

the Future  
of the Accounting  
Profession:  
Auditor  
Concentration

May 23, 2005

New York, NY

The American Assembly  
Columbia University

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## PREFACE

On May 23, 2005, fifty-three men and women, including leaders from the worlds of accounting, finance, law, academia, investment banking, journalism, as well as corporate board members and audit committee chairs gathered at The University Club in New York City for an American Assembly meeting on “The Future of the Accounting Profession: Auditor Concentration.” This meeting examined the current degree of audit firm concentration, whether more competition should be encouraged, how to prevent increased concentration, and other steps needed to ensure the continued stability and vibrancy of the accounting profession. “Auditor Concentration” was a follow-up to the November 2003 “The Future of the Accounting Profession” Assembly, held at the Lansdowne Resort, Leesburg, Virginia.

This Assembly project was co-chaired by Roderick M. Hills, partner, Hills & Stern, and former chairman of the SEC, and J. Michael Cook, former chairman and chief executive officer, Deloitte & Touche USA LLP. We are indebted to them for their leadership and guidance on virtually every aspect of this project including designing a new format for The Assembly that allowed for an effective examination of the topic in a brief period. The meeting consisted of opening and mid-day addresses and five panels; the meeting’s agenda, which includes the names of the speakers, moderators, and panelists, can be found at the end of the report. We are extremely grateful to each of our presenters for their valuable intellectual contribution. We are especially appreciative of Stefanie Smith, principal, Stratex Corporation, for her expertise and assistance throughout the planning of this project and for her help in assuring the success of this Assembly. Additionally, The Assembly’s Megan Wynne and Victoria Vyalikova of Hills and Stern were instrumental in the administration of the project.

We are grateful to Professor James D. Cox for allowing us to distribute his paper, "The Oligopolistic Gatekeeper: The U.S. Accounting Profession," and to Professor Rajib Doogar for the use of his data tables, which provided background for our diverse group of participants. The participants were also sent excerpts from the Government Accountability Office's (GAO) July 2003 study, "Public Accounting Firms: Mandated Study on Consolidation and Competition." The entire GAO report is available at <http://www.gao.gov/new.items/d03864.pdf>.

Unlike other American Assemblies, which take place over several days of intensive discussions, or Assembly reports, which are reviewed by the participants at a final plenary session, this meeting did not intend to fully examine every issue identified in our ambitious agenda in this report. This report aimed to identify and describe briefly key issues put forth by the participants in their discussions. What follows is our best reflection of what was said at this meeting, and it is our hope that it may provide impetus for further study. The text of the report is available on The Assembly's website, [www.americanassembly.org](http://www.americanassembly.org).

The American Assembly takes no position on any subjects presented here for public discussion. Comments by participants were on a not-for-attribution basis, and it should be understood that participants spoke for themselves and not for the organizations with which they are affiliated. It should also be noted that the three current regulators who participated in the conference did so not in an official capacity but as individuals. Their participation should in no way be seen as an endorsement of the report or its findings.

The American Assembly wishes to gratefully acknowledge the generous support of the foundations, corporations, and individuals who made this project possible.

Richard W. Fisher  
Chairman  
The American Assembly

David H. Mortimer  
Chief Operating Officer  
The American Assembly

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### **DISCLAIMER**

**The participants in the American Assembly meeting "The Future of the Accounting Profession: Auditor Concentration" on May 23, 2005 in New York City, did not review a draft of this report at the conclusion of the meeting, or prior to its publication. This report is our best representation of what was said at the meeting. No attempt was made to reach conclusions or achieve consensus at the Assembly.**

**The participation of those who presently serve in a regulatory position should not be taken as an endorsement of any of the views or recommendations herein.**

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## INTRODUCTION

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In its 2003 report “The Future of the Accounting Profession” The American Assembly reaffirmed the fact that respect for our capital markets depends on the integrity of our financial reporting system. James D. Cox in his paper, “The Oligopolistic Gatekeeper”, which was distributed to participants in advance of this Assembly, described the auditor as “the guardian of financial disclosure.” It necessarily follows that the auditing profession must remain healthy, viable, and stable. This timely Assembly convened to consider the questions:

- Whether the loss of Arthur Andersen has caused a dangerous concentration of the profession.
- Whether steps can and should be taken now to alleviate that concentration; and
- Whether steps can and should be taken to prevent a further concentration.

## I. THE ISSUES OF CONCENTRATION

### THE STATE OF THE PROFESSION

The process of consolidation that has produced the current degree of concentration began in 1989, when mergers reduced the number of big firms from eight to six. The 1998 formation of PricewaterhouseCoopers cut that number to five. At that point, there was concern among regulators and legislators that the degree of concentration would reduce competition, limit audit clients' choice, and potentially have a negative impact on both audit quality and cost.

