.S. public companies by firm count; by revenues, they audited 99% of the annual sales of public companies<sup>2</sup>.

2. During this period of consolidation, the largest firms moved from being mostly auditing firms to deriving a significant portion of revenues from non-auditing consulting services<sup>3</sup>. The trend reversed in the early part of the 21st century as firms and legislators grew nervous about the threat these symbiotic arrangements posed to the integrity of audits. The Sarbanes-Oxley Act of 2002, discussed below, instituted a number of new regulations in the industry, including limits on the non-audit services that the Big 4 could provide to their audit clients. Management consulting services fell dramatically as legislation took effect; three of the Big 4 divested a significant portion of that business to independent spin-offs or to non-auditing companies<sup>4</sup>. Because of these shifts in the industry, by 2008, 53.5% of accounting services firms' revenue was derived from the auditing segment, while advisory services comprised 21.1% by revenue<sup>5</sup>. In yet another swing of the pendulum, some accounting firms (notably, Deloitte) have increasingly begun to offer non-auditing consultancy services to companies that are not audit clients<sup>6</sup>.

3. The Big 4 accounting firms are all active globally, although they have separately-run affiliates in each country; local affiliates are well-versed in local accounting requirements, which are widely divergent. The stated motivations of proposed and consummated mergers were to increase global reach<sup>7</sup> and to take advantage of the economies of scope available to firms large enough to implement the massive technology upgrades that would allow vastly improved data collection and analysis. Moreover, combining one or more of the Big 8 could allow a more efficient use of labor and also enable firms economically to develop significant staff expertise in specific industries.

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<sup>1</sup> The “Big 8” firms were: Arthur Andersen, Arthur Young & Co., Coopers & Lybrand, Ernst & Whinney, Deloitte, Haskins & Sells, Peat Marwich Mitchell, Price Waterhouse, and Touche Ross.

<sup>2</sup> See: U.S. General Accounting Office, “Public Accounting Firms: Mandated Study on Consolidation and Competition”, Report GAO-03-864, July 2003 [hereinafter, “GAO 2003 Report”].

<sup>3</sup> In 1975, auditing services comprised about 70% of the Big 8's total revenues, while management consulting services contributed about 11%. In 1998, consulting services were about 45% of revenues, and auditing services were just over 30%. See: GAO 2003 Report.

<sup>4</sup> Deloitte retained its consulting group.

<sup>5</sup> “Accountancy in the United States: Industry Report” *Datamonitor USA*, September 2008.

<sup>6</sup> Byrnes, Nanette, “Consulting Pays Off for Accountants Again,” *Business Week Online*, August 21, 2007.

<sup>7</sup> In response to the increased globalization of their clients.

**Table 1. Top 10 Accounting Firms, by Size**

<b>Firm</b>	<b>Revenue (\$m)</b>	<b>Employees</b>	<b>Offices</b>	<b>SEC Clients</b>
<i>Deloitte</i>	9,849.0	32,483	101	1,264
<i>Pricewaterhouse Coopers</i>	8,362.0	24,692	75	1,193
<i>Ernst &amp; Young</i>	7,561.0	22,477	90	1,631
<i>KPMG</i>	5,357.0	16,879	89	1,033
RSM McGladrey	1,467.6	6,128	100	159
Grant Thornton	1,195.0	4,438	52	361
BDO Seidman	659.0	2,406	37	345
CBIZ & Mayer Hoffman McCann	500.7	2,329	33	27
Crowe Group	492.6	1,749	23	107
BKD	353.9	1,553	27	48

Source : Public Accounting Report's 2008 Top 100 (August 2008)

## 2. Industry participants

4. As is clear from Table 1, there is a significant gap between the Big 4 and the next-largest firms, by both revenue and employment. In fact, the revenue of the 5th through 10th largest firms combined is less than that of the smallest of the Big 4 (KPMG). Note also that the number of SEC firms served by accountants outside the Big 4 is dramatically lower as well. This supports the claim that large public companies have a strong preference for the skills, or at least the imprimatur, of Big 4 auditors on their mandatory financial reports. This could be a signal to investors regarding the quality of the firm<sup>8</sup>.

