COUNT DOWN

The Past, Present and Uncertain Future of the Big Four Accounting Firms

Second Edition

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BY

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India – Malaysia – China

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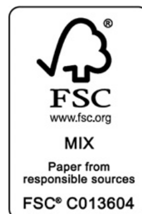

INVESTOR IN PEOPLE

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PREFACE TO THE SECOND EDITION

When Emerald Publishing released the first edition of *Count Down* in December 2015, aiming chiefly at its core audiences in the academic and scholarly communities, it was also my desire to extend its reach more widely.

Recent months have not been happy for the Big Four accounting networks — despite their extended market dominance and the growth of their combined global revenue, reaching $128 billion in the latest year — making timely this revised and extended second edition:

- Deloitte's Brazil firm in December 2016 incurred an $8 million penalty, the largest ever imposed by the PCAOB, and practice bars and other sanctions against twelve partners and employees, over confessed alteration of documents, false testimony, and lack of cooperation with the PCAOB's inspections and investigations. Lesser sanctions were also imposed on its firms in Mexico and the Netherlands for other PCAOB violations.
- EY in September 2016 was the target of two SEC enforcement actions, involving censures, fee disgorgements and fines of $ 4.4 million and $ 4.9 million, and practices bars against its personnel, over charges of loss of independence based on "close personal relationships" between engagement partners and client personnel — in one case a romantic relationship and in the other, significant expenses paid for travel, entertainment, sporting events tickets, and family vacations for the client CFO and his family.

- KPMG in April 2017 fired five partners and an employee, including its Vice Chair of Audit and its head of Audit Quality and Professional Practice, over its receipt and handling of advance inspection information leaked by an employee of the PCAOB. Meanwhile in the United Kingdom, pressures remain on the Financial Reporting Council and the Financial Conduct Authority over their treatment of KPMG's role as auditor of failed bank HBOS.
- PwC's delivery of the wrong "best picture" envelope, and the resulting tumultuous ending to the February 2017 broadcast of the Academy Awards, evoked outbursts of public ridicule — which were pale in significance compared to the potentially fatal financial impact of two multi-billion dollar lawsuits, relating to its audits of Colonial Bank and MF Global, where jury trials in process in August 2016 and March 2017, respectively, were discontinued in favor of settlements for confidential amounts.

The corrosive effects of these and other events on credibility and the public trust have left the Big Audit model increasingly fragile, yet still standing — so far. While fresh issues will no doubt displace this sampling, the central issues retain their relevance and urgency, and drive the importance of their scrutiny.

Those with directly affected interests include not only the auditors, but all participants in Big Audit whose professional or business positions, activities, investments and financial security are exposed to the flaws in the structure by which the Big Four provide audit opinions on the financial statements of the world's large public companies:

- Executive and financial leaders and the directors and audit committees of the corporate issuers.
- The community of financial information users: investors large and small, lenders, bankers, customers, and other sources of credit and capital.

- Professional standard-setters along with government agencies of oversight and law enforcement.
- And especially the accounting professionals themselves — the partners and employees of the Big Four networks that dominate the sector, and their no-less-affected colleagues in the smaller firms.

Extending my appreciation for their support to the Emerald team led by Charlotte Maiorana, series editor Gary Previts of Case Western University, and my agent Carol Mann — I believe in both the importance of assurance to the successful functioning of the capital markets and the necessity of full engagement by all parties in examining the challenges in today's model, and welcome this opportunity to contribute to the dialog.

Paris
May 2017

FOREWORD

At a meeting in the spring of 2001, I was taken aside by a senior partner of one of the large international accounting networks. It was, with hindsight, the quiet before the storm. Six months later, Houston-based energy giant Enron Corp. collapsed, followed rapidly by the criminal indictment and demise of the 88-year-old accounting firm of Arthur Andersen.

Here was a man at the peak of his career, with an executive position in his firm — not Andersen. He had stature and recognition both in his own country and internationally, and financial security and prosperity.

"My two children are both happy in college," he said. "And I have achieved my goal in career guidance. Neither one is going into public accounting."

How profoundly sad, at the personal level, despite his evident satisfaction, delivered with no trace of irony. This apparently successful professional, at the top of his form, did not see the value to society of the firm to which he devoted his entire working life as worthy to pass to the next generation.

How disquieting. One of the accounting profession's illustrious and respected members thought so little of its career potential that he would take satisfaction in dissuading his children from following in his steps.

A year later, I had as much reason as anyone to be dismayed at Andersen's flame-out. From 1982, I had been a senior member of Andersen's in-house legal group. For 16 years, I had been a partner in the uniquely successful Andersen worldwide organization, sharing fully and enjoying its prosperity and its handsome profitability.

I had recently reached the firm's early retirement age. I left with a generously promised package of retirement benefits, promptly blown to bits in Andersen's post-Enron collapse and inflicting a multi-million dollar hole in my retirement expectations.

There was real pain to go around. Andersen's active US partners lost their capital. Retired partners lost their unfunded benefits. A handful of senior management, labeled "toxic" for their proximity to the disaster, disappeared under the career-ending taint of responsibility for the disintegration of an institution often cited as the profession's "gold standard."

But there were few enough of us to mourn Andersen's demise. The non-US firms of the Andersen network relocated promptly into the cautious if welcoming arms of the other large networks. In the United States, Andersen's 25,000 employees mostly licked their wounds and went on — moving into the regional practices of the other large firms or combining into new niche practices with geographic or industry specializations.