In 1997 an announcement by Ernst & Young and KPMG that they were planning a merger, following the merger announcement of Price Waterhouse and Coopers & Lybrand, prompted both the United States Department of Justice and the European Commission of the European Union to begin consideration of whether that merger should be opposed as anticompetitive. The parties decided not to merge for

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business reasons and not, apparently, because of any threatened government opposition to it. Nonetheless, there was considerable concern at the possibility that there would be only four big firms.

The collapse of Arthur Andersen in 2002 made real what the Ernst & Young/KPMG merger threatened and created a new accounting landscape: now there are only four firms capable of serving the largest U.S. public companies. The current members of the "Big 4" are PricewaterhouseCoopers, Deloitte & Touche, Ernst & Young, and KPMG. Arthur Andersen's collapse, together with the revelation of numerous accounting scandals, also created a new regulatory environment; the passage of the Sarbanes-Oxley Act of

2002; the attendant creation of the Public Company Accounting Oversight Board (PCAOB) to oversee the formerly self-regulating auditors of public companies; and the imposition of new regulations from the stock exchanges and the U.S. Securities and Exchange Commission (SEC).

One feature of the Sarbanes-Oxley Act barred firms from providing certain non-audit services to their audit clients and required that the corporation's audit committee must approve all services provided by the firm's external auditor. The Act also required auditors to examine and report on companies' internal

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controls – the practices in place to maintain records and prevent abuse or fraud known as Section 404.

As a result both of the scandals and the new laws and regulations, the accounting profession has much

more work to do but those companies that rely on the large accounting firms must deal with the fact that today there is one less large firm to provide the various services they require.

According to the Government Accountability Office's (GAO) July 2003 Mandated Study on Consolidation and Competition, the Big 4 audit 78% of all U.S. public companies and 97% of those with sales of more than \$250 million. The Big 4 audit 99% of all public company sales, and dominate the international audit market. The next tier of global firms, the largest of which are Grant Thornton, BDO Seidman, and McGladrey & Pullen, generally lack the capacity to audit the largest public companies. According to the GAO study, each Big 4 firm has almost three times as many partners and more than five times as many non-partner professional staff as the average for the next three largest firms. The smallest Big 4 firm in terms of 2002 partners and non-partner professional

staff from U.S. operations is over five times the size of the next largest firm. Moreover, the gap between the Big 4 and the mid-tier firms has grown significantly since 1988. Arthur Andersen's demise only heightened the degree of concentration; according to the GAO report, 87% of the more than thousand companies formerly audited by Arthur Andersen switched to a Big 4 auditor. Mid-tier firms have significant difficulty competing for large, multinational companies as clients, and face legitimate and artificial barriers to acquiring a larger share of the audit market. The GAO study concluded that the Big 4 firms constitute an oligopoly, which they defined as the top four firms accounting for a very high percent of the large company audit market, with other firms facing significant barriers to entry.

The participants at the "Auditor Concentration" Assembly examined the current state of concentration among audit firms. The first question discussed by the Assembly was whether this concentration has caused or is likely to create serious anti-competitive problems for business.

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## **IS CONCENTRATION A SERIOUS PROBLEM?**

There was a broad understanding that concentration can only be a problem for those companies that believe they must use one of the Big 4. Whether that belief is well founded for all companies is a matter discussed later.

As earlier indicated, the Big 4 clearly constitute an oligopoly, but there is no indication that they have behaved like one in terms of pricing, competition, and commoditization of services. The July 2003 GAO report noted that "the observed high degree of

concentration to date is not necessarily inconsistent with a price-competitive environment.” In “The Oligopolistic Gatekeeper” Professor Cox writes that since 1972 when the American Institute of Certified Public Accountants (AICPA) removed its ban on bidding for audits, competition among major accounting firms has been “intense and vicious.” While audit costs have risen in the past two years, it is widely acknowledged that much of the additional cost can be traced directly to the requirement of complying with the provisions of the Sarbanes-Oxley Act, particularly with Section 404.

The greatest potential problem of concentration is the degree to which companies have a real choice of auditors. Companies must

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grapple with new regulations that aim to prevent conflicts of interest by barring firms from offering auditing and other services to the same company.

When a large company wishes to change from one of the Big 4 firms to another it may face a real dilemma. It surely will be using one of the other Big 4 firms for tax advice, to assist with the internal audit, or for other non-audit consulting services that its existing external auditor is forbidden to perform, and it is not unusual for a firm to be using all four of the Big 4.

Also, some companies believe that it cannot retain an auditor that serves its chief competitor, and many have conflicts of interest through personal or other disqualifying relationships. Lack of choice is especially pronounced in some industries where two accounting firms dominate the available expertise. Participants cited several examples of this, including petroleum and coal products companies, where, in 2002, two firms audited nearly 95%

of the industry, measured by assets, compared to three of the Big 6 auditing roughly 83% of the industry in 1997.

