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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

1. Overview

1. Prior to 1989, there were eight major accounting firms in the U.S.[1]. 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[2].

2. During this period of consolidation, the largest firms moved from being mostly auditing firms to

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[11].

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[12]. 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[13].

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[14]

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[18].

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

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[34]. 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 efiort 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 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.