Andersen's world-class roster of departing clients showed an absence of loyalty to the firm in its death throes — believing, correctly as events proved, that they could obtain elsewhere the same services of equal value, with ease and at times even at less cost. The reduction of the large global networks from five to four involved creaking and groaning adjustments, but was accomplished with a minimum of real disturbance.

This book is not a memoir. It is not the story about Andersen. Although relevant in the classroom, it is not a textbook, but a business-oriented narrative, addressing Big Audit as a critical component in the functioning of the world's capital markets. Nor, to my regret as a story-teller, does it feature a central personality — a hero to cheer or a villain to hiss.

It is about the questionable value and the uncertain viability of Big Audit — the business, regulatory and legal model by which audit services are delivered to the world's largest companies by

the surviving global accounting networks: the Big Four — Deloitte, EY, KPMG and PwC.

Today the standard audit opinion is an outmoded product that nobody values, at a cost that nobody wants to pay. Its requirement by regulators inhibits evolution to assurance of real usefulness, and exposes the Big Four to litigation exposures that they cannot afford.

How Big Audit came to this fragile state, why the proposed quick and simple fixes are unachievable and how assurance of real value might be designed and delivered instead — these are the topics.

After the Introduction for context and history, the story proceeds in these parts:

- A review of the events leading to today's troubled and urgent state.
- An examination of the so-called "solutions" — none of which can withstand scrutiny as practical, effective or achievable.
- Scrutiny of the attitudes and behaviors of the major players in Big Audit, who by their very DNA and their mutually conflicting and antagonistic interests are constrained in their ability to bring coherence to a positive process of change.
- To finish, a last section — to which the impatient are referred if unwilling to wait or unable to defer — that outlines some of the necessary, and possible, elements of a re-engineered approach to financial reporting and assurance — a newly structured Big Audit model, sustainable to meet the needs of the 21st century.

Addressing along the way the discomforts caused by the present dysfunctionality, I will propose a complete re-structuring of Big Audit, either following its collapse as presently threatened or, much more desirably but highly unlikely, under forward-looking leadership prepared to accomplish the sweeping changes needed to avoid that collapse.

As a preview: Newly designed audit firms, perhaps evolving from and built on the present Big Four and others, would be free to supplant today's obsolete "pass-fail" opinion with assurance specifically tailored to the needs of issuers and users. New business models would include flexible forms of organization, permissibly associated with any other client services, drawing upon the support of corporate ownership or third-party capital. Firms would no longer be constrained by the obsolete limitations of "appearance of independence" or restraints on the scope of their ancillary services.

Regulators and law enforcement would retain authority to oversee both issuers and auditors and to enforce appropriate investor protections, while assurance reports would only be published subject to strict limitations of liability.

Because today's Big Audit model is unsuitable beyond salvation, it may be emotionally wrenching for many of its players to surrender beliefs they have clasped closely for decades. Difficult as it may be to imagine, however, only such a dramatically new model will allow for a sustainable Big Audit function, fit for purpose in the complex world of the modern capital markets.

I

INTRODUCTION — THE PAST — HISTORY AND CONTEXT

"WHERE *WERE* THE AUDITORS?"

The end of Big Audit started with events that are now familiar.

The Arthur Andersen accounting firm, founded in Chicago in 1913 and a pillar of its once-noble profession, died in the winter of 2002, under a deluge of accusations, investigations and recriminations.[1]

Painfully and in full public view, Andersen faced and lost a fight for its life — a fight that turned out to be unwinnable, under the crushing combined weight of law enforcement investigations, a media circus of multiple legislative hearings, and shareholder class action litigation claiming damages measured by Enron's $67 billion bankruptcy.

Andersen was mortally wounded from the very outset of the Enron debacle. At the time of Enron's collapse, Andersen was already laboring under a litigation inventory that included such crippling exposures as Waste Management, Sunbeam and Baptist Hospital. Had it not disintegrated under the influence of its criminal indictment in Houston, it had waiting the additional potentially devastating impacts of WorldCom, Qwest and others. Its financial resources, its solvency and its existence were in no way answerable to the inflictions it faced.

Andersen's inevitable demise was accelerated and sealed by its criminal indictment, announced on March 14, 2002. The United States Justice Department charged Andersen with obstruction of justice and destruction of evidence, for the exercise in document and files cleanup led by its then high-flying young partner, David Duncan, in Andersen's Houston office.

Trust in the Andersen franchise — both internal and external — was irretrievably lost. When Andersen's management failed to negotiate a plea bargain with US Justice that could have avoided the criminal indictment of the firm, the trickle of departing clients and partners became a flood. Practice units of the firm in the United States, unable to find a single merger partner willing to risk inheriting Andersen's litigation legacy, splintered into regional deals and start-up niche practices. The international network dissolved almost overnight as its separate national practices around the world were thrust into shotgun marriages with the other large networks' local firms.

Convicted after a trial in Houston on June 15, 2002, the Andersen firm in the United States announced that it would cease performing audits and surrender its professional licenses as of August 31. Not ever formally bankrupt, even at this writing, the firm effectively shut itself down.

Although the US Supreme Court rarely intrudes into the conduct of trials by the lower courts, it accepted Andersen's petition for review, and in 2005 gave its Pyrrhic judgment setting aside Andersen's conviction.[2] By that time, any hope of survival or revival was long since lost.[3]

Where did the world think Andersen had been?