Because of the current degree of concentration and seeming dearth of options, audit firms do have an increased degree of influence over their clients. With their options so limited and with the expensive prospect of redoing Sarbanes-Oxley compliance work in the event of retaining a new auditor, panelists as well as the others in attendance recognized that the loss of Arthur Andersen and regulatory changes has severely limited the options available to those companies that believe they must use one of the Big 4 firms.

Notwithstanding these limitations on choice, the prevailing view of the panelists was that the business world can live with the four firms. The sentiment of the audience as a whole accepted this conclusion and no one suggested the need for drastic action today to increase the number of large firms.

Nonetheless, the strong view of the participants is that those companies that must use one of the Big 4 may have problems because of the lack of more competition and choice. Moreover, the near unanimous view of the participants is that loss of another of the Big 4 could create an intolerable situation.

## II. CAN WE GET MORE COMPETITION?

Participants commented on a variety of factors that have produced the current oligopoly. One of the most important of these is the global expansion of U.S.-based companies. As their clients expanded sales and production internationally, accounting firms responded by creating a global infrastructure to serve every part of an international business. The need for such infrastructure and to

establish economies of scale to ensure efficiency and profitability also drove the mergers of the largest firms from eight to five. Their greater size and resources allow the largest firms to self-insure and manage the ever-present risk of litigation. Increased size enabled firms to develop deep industry and technical expertise. Because of the necessity of size, global reach, technical expertise, and capacity it was generally agreed by the participants that the largest firms now serviced by the Big 4 are beyond the reach of even the largest of the mid-tier firms.

Most of the participants accepted that mid-tier firms do have to *...mid-tier firms do have to play a larger role in the market...* play a larger role in the market and noted that there are both real and artificial barriers to their ability to increase their market share and present a real alternative to the Big 4 for companies of appropriate size and scope.

### **REAL BARRIERS TO COMPETITION FROM THE MID-TIER FIRMS**

As described earlier, even the largest of the mid-tier firms are significantly smaller than the smallest Big 4 firm. Mid-tier firms are constrained by their lack of capacity, limited global reach, and lack of experience and technical expertise in certain industries. Greater size has allowed the Big 4 firms to attract large numbers of the brightest graduates and retain talented, experienced professionals. Multinational companies cite the deep and broad concentration of expertise and talent in the national office of a Big 4 when selecting one of those firms as their auditor. Big 4 firms often include former regulators and are seen as having insight into the thought and actions of the regulatory bodies. The Big 4's facility with new requirements is seen as increasingly important as

Sarbanes-Oxley compliance becomes more complex and time-consuming with the significant financial consequences of noncompliance.

Some participants, in addition to those who are members of mid-tier firms, expressed the view that belief in the Big 4's regulatory competence is overstated, citing the fact that many former Andersen partners now work for mid-tier firms, bringing with them the knowledge and contacts they possessed at a large firm.

Practically all those present expressed the belief that mid-tier firms could satisfactorily serve a large number of those companies that seem to be principally served by the

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Big 4. To the extent that there was disagreement on this point it was over the size of the market in which mid-tier firms could effectively compete with the Big 4.

## **ARTIFICIAL BARRIERS**

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In addition to the real barriers mid-tier firms face as they try to break into the market of Big 4 audit clients, there persist artificial barriers to entry that some believe can, and should, over time be reduced. Mid-tier firms are continually confronted by the perceptions of investment bankers, attorneys, analysts, the investing public, and others that constrain them from retaining as clients many companies that they believe are within their capacity to audit. Participants from these user groups conceded that such perceptions are to some extent unwarranted.

However, the patina of authority and confidence that surrounds the Big 4 influence the sell side analysts as they evaluate companies, ratings agencies as they categorize companies, buy side analysts

when advising investors, and attorneys when counseling companies poised to make an initial public offering (IPO). The dominance of the Big 4 is cemented by the encouragement, and in some cases demand, of these market players that a company retain a Big 4 auditor, even if their size is such that they could competently be audited by a mid-tier firm. Analysts and investment bankers often are 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 4 because of high risk, or raising a specter of doubt about the validity of their financial

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***For risk-averse directors, selecting a Big 4 auditor seems to be the prudent move.***

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statements. This is especially true when the company is new to the public markets (as in an IPO) or when a company is changing its auditor, always a decision that is scrutinized by investors. For risk-averse directors, selecting a Big 4 auditor seems to be the prudent move.

Mid-tier firms also suffer from their relatively low profile. It was the view of several participants that most audit committee chairs of the larger companies do not often consider the question of whether a mid-tier firm may be a good substitute for a Big 4 auditor. Picking a mid-tier firm is often not a consideration for large public companies. This is true even with those companies whose scope and breadth make them candidates for a smaller auditor, because the perception from the boardroom to the trading floor is that the Big 4 have the depth of knowledge and the global network that are believed to increase the quality and reliability of the audit itself.

## **POTENTIAL REMEDIES**

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Panelists concluded that there is little if any possibility that market conditions will enable another firm to emerge to compete with the Big 4 for their largest public company clients.