5. Another reason for a preference for a larger firm is the larger capital base that these firms offer. Auditors and firms are jointly liable for mistakes and omissions in financial disclosures; because of asymmetrical information and the sheer magnitude of the exposure, large auditors often choose to self-insure these risks. Such liability may be too large for a smaller firm to adequately insure itself and prohibitively expensive for it to insure through a third party.

6. Finally, firms view staff capacity and technical expertise as being very important when choosing an auditor; firms widely perceive the capabilities of smaller firms to be inadequate relative to the Big 4 firms in these areas<sup>9</sup>. In a GAO (2008) survey of a random sample of public Fortune 1000 companies, 86% of respondents stated that they were not likely to use a non-Big 4 firm for auditing services, indicating that smaller firms would have a difficult time expanding into the Big 4<sup>10</sup>.

7. The dissolution of Arthur Andersen in 2002 provides an interesting case study and test of some of these claims. 87% of Arthur Andersen's clients (by count) switched to a Big 4 firm. The likelihood that a client switched to a Big 4 firm was increasing in asset size. The clients that switched to Big 4 auditors had

<sup>8</sup> This may be especially important for mid-size firms.

<sup>9</sup> A single large client might need hundreds of the auditors' employees to be available during an audit. Accounting firms themselves also cite the lack of availability of qualified employees as one of the most significant hurdles to firm expansion.

<sup>10</sup> See: U.S. Government Accountability Office, "Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action," Report GAO-08-163, January 2008 [hereinafter, "GAO 2008 Report"].

average assets of \$2.5 billion, while the average asset size of the firms switching to non-Big 4 firms was significantly smaller, at \$309 million<sup>11</sup>.

### 3. The effect of consolidation on competition in the industry

8. In studies of the shift from the Big 8 to the Big 6, researchers have generally found that the efficiency gains realized by Ernst & Young and Deloitte Touche in their 1989 mergers appeared to dominate market power effects from the mergers. For example, audit price adjusted by the dollar value of assets audited declined steadily from the period 1990 through 1996, consistent with a more competitive industry<sup>12</sup>. Moreover, measures of input costs also indicate efficiency gains. Over this period, both the number of offices and the number of professional staff relative to total assets audited declined at a greater rate at the merged firms than at the non-merged Big 6 accounting firms<sup>13</sup>.

9. Based on such evidence, several studies have concluded that, despite the industry's increased concentration, there is little or no reason to suspect a reduction in price competition. Similarly, audit quality does not seem to have been much affected by consolidation. However, most studies note that it is very difficult to determine whether the price of audit services has risen in excess of the cost of providing services. Auditing requirements have changed considerably, especially as a result of Sarbanes-Oxley, and it is difficult to isolate the effects of these changes from an exercise of market power. Moreover, the quality of an audit is largely unobservable without a significant amount of effort<sup>14</sup>. There is not even agreement regarding what constitutes a "good" audit; certainly the auditor has a different perspective from mid-level management of the firm being audited. That said, none of the available, imperfect measures indicate the existence of a competitive problem.

10. The GAO 2003 Report analyzed whether the high market shares of the Big 4 could be consistent with price competition<sup>15</sup>. To do this, market shares were simulated by assuming that clients simply choose the firm with the lowest price; firms are thus homogeneous with respect to quality, expertise and reputation. This simple simulation yields market shares very close to what was actually observed; this is consistent with the hypothesis that the tight oligopoly structure of the accounting industry allows price competition. A 1998 study by Doogar and Easley reached a similar conclusion, using similar methodology<sup>16</sup>.

11. Additionally, a 2008 report published by the GAO finds that the increase in concentration of the audit services industry has not significantly affected the audit fees for large public companies<sup>17</sup>, who are

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<sup>11</sup> See Appendix III of the GAO 2003 Report. This number is somewhat skewed by a single large firm that switched to a non-major; 75% of those that chose a non-Big 4 firm had less than \$100m in assets. By contrast, 71% of companies that moved to a Big 4 company exceeded that threshold.

<sup>12</sup> See Susan Ivancevich and Asghar Zardkoohi, "An Exploratory Analysis of the 1989 Accounting Firm Megamergers," *Accounting Horizons*, 14:4 (2000).

<sup>13</sup> Relative to the dollar value of audited assets, the number of offices declined by 66% at the merged firms, versus 36% at other Big 6 firms. Professional staff fell 40% at Ernst & Young and Deloitte Touche; non-merging Big 6 firms decreased their staff count by 24%.