One answer came at a House Energy and Commerce Committee hearing. On January 24, 2002, Congressman James Greenwood (R-Pa) unloaded on David Duncan, Andersen's engagement partner on the Enron audit. Although it was known that Duncan would exercise his constitutional right not to testify, the Congressman launched this sarcastic sound bite:

> *"Mr. Duncan, Enron robbed the bank. Arthur Andersen provided the getaway car, and they say you were at the wheel."*

It was the same familiar outcry: "Where were the auditors?"

Heard with every outbreak of financial scandal. With every dramatic stock price collapse. With every disintegrated company that was once a fast-rising "new thing." With the evaporation of every darling investment taking in the funds of credulous investors in response to touting on the business channels.

A single example, inevitably not the last scandal *du jour,* was that of British food retailer Tesco, which in September 2014 announced a half-year profit shortfall that exceeded £250 million. Confessed irregularities in its accounting for supplier discounts and rebates accelerated the collapse of its stock price by 25% within a month.

Three years on, the Tesco story is still unfolding, with much agony to come. Shareholder class action litigations were promptly started in both the United States and the United Kingdom. The body count of jettisoned company executives reached eight plus the chairman himself. The Serious Fraud Office's investigation led to criminal charges in September 2016 against three senior Tesco executives. The company's stock price continued its fall through late 2014, to a low of 165 *p* that December.[4]

"Where were the auditors" of Tesco — namely PwC, which had served the company in the United Kingdom since 1983? It had been immediately speculated that the 32-year auditor/client relationship PwC had enjoyed with Tesco was at risk — a prophecy fulfilled in May 2015, when the company announced PwC's replacement with Deloitte.

Meanwhile, the financial cost to PwC cannot yet be calculated, although the only reason not to predict a major blow to the firm is that neither British regulators nor the courts of that county have

a history of inflicting fines and damages on the scale imposed by the Americans.

So where had the auditors been? In the aftermath of financial scandal of any type — and despite the passionate arguments from the profession's apologists that "audit failures" are not strictly involved — the impact faced by the auditors includes spasms of righteous indignation, spite and recrimination, and years of wheel-grinding in the systems of law enforcement and litigation damage claims.

WHERE IS BIG AUDIT TODAY?

The global presence of the large enterprises audited by the Big Four is as massive as all of world trade. That population — roughly, for purposes here, the world's 1000 largest public companies — comprise the Dow Jones and S&P 500 indices in the United States, the United Kingdom's FTSE 100 and 350, the DAX 30 in Germany, the CAC 40 in France, the smaller groups of country-leading companies in the other G-20 countries, and the large but local state-sponsored financial and other institutions elsewhere.

The vast portion of the trading activity in the stocks of all public companies, by number and value, involves these large enterprises, whose presence dominates the world's markets.

The auditors' mission to serve the capital markets is spelled out in detailed legal requirements, and the footprints of Big Audit are everywhere. Audit reports are mandated for public companies, in language precisely prescribed by the national securities regulators, to permit their shares and debt to trade — the driving capital engine at the heart of the great machinery of the world's economies.

In the United States, every public company is under the legal obligation of the federal securities laws to file financial statements,

examined and opined on by an auditor in good standing with the American regulators — the Securities and Exchange Commission and the Public Company Accounting Oversight Board.

How much is involved? There are some 2800 public companies listed on the venerable New York Stock Exchange (NYSE) alone — as a sample among the world's large securities exchanges. Together those companies have a total capitalization exceeding $19.3 trillion. The value to trusting investors of all of that $19.3 *trillion* is supported by the opinions of those companies' auditors.

The NYSE trades a daily average of 1.46 billion of these companies' shares, in transactions with a total daily average value exceeding $40 billion. *Every* trading day. Each and every transaction reflects the trust and confidence of the trading participants in the financial statements of the companies involved.

The Visibility of the Big Four

The business presence of the Big Four networks, as ubiquitous as the large companies they serve, is impossible to miss. (See the following *Sidebar*: *Counting the Beans — Facts and Figures on Big Audit*.) Completely dominating the delivery of audit services to the world's large companies, the Big Four together had global revenue for fiscal 2016 of nearly $128 billion. They employed close to 890,000 people worldwide. They are among the largest campus recruiters and providers of entry-level professional job opportunities at the world's leading colleges and universities.

Their partners' individual annual profits on average exceed one million dollars each. The firms' names and logos decorate prestige office towers in financial centers around the globe, with offices in more than 150 countries where they serve clients with material business presence in at least that many. As with the British Empire in the 19th century, the sun never sets on the world-circling presence of the Big Four.

With the pervasive presence of Big Audit, its successful functioning is a matter of direct personal interest to everyone who owns stocks — who expects a pension — who has a Keogh plan or a retirement account — who puts personal savings in a bank or anywhere but in the mattress — who works for a company audited by one of the Big Four or whose suppliers and credit-worthy customers are Big Four clients. In short, it matters to anyone holding this book, who has a nontrivial personal or family balance sheet.

It matters that the market for large-company audit services, represented by audited financial statements that are integral to the transactions at the heart of all of those relationships, is stable and functional.

But as the selective if colorful examples from Enron to Tesco make clear, the questions as to the value of Big Audit go to its very heart. Is there value in the audit report? If not, why is it still required? What justifies the cost of Big Audit, or its very presence?