A remote, unpalatable but theoretically possible course of action would be to split the large firms e.g. from four back to eight. This alternative to the current system was viewed as a doomsday, worst case scenario with potentially severe consequences for the firm, the profession, and the capital markets. Likewise, there was little, if any, support among the participants for urging the U.S. government, through an anti-trust initiative, the SEC, or legislation to seek to create another Big 4 competitor. A consensus view was that circumstances today are not such as to justify such drastic action.

A view expressed by more than one participant is that four major firms may be all that the market can bear. It was largely market conditions that shrunk the Big 8 to the Big 5, and even before the Andersen debacle serious consideration was given to another merger that would have reduced the number to four.

Similarly, there was considerable skepticism about the possibility that mergers amongst the mid-tier firms could produce a competitor to the Big 4. Putting two firms together that do not have the global reach or the industry expertise to challenge the Big 4 would be unlikely to create a firm that could compete.

***... there was little, if any, support ... for creat[ing] another Big 4 competitor.***

Mandatory audit firm rotation was also thought by many to be an unhelpful step. It would do nothing to alleviate the problem of concentration. It would exacerbate the already heavy workload placed on management and auditors by the new laws and regulations. Moreover, being forced by the government to stop using a Big 4 firm that is otherwise satisfactory is unlikely to cause audit committees to replace such a firm with a mid-tier firm.

Most participants expressed the belief that the mid-tier firms are capable of penetrating some part of the market that is now dominated by the Big 4. In fact, the Big 4 have been compelled to

shed some clients, to comply with new conflict of interest regulations. Also, in order to compete for the larger clients that were served by Arthur Andersen they may have had to yield their relationship with some of their smaller clients. As a result of these actions and because experienced partners of Arthur Andersen have joined them, the mid-tier firms are securing certain former Big 4 clients.

Participants offered other reasons for believing that mid-tier firms will have increasing opportunities to compete for work with the Big 4:

**...mid-tier firms will have increasing opportunities to compete for work...**

- While there was little or no support for the mandatory rotation of auditors, a number of the participants believe that audit committees should reconsider the performance of their external auditors at regular intervals: say five years. As this practice becomes more common mid-tier firms will have increasing opportunities to compete for clients of the Big 4.
- It was suggested that the mid-tier firms perform outreach to audit committee chairs, attorneys, and investment bankers who work on IPO's, and also to members of the Big 4 who will help companies consider alternatives when they necessarily shed clients. Such familiarity will improve the chances that they would advise a former client to consider a mid tier firm.
- As more firms either outsource their internal audit function or use an external auditor to bolster their own internal audit department, mid-tier firms may have more opportunities to become associated with the larger clients of the Big 4. The fact that a mid-tier firm may not have the capacity to conduct an audit of a multi-billion dollar international corporation does not mean that the same mid-tier firm could not assist the internal audit function.

- One view expressed was that regulators should include more mid-tier representatives in the debates concerning new regulations and reforms.
- A fairly general view is that analysts, credit rating agencies, investment bankers and lawyers need not be as doctrinaire as they appear to be in persuading their clients not to use mid-tier firms.

### III. CAN WE PREVENT FURTHER CONCENTRATION?

**The following part of the Assembly was spent on issues relating to the potential loss of one of the remaining Big 4 firms. This loss could result from a variety of reasons, most probably from ruinous litigation or a government decision to dissolve a firm. Time constraints prevented a full examination of these complex issues. What follows is a collection of ideas in brief about how to prevent further concentration. The participants did not explore the nuances of how, or even if, these solutions should be implemented. The aim of the discussion was to highlight the serious consequences to the capital markets of being left with just three big firms.**

Although participants were for the most part sanguine about the fact that the Big 5 has become the Big 4 there was substantial concern among most if not all participants about the potential loss of another Big 4 firm. The current degree of concentration in the profession raises the specter that the collapse of a Big 4 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

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***...any event that causes another firm's collapse would automatically call into question the viability of the survivors.***

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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.

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## **CAUSES AND CONSEQUENCES OF THE LOSS OF A BIG 4 FIRM**

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The consequences of losing another member of the Big 4 to civil and/or criminal litigation could potentially include the end of the public company audit profession. If another audit failure were to result in a severe decline in confidence in the reliability of financial statements, a possible outcome could be the government taking over public company audits. This would undoubtedly result in a decrease in the attractiveness of audit work, and would lead qualified people away from the profession.

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***...the greatest risk to maintaining the current system is the omnipresent threat of litigation.***

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Many believe the greatest risk to maintaining the current system is the omnipresent threat of litigation. And this is the conundrum. Private litigation is an essential part of our system of corporate governance

and few would argue that accountants should not bear their share of the responsibility for the corporate debacles of recent years.

However, two factors were cited by participants as reasons for regulators to take immediate steps to address the risk that unwarranted litigation may destroy one of the Big 4.