<sup>14</sup> That is, a duplication of the audit itself. Merely establishing empirically whether the Big 4 perform higher-quality audits than other firms is also quite difficult.

<sup>15</sup> See: GAO 2003 Report.

<sup>16</sup> Rajib Doogar and Robert Easley, "Concentration without Differentiation: A New Look at the Determinants of Audit Market Concentration," *Journal of Accounting and Economics* 25(1998) 235-253.

<sup>17</sup> Defined as public companies with revenues in excess of \$1 billion.

arguably the most at risk for price increases because of their reluctance or inability to use mid-size accounting firms. Looking beyond the very largest companies, which may well view the Big 4 as their only economical alternatives, smaller and/or private companies are likely to be able to take advantage of the significant amount of competition that exists below the Big 4<sup>18</sup>.

12. Although the largest corporations can nominally choose from at least four large audit services companies, in practice their choices are often more limited. Certain industries tend to heavily favor particular auditors; as either a cause or a consequence, these firms develop a depth of industry-specific expertise unmatched by rivals, and the preference for a particular auditor is reinforced. Other firms may not have adequate staff with the requisite expertise to take on more clients. Examples of industries for which auditing services are particularly concentrated are: agriculture, utilities and educational services, all of which have an industry HHI in excess of 3500<sup>19</sup>. Moreover, some firms may be unavailable due to conflict of interest considerations or because of regulatory requirements meant to assure auditors' independence. The limits Sarbanes-Oxley Act places on the consulting services that auditing firms can provide to their audit clients may serve to make the market for auditing services somewhat less competitive than it would be otherwise<sup>20</sup>.

#### 4. The prospects for further consolidation or expansion

13. There has been some concern that the remaining four accounting firms face a moral hazard problem resulting from the perception (either real or unfounded) that the U.S. government would not tolerate a reduction in the current number of market participants from four to three<sup>21</sup>. As a result, the Big 4 may be willing to take on more risk than may be prudent, convinced that the government will step in to save them in the event that a low-probability, high-cost event occurs.

14. The perception that the U.S. government may take the position that further consolidation in the Big 4, either through merger or failure, is unacceptable is partly grounded in the treatment of illegalities at KPMG in 2005. KPMG admitted to advising wealthy clients in the establishment of fraudulent tax structures. Rather than criminally investigating the company<sup>22</sup>, which could have triggered a collapse, the government prosecuted individual employees for their own wrongdoing. Eventually, however, most of the criminal charges against the individuals at KPMG were dropped<sup>23</sup>. Thus, market participants may not take the threat of enforcement especially seriously<sup>24</sup>. Moreover, it is believed that at least one proposed merger

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<sup>18</sup> The Big 4 audit 98% of the public firms with revenues of more than \$1 billion. By contrast, firms outside the Big 4 serve nearly 80% of companies with revenues of less than \$100 million. See: GAO 2008 Report.

<sup>19</sup> See: GAO 2008 Report.

<sup>20</sup> According to the GAO 2008 Report, 96% of large companies use one of the Big 4 companies for non-audit services, which could effectively reduce their choice of auditor to no more than three.

<sup>21</sup> See, for example, Lawrence Cunningham, "Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels," Boston College Law School Legal Studies Research Paper No. 108, September 2006.

<sup>22</sup> To avoid indictment, KPMG settled a federal investigation by paying a fine of \$456m. See, "Two Ex-KPMG Managers Sentenced Over Tax Shelters," *The New York Times*, April 1, 2009.

<sup>23</sup> Of the 19 criminal indictments resulting from the case, 13 were dismissed without appeal, 2 pleaded guilty, 3 were tried and sentenced and 1 was acquitted. *Ibid.*, and Lynnley Browning, "Prosecutors Pass on Chance to Revive Tax Shelter Case," *The New York Times*, December 1, 2008.

<sup>24</sup> See Cunningham (2006), *supra*, at n.21.

in the industry was abandoned during the late 1990s because the Antitrust Division expressed an unwillingness to allow the industry to consolidate from five to four<sup>25</sup>.