The Expected Attitude of the Players

The great and the good across the political, regulatory and professional world periodically and consistently tell the world why Big Audit is important, making anodyne pronouncements extolling its importance:

- In her 2015 address at the AICPA National Conference, then-SEC Chairman Mary Jo White declared that auditors share the regulators' "*weighty responsibility to maintain high-quality, reliable financial reporting*."
- PCAOB member Steven Harris said to the International Corporate Governance Network on June 28, 2016, "*The independent auditor serves a vital role in our capital markets by providing an objective third party opinion on the integrity of*

financial statements that investors rely upon for investment decisions."

- In a speech on December 9, 2013, PCAOB chairman James Doty:

  "As sophisticated as our markets and economy are, they are dependent on trust. We cannot take trust for granted. Independent audits provide that trust, and thus bridge the gap between entrepreneurs who need capital and lenders and investors who can provide capital."

- In 2011, the SEC's then-chief accountant, James Kroeker, testifying before a Senate committee:

  "Financial reporting plays a critical role in establishing and maintaining the confidence of the investing public. The objective of financial reporting is to provide information useful to providers of capital in their decision-making processes.

  Reliable financial reporting becomes even more important in a financial crisis, when concerns about a company's fundamentals are most acute .... An audit by an independent public accountant is key to investor confidence and the functioning of our capital markets, and independent audits have long been recognized as important to credible and reliable financial reporting."

The credibility of those acting as cheerleaders is at risk, of course, as these players would all be expected to talk the same upbeat messages. Their positions, their stature and their reputations are based on continuation of Big Audit's *status quo*. To expect otherwise would be like thinking that Santa's elves would risk their own unemployment by voting against Christmas.

To the Insiders, Big Audit Is So Yesterday

As a theme that will run through the entirety of this story, however, the most motivated and interested users of financial information — a key constituency among the roster of players in Big Audit — have cast their negative vote on the value of the standard auditor's report.

Namely, the bankers and others engaged in the large-scale management and deployment of investment capital now disregard the "pass-fail" audit opinion, using instead their own tools for the performance of due diligence, the assessment of earnings and asset quality of companies, and the evaluation of company management strategies and directions.

For these players, the traditional standard report is anachronistic and obsolete. Rapidly evolving opportunities in the "big data" algorithmic analysis of both the language and the figures of corporate reporting, and the wisdom and insights to be extracted from trends by industry and geography, have rendered irrelevant both the outdated statutory forms of annual and quarterly public-company filings and the sampling-based audits that are the legacy of models that time has passed by.

As will be expanded later, this dynamic environment should logically be a field ripe to be occupied by the technical training and professional experience of the Big Four firms (and, to be sure, their smaller and perhaps more agile but also less well-financed colleagues).

But until or unless the current audit report model is slated for complete replacement, the Big Four auditors can only offer these evolved assurance services for fees above those paid by clients for the statutory report alone. Frustratingly, however, it is precisely at this interface with the future that the inhibitions and proscriptions of the current Big Audit model clamp down:

- Regulators committed to an "audit-only" mind-set display increasing hostility to the Big Four's rapid expansion of their consulting and advisory competence and capabilities.

- The cost of already-required statutory reporting puts a heavy financial lid on the resources available to an audit committee or a chief financial officer to reach out for innovation.
- Conversely, pressures on the firms of time and budget are antithetical to expansion into new areas of assurance opportunity.
- And the obsolete obligations of "appearance of independence" and the understandable fear of being second-guessed in litigation close off the auditors from the opportunities to design, operate and access their clients' information systems where the valuable data reside and where the analytics can be performed.

To summarize, then — the regulators and politicians pay obligatory but sterile respect to Big Audit, to serve their own purposes, while the best-endowed users have no reason for any attitude but indifference.

To the Rest of the World — Accounting Is *So* Boring

What then of the larger population of investors? Beyond the self-protective posturing of the public servants, and the alternative strategies of the large market players, how is it that the broad population of information users shows such lack of interest?

Surprised and insulted at a Tesco or an Enron? When the shareholders of GM were wiped out by its government-led bailout, within months of the clean audit opinion from Deloitte? By the rolling series of bad news emerging from Fannie Mae, the quasi-governmental mortgage guarantor whose spectacular conflagration amid the financial crisis left in smoldering ashes the unqualified audit opinions issued by KPMG through 2004.

Admit it, straight out, as I have done with those who counseled against the boredom factor in setting out to tell this story: "Face it — accounting is not sexy."

Agreed. Pulses are not set racing. Big Four auditors do not sell racy novels, star in Hollywood blockbusters, or compete on celebrity television.[5] The profession offers no personality like that of Billy Bean propelling "Moneyball," or Lloyd Blankfein, the leader of Goldman Sachs, the "great vampire squid" of the financial crisis. The late comic Rodney Dangerfield had the best line about the profession: it's easy to spot the most dynamic auditor at the cocktail party — he's the one who looks at *your* shoes when he talks.[6]

For all the passions briefly aroused when "bad things" happen in the markets, and investors feel real pain in their accounts and their portfolios, their perspectives are filtered through their brokers, investment advisers and fund managers, so that the day-to-day public attitude toward the auditors remains one of distance and disregard.

Not so with the other professionals. Throughout the financial crisis that began in 2007–2008 with the fall of Bear Stearns and Lehman Brothers and the bailouts of institutions ranging from AIG to GM, other large institutions were demonized. Bankers were vilified. But there was no movement to "Occupy the Big Four."