First the tempo of litigation against accountants has picked up substantially. Each of the Big 4 firms have significant claims in excess of capital.

Second, there is widespread agreement that the profession in the United States needs to move away from what is called a rules-based system to one that is based more on basic principles. There is a justifiable fear that the submission of the judgment of auditors to courts and juries will only exacerbate the spread of unwarranted litigation against auditors. Fear of liability leads firms to a check-the-box approach to auditing, attempting to avoid possible penalization by complying to the letter, rather than the spirit, of the law. The recommendation that auditors should move away from a “rule checking” mentality to one that relies far more on judgment was raised in the November 2003 American Assembly on “The Future of the Accounting Profession.” That report contains an extensive discussion of the implications of such a move.

## UNDERSTANDING THE AUDIT’S ROLE

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Investors should be comfortable that they are getting reliable data in as timely a fashion as possible, which may call for more flexibility in the timing and context of financial disclosures. It is important that financial statements communicate the actual financial conditions of the firm, not merely in relation to Generally Accepted Accounting Principles (GAAP). A company’s failure comes as a surprise when regulators, auditors, and investors focus on compliance with a set of rules rather than information pertaining to the financial condition of the firm.

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***... financial reports, no matter how accurate, are static representations of fluid, complicated companies.***

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However, financial reports, no matter how accurate, are static representations of fluid, complicated companies. It is impossible to identify all problems or account for all contingencies in the audited financial statements. An audit firm’s attestation is the result of a

series of subjective judgments and its limits should be recognized by regulators, financial analysts, and investors. Moreover, it is almost impossible for an auditor to unearth a collusive fraud when it is the product of a conspiracy involving senior managers at the client company, especially if there is third party involvement. Though auditors often convey this limitation to audit committees, it is not clear to the investing public, which harbors a belief in the audit's perfection. There is a profound disconnect between investors' expectations and what an audit can actually accomplish. The profession must reconcile this disconnect. There are varying degrees of certainty that auditors can deliver, and the attestation should reflect what is definitively measurable, such as cash flow, but certify that fair-value estimates or management judgments are reasonable within a certain range. Since the attestation does not currently reflect differing levels of certainty or the subjective nature of many of the judgments, auditors are held accountable to the same degree when attesting to all aspects of a financial statement.

#### **INCREASED LITIGATION IS A SEVERE THREAT TO THE REMAINING BIG 4**

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As noted above, litigation plays an important role in maintaining accountability in financial markets. Regulation is not an adequate substitute for litigation as a means of ensuring accountability. Litigation offers compensation to aggrieved shareholders, serves as a corrective for non-compliant or fraudulent firms, underscores the reliance investors place in the market, and can foster quality within firms.

The downside of litigation is that it increases transaction costs that are already enormous. The real problem is that unwarranted litigation puts serious accounting issues before unsophisticated juries. Whenever a corporation has a serious and unexpected

earnings downturn our watchful and vigorous plaintiff's bar is likely to sue the auditors claiming that they approved misleading financial statements.

The current pattern of litigation involves huge claims—one Big 4 firm faced claims for damages of \$12.5 billion—the extent of which

***The current pattern of litigation involves huge claims...***

prevents firms from even bringing their cases to trial, forcing them to settle to avoid potentially debilitating damages. Jury trials pose a significant hurdle for defendants, as the complex, technical issues that fraud and other cases often involve are difficult to explain to those with limited financial background, especially in the face of unrelenting publicity and sympathetic plaintiffs.

Even without going to trial, and exempting the possibility of damages, litigation is costly to the individual firm being sued. Litigation also damages the profession as a whole by decreasing the attractiveness of an audit career and making the partner position less appealing because the threat of lawsuits puts a partner's equity stake in the firm in jeopardy. For partners, the specter of being held accountable for an audit failure in a separate office in a different state or even country is daunting, which prompted discussion of whether the limited liability partnership was the appropriate business model for the profession. Malfeasance or incompetence in a distant outpost could potentially destroy an entire firm.

Moreover, there is no potential for a functional insurance product to deal with the problem of excessive litigation. While insurance covering routine business risks is available, the Big 4 are essentially unable to obtain any catastrophic risk coverage. Catastrophic risk is so unpredictable, akin to lightning striking, that it is nearly impossible to determine what premium to charge. Insuring large accounting firms has historically been a money-losing endeavor;

with the current degree of concentration the pool is not large enough to spread risk and costs to produce returns for the insurer. The view of the Big 4 as having deep pockets contributes to insurance not being a solution to contain liability. This has left the Big 4 in the inherently risky position of being self-insuring as they confront an unprecedented wave of litigation.