15. Firm failure may be especially likely in the current economic environment, as there is evidence that investors tend to sue firms and their auditors more often in times of economic downturns<sup>26</sup>. If the Big 4's costs increase substantially because of litigation expenses, it could lead to the failure of one or more accountancy firms. Failure could result either from the direct monetary costs of lawsuits or from damage to a firm's reputation sufficient to cause a mass exodus of clients - a major factor in the collapse of Arthur Andersen.

16. Despite the risk of further consolidation among the Big 4, it may be possible for smaller firms to break into the top tier in the longer term. Although it is difficult to make predictions about the long-term future structure of the industry, small and mid-tier accounting firms are increasingly gaining clients relative to the Big 4, especially small and mid-sized clients<sup>27</sup>. Indeed, the share of firms with \$100 - \$500 million in revenues audited by the Big 4 fell from 90% to 71% between 2002 and 2006<sup>28</sup>. Moreover, the second tier of accounting firms have been merging with one another to overcome some of the hurdles in serving the largest firms<sup>29</sup>. If these trends continue, the result could be a firm strong enough to one day challenge the Big 4's high share of the auditing services of the largest companies.

## 5. The Sarbanes-Oxley Act of 2002 and current issues in accounting

17. One of the most important recent developments in the accounting field occurred with the passage of the Sarbanes-Oxley Act in 2002. In response to a number of corporate and accounting scandals around the turn of the century<sup>30</sup>, the Act was intended to shore up investor confidence in publicly-traded companies. Sarbanes-Oxley introduced a number of new regulations designed to provide financial transparency to capital markets with respect to publicly-traded companies. The legislation increased financial reporting requirements, strengthened internal control structures and detailed the responsibilities of firm audit committees. It sought to ensure auditing independence and integrity by placing limits on the non-auditing activities that auditors could perform for their clients, and by requiring the rotation of managing audit partners<sup>31</sup> after five consecutive years in the service of a given client<sup>32</sup>.

18. In addition to these internal firm rules and regulations, the Act established the Public Company Accounting Oversight Board (PCAOB) to monitor accounting firms' activities and enforce compliance. The PCAOB is a private-sector nonprofit that is responsible to the SEC, which approves the PCAOB's proposed rules for accounting firms<sup>33</sup>. The PCAOB provides guidance to accountancy firms and

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<sup>25</sup> See: Antitrust Division, U.S. Department of Justice, Annual Report, 1999, available at: <http://www.usdoj.gov/atr/public/4523.pdf>.

<sup>26</sup> See: GAO 2008 Report.

<sup>27</sup> That is, less than \$500 million in annual revenues. See: Bill Carlino, "The Audit Order Changeth," *Accounting Today*, January 26-February 10, 2008.

<sup>28</sup> See: GAO 2008 Report.

<sup>29</sup> See: Philip Smith, "Mid Tier Could Shrink by a Fifth," *Accountancy Magazine*, June 2008.

<sup>30</sup> For example, Enron, Tyco and WorldCom.

<sup>31</sup> Note, this is not a requirement to switch auditing firms; rather the individual partners in charge of conducting the audit must be rotated.

<sup>32</sup> See: GAO 2008 Report.

<sup>33</sup> *Ibid.*

essentially audits the auditors, with the goal of providing an external source of information regarding audit quality.

19. There is little doubt that the additional requirements of Sarbanes-Oxley have increased auditing costs for publicly-traded firms<sup>34</sup>. In addition to there simply being more work to do, reporting requirements have become increasingly complex and technical. The oversight by PCAOB also increases auditing costs, as it takes time and effort to prepare for a PCAOB inspection. Implementation of Sarbanes-Oxley has occurred gradually, with full implementation achieved in December of 2008. By comparing firms that have adopted the new rules to firms not yet subject to the enhanced requirements (and controlling for other factors), a 2008 GAO study found that Sarbanes-Oxley requirements increased the firms' auditing bills by approximately 45%.

20. There remains a considerable amount of debate regarding whether the industry's reputation has recovered from the scandals of the late 20th century and whether the firms are today providing truly independent, high-quality auditing services. Having just reached full implementation in December 2008, Sarbanes-Oxley's progress toward that goal is still being evaluated.