In the Elizabethan era, Shakespeare's anarchic Dick the Butcher urged that "The first thing we do, let's kill all the lawyers." But for all the personal and institutional wealth that evaporated since the financial crisis began, nobody has ever aimed such murderous hostility at the auditors.

Instead, the accountants have received a pass. There has simply been no sustained arousal of insult, outrage, or even sustainable concern. To borrow baseball legend Yogi Berra's assessment of the public reluctance to buy tickets to see a losing team:

"If the fans don't want to come out, you can't stop them."

What accounts for the general public inattention to the work of the auditors, whose function is mandated by government and

when so much seems to be at stake with their role in the free-market economies?

Familiarity

First, to look back, the role of the independent auditor was invented in the Victorian era in England and Scotland, in direct response to the desires of investors. Since then, over the entire course of economic history since the beginning of the Industrial Age, it has simply *always been there*.

Despite the massive changes in business and commerce over a century and a half, and the complexity of the transactions now reflected in corporate financial statements, the message delivered by the auditors is little changed since the 1850s, and the basic audit report is little evolved since the passage of the major American securities laws in the 1930s. The report language is regulated and standardized. Without seeing the logo or name of the issuing audit firm, a reader would be clueless to identify its source.

To modify the cliché, familiarity may not breed contempt, but it does breed passive indifference.

As familiar as water at the tap — electricity at the switch — television or music at the touch of a button. As dull and uncontroversial as any utility whose instant presence is expected and assumed.

Complexity Conceals

And yet … Any can of worms looks simple with its lid on.

Beyond its boredom-inducing familiarity, a *second* reason for suppressed public concern is the daunting complexity of the financial markets in general. It is challenging enough to those on the inside, to comprehend the array of products, rules, standards and regulations. Perplexed outsiders confront the observation that "all professions are conspiracies against the laity."[7]

There was a time, as an analogy, back when fathers spent Saturdays under the hoods of the family cars and high-schoolers

took Auto Shop, that common knowledge included the ability to gap a set of spark plugs or clear a flooded carburetor. Today, the percentage of car owners having the competence even to change a tire — much less any interest in ever having done so — hovers in the low single digits.

No less with the protocols of accounting and audit. Even though the principles are the same as those involved at the dawn of civilization when trade was invented, they have now evolved to eye-crossing complexity. A major cause of the financial crisis was the impossible intricacy of the financial products invented and sold by the investment banks — well beyond the understanding and risk evaluation even of the professionals. It was no wonder that even a knowledgeable investor could only stand by in wide-eyed incomprehension.

For both autos and auditors, we know much less in a more complicated modern world about the workings under the hood. Obliged to carry on with reduced familiarity about their inner machinery, we accept both benefits and hazards that are subject much less to individual understanding or control.

Big Audit Looks Like Any Other Utility

Third, Big Audit looks boring on the surface because its characteristics are those of a public utility:

- Market forces strictly limit the number of providers with the necessary scope, scale and economic incentive to deliver — whether a "natural monopoly" or, like the Big Four, a cartel with a few players. Examples are subway systems, cable providers and power grids.
- The product or service is standardized and undifferentiated among users — just as one telephone line or one bus ticket is pretty much like all the others, so is an audit report.
- The process and the product are highly regulated — whether by a public utility commission or a county water board or a transit

authority — or for Big Audit, by the SEC, the PCAOB and their counterparts in other countries.

- The costs of switching to an alternative provider are dauntingly high, or choice may be simply impossible for want of another source.
- Innovation is not prioritized, for reasons running from history and culture to inertia and political protection of incumbent suppliers.

Customers of a utility display acceptance of their lot — expecting that water will appear at the turn of a faucet, that lights will go on with the flick of a switch, and that at the press of a remote, the cable system will deliver a sporting event or a news channel. And that buried deep in every year's corporate annual report, the same audit opinion will appear, and be ignored.

The reasons lie in the nature of a utility itself.

Change is constrained and inhibited when a utility enjoys official protection — as shown by the sluggish pace of change among the cartels under state ownership or sponsorship, in such fields as transportation, telephony and electricity.

The same with Big Audit. Laws and rules of the world's securities regulators require that public-company compliance and access to stock trading privileges include the annual filing of a standard-form auditor's report — the scope and language of which are strictly prescribed.

The mutually interlinked relationships among the players in Big Audit's market mean, in other words, that everyone's back gets scratched. Regulators set the rules of compliance so that only a handful of audit firms have the capability to fulfill them. Symmetrically, audit firms and their revenues are protected inside that system from the emergence of either new competitors or new forms of assurance.

The handcuffs are golden, and well-tempered by time and history.

Yet, government has another role in the typical utility model. It is the backstop of last resort when a delivery failure has occurred. Unlike breakdowns in a market of unconstrained competition, costs of a utility failure are effectively socialized, and spread across the population:

- By the widely shared inconvenience and distress — think of a power outage or a transport strike.
- By the financial burden put on a citizenry to adjust and cope with, for example, the nationalization of a failed railroad system.

Because utility customers expect that they will receive continuous, zero-defect service, they behave with both indifference and lack of influence. They are aroused only with a breakdown and even then, only to impotent complaints: "How long until the power is back on?" and "Where in hell is the cable guy?"