With the huge financial repercussions that stem from restatements or fluctuations in earnings and profits, the threat of litigation, and no catastrophic protection from either insurance or regulators, firms are becoming increasingly cautious, dropping clients whose businesses are more complex, more volatile, more troubled and thus more prone to having their audited financial statements subjected to second-guessing by investors and others. Firms are further protecting themselves by urging their clients to reinforce their internal audit function, and assisting them in that process. Another consequence of firms' increasingly cautious behavior is the adherence to a rule checking mentality.

## RECOMMENDATIONS

Participants generally agreed that regulators must provide serious leadership as they balance their responsibility to respond to sloppy auditing work or even abuse with an understanding of the potential impact of losing another Big 4 firm. Establishing proportionality is essential so that audit inaccuracies do not result in the demise of entire firms, ending the careers of thousands of people and disrupting the financial markets. Regulatory bodies can play a crucial role in maintaining the health of the audit profession by responding to industry concerns outside of the legislative framework. An industry task force may well be

essential to establish responsible public policy solutions.

Participants widely agreed that the threat of liability and the consequences of losing another Big 4 firm are more serious than most people realize, and far more serious than just a few years ago. The following recommendations to prevent further concentration in the audit profession garnered the largest degree of support.

- Regulators should use their authority and wide public reach to establish in the public mind that there is no such thing as an infallible audit. Enabling auditors to offer a range of attestations that reflect the real range in values that exist in practice would be a way to acknowledge the unavoidable, integral role that judgment plays in an audit.
- Participants suggested that a different business model, more akin to a multi-national corporate structure with subsidiaries operating worldwide, would be better equipped to deal with the 21st century's complex global economy than the limited partnership format currently used. Centralizing firm management to institute uniform audit standards would give firms a better opportunity at preserving liability limited to those geographies. It would also lessen risk, protect a firm's reputation, and ensure compliance. Implementing this change would face significant obstacles from state and country regulators, which prohibit outside influence or ownership of local firms.
- Participants did not agree on whether setting a cap on damages is a sensible objective. It would serve as a way to establish proportion between losses sustained, a firm's assets, and damages sought. A problem today is that an accounting firm may not be able to take the risk of a jury trial when the claim is

for billions of dollars even if the firm is reasonably certain of winning. A ceiling on damages would allow firms to take their cases to trial, and would not undermine the accountability that liability provides.

- Participants discussed at length the impact that the PCAOB's inspections will have on the quality of auditing work. Participants understood that the PCAOB may examine the audit work done by the Big 4, and others, on high risk accounts. If a firm has been found in good shape by the PCAOB participants expressed the view that this fact alone should provide a measure of protection from unwarranted litigation.
- Lawyers among the participants expressed the view that the SEC does have the authority to create a limited safe harbor that would protect auditors from having good faith judgments subjected to undue litigation. Perhaps such a safe harbor could be contingent upon a review by the PCAOB of the audit in question. The safe harbor certainly would not prevent the SEC from itself pursuing a firm in cases of malfeasance or egregious oversight. Participants appeared to be in agreement that the SEC and the PCAOB should explore the feasibility of some type of safe harbor provision to reduce the risk of having a firm destroyed by unwarranted litigation.

## CONCLUSION

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The audit profession plays a crucial role in ensuring the integrity of financial reports and thus of the financial markets. In the words of one participant, the current state of the auditing profession is akin to a coral reef in the wake of a hurricane. The fragile ecosystem has been damaged in some areas and remains vulnerable, but is alive and in the process of rebuilding.

This Assembly addressed the issues facing the audit profession in the context of worrying levels of concentration. While the goal of the meeting was not to reach a consensus or come to specific conclusions, a general view of the status of the audit profession and the threats it faces did emerge. Concentration is problematic insofar as it creates an environment where large public companies may have no or only one alternative to their current auditor. The existence of an oligopoly, however, has not affected audit cost or quality. The largest multinational companies require similarly large and multinational audit firms, and their needs are currently being met by the members of the Big 4, even if their choices among the firms are limited. More can be done so that mid-tier firms can confidently and competently audit a greater share of the market. Participants did not believe that government action should be taken to attempt the creation of another large firm. Increased concentration, brought on by the collapse of one of the four large firms, however, would be disastrous for the remaining firms, public companies, the financial markets, shareholders, and investors.

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There is a need for financial leaders to act with a sense of urgency and coalesce around solutions to offer a framework of what the audit profession, regulators, and government officials should do to protect and preserve the role of the private audits of public companies.