21. In addition to Sarbanes-Oxley, several proposals have been made to deal with the industry's independence, further consolidation and moral hazard issues. To deal with auditor independence and integrity, for example, some have suggested that it may be useful to create audit-only firms or implement a mandatory rotation of accounting firms<sup>35</sup>. However, this would be at the expense of significant disruption and monetary cost. Moral hazard, some claim, could be addressed by putting a financial statement insurer between the auditor and the client. Because it would be liable for the quality of the audit, the insurer would have a clear interest in enforcing rigorous audit standards and practices at the accounting firm to mitigate risk. A strategy to maintain at least four major competitors might be to hold individual auditors criminally responsible for their misconduct. This would allow the government to punish bad behavior without putting the entire firm at risk of failure. Many proposals have also been made to reverse concentration in the industry; however, as discussed above, these find little support based on the available evidence of the effects owing from consolidation over the past two decades.

## **6. Past DOJ and FTC enforcement and advocacy**

22. Over the years, the Department of Justice and Federal Trade Commission have brought a number of enforcement actions and engaged in competition advocacy in an effort to promote competition in the profession. As noted in our submission to the June 1999 roundtable,

*In 1997, FTC staff opposed a proposed rule by the Washington legislature that would require candidates for Certified Public Accountant status to earn at least 150 semester hours of undergraduate academic credit. Economic analysis indicated that such a rule would raise the educational entry requirements for CPA licensure and in turn would likely increase costs of entry and raise prices to consumers of CPA services. The comments also noted there was no persuasive evidence that the net effect of the proposal would be beneficial to consumers.*

*In 1990, the Commission charged the American Institute of Certified Public Accountants, the dominant professional association in the accounting field, with restricting truthful, non-deceptive advertising by prohibiting members from making truthful claims in self-laudatory or comparative advertisements, or using truthful testimonials. It also alleged that the association restricted*

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<sup>34</sup> That is, the misconduct of accounting firms has led to an increase in the demand for their services.

<sup>35</sup> Recall that Sarbanes-Oxley requires auditor rotation, not firm rotation.

*members' efforts to solicit clients directly and by referrals. The consent order bars the association from prohibiting its members from engaging in these practices*<sup>36</sup>.

23. The DOJ was involved in reviewing the major accounting firm mergers of the late 1980s and late 1990s. In the 1980s, the DOJ threatened to sue the West Virginia Board of Public Accountancy and sued Louisiana's State Board of CPAs over their advertising and solicitation bans. In the 1970s, the DOJ successfully sued the American Institute of Certified Public Accountants and the Texas State Board of Public Accountancy for their competitive bidding bans.

24. The state action doctrine exempts certain anticompetitive actions of state licensing boards from antitrust scrutiny. The DOJ's suit against the State Board of CPAs of Louisiana was dismissed on state action grounds in 1987<sup>37</sup>. More recently, in *Earles v. State Bd. of Certified Public Accountants of Louisiana*<sup>38</sup>, a private antitrust action, the court held that a board established by the state to regulate the accounting profession was exempt from a claim based on the federal antitrust laws because the board was acting pursuant to a state policy to displace competition with regulation that was clearly articulated and affirmatively expressed. The broad statutory grant of authority to the board to "adopt and enforce all rules and regulations, bylaws, and rules of professional conduct as the board may deem necessary and proper to regulate the practice of public accounting" included, according to the court, "the power to adopt rules that may have anticompetitive effects." The challenged rules prohibited CPAs from accepting commissions and engaging in the practice of "incompatible" professions; plaintiffs were CPAs who also wished to practice concurrently as securities brokers.

25. Accountants have at times also been subject to law enforcement actions as a result of their direct participation in anticompetitive conduct. In *U.S. v. Federation of Surgeons and Specialists, Inc.*,<sup>39</sup> for example, the DOJ in 1999 sued and obtained a consent decree that prohibited a federation of surgeons and specialists and its accounting and consulting firm from negotiating with managed care plans jointly on behalf of otherwise competing member physicians to obtain higher fees for their services. The firm acted as the negotiating agent for the federation.

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<sup>36</sup> American Institute of Certified Public Accountants, 113 F.T.C. 698 (1990).

<sup>37</sup> *U.S. v. State Bd. of Certified Public Accountants of Louisiana*, 1987 WL 7905 (E.D.La.).

<sup>38</sup> 139 F.3d 1033 (5th Cir.), cert. denied, 525 U.S. 982 (1998).

<sup>39</sup> 1999 WL 1210842 (M.D.Fla.).