With no meaningful involvement in the repairs or the restoration of interrupted or substandard utility service, customers know only that eventually some anonymous *they* will plow the roads or repair the broken switch or reboot the transformer. And for the most part, *they* do just that. Sooner or later, after some level of public grousing and discomfort, the power is restored — the water flows — the trains run again.

What does not happen are consumer lawsuits against the utilities, or punitive cries that they should be put out of business for their substandard performance.

"Mind the Gap"

Just as consumers expect seamless integrated service from their other utilities, what much of the investor community knows — or think they know — is that the job of Big Audit is to protect the shareholders, to bless the stability and prosperity of a company,

to assure the absence of corporate fraud or financial misfeasance and to stand guard over stock prices that should go nowhere but up.

But those views are clashingly inconsistent with the vision, mission, responsibility and capability of Big Audit — as is reemphasized anew, every time the cry is raised, "Where were the auditors?"

The difference between what users seek and what Big Audit has the ability to deliver is starkly known as the "Expectations Gap" — a yawning divide created in no small part at the profession's own initiative and responsibility, and which now threatens to engulf both the suppliers and the users of Big Audit.

Since securing the franchise to provide financial statement assurance for public companies, under the American securities laws of the 1930s, the accounting profession has borne self-inflicted responsibility for the creation and expansion of the Expectations Gap. Its actions included:

- Overselling the level of comfort its reports convey — going back to the inference of a "guaranty," conveyed by the unfortunate and now-replaced terminology of a "certificate," and the profession's futile inability to escape the lingering shadow of that language.
- Tolerating the misplaced label of "watchdog," as applied by jurists and academics whose presumption of guidance exceeds their real experience.
- Fostering the obsolete and intellectually fragile "appearance of independence" — a trope at odds with the "client-pays" model in place since Mr. Deloitte's era, which delivers neither protection for the auditors themselves nor enhanced comfort to users.

In addition, to be fair, responsibility for the users' side of the Expectations Gap includes in good part the challenge that Big Audit itself is complex.

Even at its best and working well, Big Audit involves a complicated set of tensile interlocking relationships among the players: standards that are as complex as the full range of business activities comprising the world's commercial economies, and expectations of users that are difficult to articulate, inconsistent with each other and harder still to reconcile.

Analysis and evaluation become even more difficult in the situations reflecting systemic stress. Resort to oversimplification is ever-present and tempting. Examples include such core topics as the proper balance between completeness of financial disclosure and reporting overload, or the competitive pressures of local-country regulatory autonomy and the desirability of consistent global standards, or the height of the bar by which to measure audit quality.

This challenge can at least be made easier to grasp by focus on the resemblance of Big Audit to other utilities — no different from that presented everywhere else in society's debates over policy choices about the allocation of conflicting priorities and scarce resources. Few of us know the engineering of a nuclear plant or the technology of a wind turbine, but we do have legitimate community interests in constant access to dependable electricity in our homes and offices. Only the experts can grasp the intricacies of phone and data service distribution, but we all expect our connected devices to work on demand, home or mobile, all the time.

The Limits of the "Utility" Metaphor

Here is the difference between traditional utilities and Big Audit: There is no "they" to provide a fix. Big Audit has become so structurally fragile that one more serious shock will leave it in catastrophic collapse. The liability regimes that permit death-blow litigation against the auditors could well deliver a result that is mortal.

Andersen's collapse showed that a large audit network *can* fail. It *could* have taught the public lesson that a systemic breakdown

was and remains a dangerous possibility. But that lesson was not learned — at least not yet.

To round out the utility discussion, there are two additional problems with "socializing" the costs of a systemic breakdown of Big Audit:

First, among all the functions that government has tried with varying degrees of success to assume and provide, it has never been seriously asserted that nationalized "big government audit" could replace the current structure to the satisfaction of any of the players.

Other and better forms of assurance are available for design and delivery — a very lively part of the current discussion, to be visited in Part V. But it is unambiguously clear that whatever value may reside in today's commoditized audit report, it cannot be delivered by civil servants working under the same governments that have inflicted such nightmares as the Internal Revenue Service or the Transportation Security Administration, the National Health Service or National Rail.

Second, then, the socialized costs of the collapse of privately delivered Big Audit could come in the form of its extinction and complete disappearance, like the dinosaurs of old or the urban streetcar franchises of the 19th century.

If the Big Audit model fails today, there is simply no governmental authority with the vision, competence and authority to sustain and keep it alive. Which means that in its post-collapse absence, the model to replace today's Big Audit would have to be invented and constructed out of the available parts left in the pile of its wreckage.

Where Are the Critics?

There are commentators focused on the accounting profession who view Big Audit with unrelieved hostility — pointing to malign characteristics that range from client or agency capture to venality and downright corruption.

I decline to join their impassioned forces, chiefly because those critics take themselves out of active participation in any constructive dialog.

I am not an apologist. I believe that the profession has earned much of the criticism and general lack of sympathy bestowed on it, and that its leaders are fairly chargeable with a long history of lack of vision and a record of strategic and tactical ineptitude.

But I also believe that the profession's members are overwhelmingly people of good faith, with a resounding degree of technical competence, a basic commitment to their profession's central tenets and goals, and value to bring to the effective functioning of the capital markets.

To construct a bridge of comprehension and analysis across the Expectations Gap — rather than shout in futility from the opposing ledges — is a task of formidable dimensions. If this book does not reach the level of a blueprint for that task, it may perhaps at least be one form of a design proposal.