## PARTICIPANTS

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*Founder & Chief Executive Officer*  
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*President*  
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*Audit Committee Chairman*  
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**Philip Livingston**

*Vice Chairman*  
Approva Corporation  
Vienna, VA

**\* Simon M. Lorne**

*Vice Chairman*  
Millennium Partners, LP  
New York, NY

**† Thomas J. McCool**

*Managing Director, Financial Markets  
and Community Investment*  
U.S. Government Accountability Office  
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*Retired Chairman of the Board and CEO*  
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Boise, ID

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*Deputy Chairman*  
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*Vice Chair*  
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*Former Chairman of the Board*  
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*Advisory Director*  
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Graduate School of Business  
University of Chicago  
Chicago, IL

**Ω Michael R. Young**  
*Partner*  
Willkie Farr & Gallagher LLP  
New York, NY

## **REGULATORS**

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Regulators participated at The Assembly as individuals, but take no stance on the report

**Ω Kayla J. Gillan**  
*Board Member*  
Public Company Accounting Oversight  
Board (PCAOB)  
Washington, DC

**∞ Ω Charles D. Niemeier**  
*Board Member*  
Public Company Accounting Oversight  
Board (PCAOB)  
Washington, DC

**Ω Cynthia A. Glassman**  
*Commissioner*  
U.S. Securities and Exchange  
Commission (SEC)  
Washington, DC

## **OBSERVERS**

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**Julie Bell**  
*Counsel to Commissioner Cynthia A.  
Glassman*  
U.S. Securities and Exchange  
Commission (SEC)  
Washington, DC

**Stefanie Smith**  
*Principal*  
Stratex Corporation  
New York, NY

♣ Co-Chair  
Ω Panelist  
\* Moderator  
† Respondent  
∞ Addressed Assembly

## **APPENDIX**

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### **THE AMERICAN ASSEMBLY**

#### **Columbia University**

#### **“The Future of the Accounting Profession: Auditor Concentration”**

**May 23, 2005**

#### **Monday, May 23**

9:10 am Welcome: David H. Mortimer  
*Chief Operating Officer,  
The American Assembly*

9:15 am Opening Statement:  
“A Summary of the Issues of Concentration”

Delivered by: J. Michael Cook  
*Former Chairman and CEO,  
Deloitte & Touche USA LLP*

Respondents: James D. Cox  
*Brainerd Currie Professor of Law,  
Duke University*

Thomas J. McCool  
*Managing Director, Financial  
Markets and Community Investment,  
U.S. Government Accountability Office  
(GAO)*

David S. Ruder  
*Professor of Law, Northwestern  
University School of Law; Former  
Chairman, U.S. Securities and Exchange  
Commission (SEC)*

Brief Period of Questions and Answers

## PANEL DISCUSSIONS

*The Moderator briefly frames the issues and introduces the panelists who give short presentations to stimulate participation from the audience. The Moderator may interject further questions to the panelists or the audience.*

### I. WHAT ARE THE PROSPECTS OF CREATING MORE COMPETITION?

10:30 am PANEL 1

**Are there steps that can be taken that will enable the mid-tier firms to compete for more of the existing clients of the Big 4? Is it realistic to believe that one or more of them can eventually evolve into a full scale competitor of them?**

- Are there artificial barriers that prevent mid-tier firms from competing successfully for a significant number of Big 4 clients?
- Do companies preparing for an IPO have a significant advantage if they switch to a Big 4 firm?
- What size, geographical, or technology issues prevent the mid-tier firms from representing more Big 4 clients?
- Is a mid-tier firm likely to be less expensive than a Big 4 firm?
- Are the mid-tier firms currently acquiring significant work from former clients of the Big 4?

**Moderator:** Roman L. Weil  
*V. Duane Rath Professor of Accounting,  
University of Chicago Graduate School of  
Business*

**Panelists:** Cheryl Francis  
*Vice Chairman, Corporate Leadership Center;  
Board Member, HNI Corporation, Hewitt  
Associates, and Morningstar*

Cono Fusco  
*Managing Partner, Strategic Relationships,  
Grant Thornton LLP*

Trevor Harris  
*Managing Director, Morgan Stanley*

Richard Kilgust  
*Senior Partner, PricewaterhouseCoopers LLP*

Robert Reeder  
*Partner, Sullivan & Cromwell LLP*

12:00 Luncheon

**Speech:** "Liability and Risk Management in a Post  
Sarbanes-Oxley World"

**Delivered by:** Charles D. Niemeier  
*Board Member, Public Company Accounting  
Oversight Board*

1:30 pm PANEL 2

**What steps can and should be taken to increase the number of  
global audit firms?**

- Is there any reasonable government action that can create an addition to the Big 4 either by requiring divestiture or by offering incentives? What kind of incentives?
- Is there any economic limitation to the number of large accounting firms that can succeed? Why did the Big 8 shrink to the Big 5?

- Were any regulatory concerns expressed by regulatory authorities about a proposed merger that would have reduced the Big 5 to 4?
- Are there circumstances that would cause the Big 4 to make their overseas offices available to mid-tier firms to make them more competitive for the business of global companies?