My goal here is to take the lid off the can of worms. To separate and look at the complex issues facing Big Audit, in blocks of comprehensible size. I realize that the examination of complex issues can only be simplified so far without degrading into simple-mindedness, so there will be some use of terms and concepts that are technical or professional — no more than necessary, I hope.

FRAMING THE ISSUES

> "None of us has a clue."
>
> — *Outgoing PCAOB Chairman William McDonough, to a reporter asking how regulators would respond to another failure among the Big Four*[8]

A basic reordering of the relationship between large global companies and their accounting firms is inevitable. Although evolution

can be postponed, it cannot be stopped. But the need is neither well recognized nor openly discussed.

Auditors' reports on the financial statements of large companies have for decades been deemed important in the operation of the world's capital markets.

By tradition, consensus and eventually, law and regulation, "pass-fail" assurance on the financial information issued by publicly held companies has been provided to regulators, investors and other users by private accountancy partnerships organized into large international networks.

But recent events show this structure and the firms' business model to be unsustainable. Instead, the global organizations that remain from what was known for years as the Big Eight — often identified, inaccurately and without irony, as the Final Four[9] — are now down to an irreducible minimum.

Nothing good has happened since Andersen fell in 2002, which might relieve the threat that the Big Audit model may be unsustainable. Big Audit cannot survive another loss at the Big Four level. Vigorously as the ambitious leaders of the next smaller networks would assert their growth plans, challenges of global scope and depth of resources constrain their ability to deliver audit services at the top of the corporate size tables.

Yet the combined pressures of regulation and litigation are irresistible.

If another of the Big Four should go down — an acute and present peril — the investors, bankers and other users who for years have proclaimed the importance of Big Audit and the accountants' core product, along with politicians and regulators alike, will awake to find that the one-page document they have for so long either criticized or taken for granted is no longer available from any source.

A confluence of factors combine to threaten a profession that has served society with great value for over 165 years, and define

the challenges under which the players in the world's capital markets will be obliged to adjust and cope.

Andersen/Enron — The Beginning of the End

"How did things ever get so far?"

— Vito Corleone (Marlon Brando),
"The Godfather" — 1972

The major lesson left unlearned by Andersen's collapse is that the litigation exposures and regulatory stress on the Big Four today are every bit as grave as Andersen's, and their financial capabilities and limited multinational cohesion are if anything more fragile.

To which, public indifference extends among their clients, the users of the issuers' financial statements, and the lawyers, regulators, law enforcement officers and politicians. Their simplistic reaction to the death of Andersen was, essentially, "Too bad — those auditors have just got to learn their lessons."

As one example: when he was interviewed in the fall of 2003, Sir David Tweedie, the then-chairman of the International Accounting Standards Board, was asked about the capacity of the surviving large firms to contribute the professional resources necessary to achieve the improvement and convergence of international accounting standards that are the mission of the IASB, in light of their surrounding structural pressures. His dismissive answer was that "they'll just have to do better."

In an environment of parochial interests and denial, as will be seen, a complex of interacting factors makes impossible the ability of the firms to "do better." This question is not answered, because it has gone unasked:

"If Andersen could not survive Enron, then who or what could save today's Big Four?"

The Diminished Value of Today's Assurance Product

The spate of financial scandals that started with Enron in 2001 in the United States continued through WorldCom and Tyco and Adelphia. It extended to such multinationals as Ahold, Adecco, Parmalat and Shell. Still to come was the financial crisis that began in 2007–2008 and tarred — or claimed — such iconic names as Bear Stearns, Lehman Brothers, AIG and Merrill Lynch, as well as banks and other financial institutions in the United Kingdom, Ireland, Iceland and across Europe.

The eruptions have continued steadily since — Satyam in India and BT in Italy, Tesco in the United Kingdom and Petrobras in Brazil, FIFA in Switzerland, Olympus and Toshiba in Japan, MF Global and Valeant and Wells Fargo in the United States — with the certainty that there will be more to come.

Recent history shows that the traditional standard auditor's report is obsolete and no longer relied upon. There is no differentiation in content among issuers of the standard product — showing commodity pricing and market behavior consistent with a utility product of diminished value.[10]

The Big Audit model does not reflect pricing premiums on audits of global companies — but, to the contrary, fee pressures and reductions, and relentless pressure on staff time and budgets. As with such commodities as brands of toothpaste, identical mid-sized cars, and gasoline at the pumps, the price-cutting effect applies no less to *verbatim* audit reports and their "pass-fail" opinions — identical and undifferentiated across both companies and their audit firms.[11]

Further, evolution in the capital markets has rendered the traditional auditor's report both obsolete and irrelevant.

Sophisticated investors have long since stopped relying on Big Audit's reports — dating back 30 years to the twin phenomena in the 1980s of junk securities and leveraged recapitalizations. In that era, no lawsuits against auditors were ever brought by the

"smart guys" — the venture capitalists, the managers of private equity, or the financiers of leveraged recapitalizations — who glanced at an audit opinion under the cover of a corporate annual report, yawned, and went about their real diligence.

Less sophisticated investors also ignore audit reports confined to traditional financial reporting, as shown by the complete disconnection, during and since the bubble years of the 1990s, between share prices and audited financial results. Soaring prices were supported by neither assets nor earnings under generally accepted accounting principles — nor, in time, even by revenue. The analysts herded their clients, and each other, down roads paved with airy business plans, empty promises and inflated expectations. At the point of collapse, a clean audit report provided shareholder plaintiffs only with a ticket to the courthouse.