**Moderator:** David S. Ruder  
*Professor of Law, Northwestern University  
School of Law; Former Chairman, SEC*

**Panelists:** Cynthia Glassman  
*Commissioner, SEC*

William Kolasky  
*Partner, Wilmer Cutler Pickering Hale and Dorr  
LLP*

Robert Kueppers  
*Chair, Executive Committee, AICPA Center for  
Public Company Audit Firms; National  
Managing Partner, Risk, Professional and  
Regulatory Matters, Deloitte & Touche USA LLP*

Ira Solomon  
*R. C. Evans Chair in Commerce and Head,  
Department of Accountancy, University of  
Illinois at Urbana-Champaign*

Peter Wallison  
*Resident Fellow, American Enterprise Institute  
for Public Policy Research*

## II. WHAT STEPS, IF ANY, CAN BE TAKEN TO PREVENT THE LOSS OF ANOTHER BIG 4 FIRM?

3:00 pm PANEL 3

### Can responsible steps be taken to address the apparent problem of excessive litigation that confronts the industry?

- What are the consequences of losing another of the Big Accounting Firms to civil and/or criminal litigation?
- What are the implications of the movement to reduce accounting reliance on rules and require far more reliance on judgment?
- Can the attestations required of auditors be restructured in a manner that will reduce their exposure to litigation?
- Can the investor protection provided by Sarbanes-Oxley, and particularly the PCAOB be the basis for the SEC to provide some safe-harbor protection from third party litigation?

**Moderator:** Simon Lorne  
*Vice-Chairman, Millennium Partners LP;  
Former General Counsel, SEC*

**Panelists:** Rick Antle  
*Senior Associate Dean and William S. Beinecke  
Professor, Yale School of Management*

Kayla Gillan  
*Board Member, PCAOB*

Robert Herdman  
*Managing Director, Kalorama Partners LLC;  
former Chief Accountant, SEC*

Judith Richards Hope  
*Distinguished Visitor in Residence and Adjunct  
Professor of Law, Georgetown University Law  
Center*

Michael Young  
*Partner, Willkie Farr & Gallagher LLP*

4:45 pm PANEL 4

**Can procedures be put in place in the reasonably near future to protect the viability of a Big 4 firm seriously threatened with criminal or civil litigation?**

- Consider again the consequences of losing another large accounting firm.
- Is there a level of approval that can be given by the PCAOB that can or should protect an accounting firm from criminal indictment?
- Was Arthur Andersen's viability in doubt before the criminal indictment?
- Can a functional insurance product be created to deal with the problem of excessive litigation?
- Are there regulatory policies that could be put in place, in appropriate circumstances, that could provide sufficient assurance to employees and clients of a threatened firm that they need not leave the firm?

**Moderator:** James Doty  
*Partner, Baker Botts, LLP; Former General Counsel, SEC*

**Panelists:** Neri Bukspan  
*Managing Director/Chief Accountant, Standard & Poor's*

Ray Groves  
*Senior Adviser, Marsh Inc.*

Lawrence Keeshan  
*Global General Counsel,  
PricewaterhouseCoopers LLP*

Geoffrey W. Morris  
*Deputy Chairman, Aon Professional Risks*

Charles Niemeier  
*Board Member, PCAOB*

5:45 pm General Discussion Among Participants

**Moderator:** Roderick Hills  
*Chairman, Hills Program on Governance, CSIS; Partner,  
Hills & Stern, LLP; Former Chairman, SEC*

**Panelists:** James Doty  
*Partner, Baker Botts LLP; Former General Counsel, SEC*

Simon Lorne  
*Vice-Chairman, Millennium Partners LP; Former General  
Counsel, SEC*

David S. Ruder  
*Professor of Law, Northwestern University School of Law;  
Former Chairman, SEC*

Roman L. Weil  
*V. Duane Rath Professor of Accounting, University of  
Chicago Graduate School of Business*

## **ABOUT THE AMERICAN ASSEMBLY**

The American Assembly was established by Dwight D. Eisenhower at Columbia University in 1950. It holds nonpartisan meetings and publishes authoritative books to illuminate issues of U.S. policy. The Assembly seeks to provide information, stimulate discussion, and evoke independent conclusions on matters of vital public interest.

An affiliate of Columbia, The Assembly is a national, educational institution incorporated in the State of New York.

## **AMERICAN ASSEMBLY SESSIONS**

The American Assembly has developed and honed a conference technique since its founding. Authorities are retained to write background papers presenting essential data and defining the main issues of each subject. These are sent to the participants in advance of the Assembly.

Typically, a group of men and women representing a broad range of views, backgrounds, and experience meet for several days to discuss the Assembly topic and consider issues of national policy. Participants meet in small groups generally in four lengthy periods. All groups use the same agenda. At the close of these informal sessions participants adopt in plenary session a final report of findings and recommendations.

Regional, state, local, and other Assemblies are often held following the national session. Assemblies have also been held in England, Switzerland, Malaysia, Canada, the Caribbean, South America, Central America, the Philippines, China and Taiwan. Over one hundred sixty institutions have cosponsored one or more Assemblies.

“Auditor Concentration” followed a new one-day model.

**THE AMERICAN ASSEMBLY**  
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