The Players in the Matrix — Their Interlocking Mutuality of Interests

Post-Enron, to the extent public awareness of the involvement of accountants in the creation and issuance of financial information was changed, the perception took the form of criticism and disrespect.

The diminished contribution of the profession — although it was deemed tolerably important to the effective operations of the capital markets, if both unnecessarily complex and terminally dull — only polluted further the stifled atmosphere in which the private provision of assurance now functions.

The central proposition is this: The imminent collapse of Big Audit would require the capital markets to adjust to the unavailability of financial statements examined under generally accepted auditing standards and bearing a "pass-fail" opinion. Players in those markets would be forced to identify alternative assurance products, sourced from a new configuration of suppliers, designed

and implemented to be responsive to the needs of a world more complex than ever.

The structural components of the Big Audit model involve a complex interplay among the major players, each having both self-interested vision and limited influence and authority. They are:

- Listed public companies — the large corporate issuers of financial statements, examined and reported on by the auditors.
- The Big Four accounting firms themselves — the providers of the audit function and its standard commodity report.
- Investment bankers, analysts, rating agencies, investors, and other financial statement users — with their varying and inconsistent attitudes toward the auditors' opinions.
- The professional accounting and auditing standards-setting and oversight bodies — jockeying among themselves and in their respective jurisdictions for recognition and credibility.
- The regulators of the profession and of the world's securities and capital markets — thinly stretched, and motivated to drive actual audit performance toward a box-ticking exercise to satisfy their mechanistic inspection-oriented programs.
- Politicians and legislators — overwhelmed by market forces so complex as to be incomprehensible, and driven by the primary imperative of every office-holder, to be retained in the comfortable enjoyment of incumbency.
- Agencies of law enforcement — hampered by limitations of resources and jurisdictional boundaries, and caught up in the pressures of political accountability.
- The ever-present casts of lawyers acting for all of the above.

These differently motivated parties contribute separately to the current environment. But each of them operates under limitations

of geographic and jurisdictional authority, organizational competence, and simple self-interest — limits built into their very DNA that constrain their capacity for change.

There have been frequent public statements to the effect that, after the fall of Andersen, no one actually desires the failure of another large accounting network. Which may well be so. Regulators have somewhat moderated their bellicose messages and tactics. There are even statements to the effect that "they" will not allow another of the Big Four to fail.

But as the acerbic Gertrude Stein said of an urban dystopia, "there is no 'there' there." There is no "*they*" — regulators, politicians, or others — having either the will or the authority to prevent the next failure. The concept of a rescue mission for a Big Four firm driven to the brink of failure, by an unbearable litigation award or an irresistible prosecution or enforcement proceeding, would be both politically unachievable and legislatively impossible.

In the matrix of Big Audit's interested parties, complex pressures on the issuance and assurance of financial information are combined and interrelated. As summarized here, and expanded and fleshed out later:

- Societal expectations about the value and function of auditors are mismatched with the reality of corporate behavior.
- Accounting and reporting standards — too complex for comparable implementation in their requirements for broad ranges of judgment and degrees of estimation — are exploited by financial statement issuers to the point of overt manipulation.
- Built-in limitations on the realistically achievable level of auditor performance are unrecognized.
- The last four large accounting networks — along with their smaller counterparts — suffer unbearable professional liability litigation exposure.

- The Big Four have consistently failed to achieve levels of practice quality to match the expectations of the users of large-company financial statements. Instead, they attract year-after-year criticism from regulators such as the PCAOB and, more importantly, an unbroken stream of litigation more than large enough to be life threatening. The Big Four and their partners lack the financial resources to withstand the potentially devastating impact of a "worst-case" litigation outcome, on the scale that rapidly spun Andersen to its destruction. Their available capital — thin if adequate to meet their routine demands — does not begin to match their exposures.

At the same time, the large firms' ability to innovate in the delivery of assurance products having real value to the capital markets is hobbled on multiple fronts:

- By scope-of-practice constraints imposed by the restrictions of the obsolete and intellectually unsound concept of "appearance of independence" — a system providing neither protection for the firms nor comfort for the community of users.
- By the "golden handcuffs" of a business model that requires delivery of audit opinions in the commodity language demanded by regulators — creating an environment in which innovation is stifled by the combination of client budget demands and anxiety at the prospect of regulatory second-guessing.
- By the impact of scale and the barriers to entry imposed by the demands of global clients for services in dozens of countries, making niche introduction of new competitors and new forms and techniques of assurance both unfeasible and uneconomic.

The players making up Big Audit have been talking past each other about its issues since well before the collapse of Enron. But the persistent recurrence of disruptions and scandals makes plain

their ineffectiveness, and the lack of a suitable venue or forum to communicate, evaluate and mediate their disparate interests.

Because of the structural and political impossibility of a cooperative and holistic approach involving all of these important actors, there are a number of near-term scenarios under which the global accounting networks could be forced out of the audit business.

Most likely among these, overwhelming litigation would drive one or more of the remaining Big Four over the brink of collapse.

The next of the Big Four to fail would take down the entire Big Audit structure, in a cascade of network failures, disintegrations and risk-averse market withdrawals. A three-firm system cannot survive, under the pressures on the remaining firms caused by the limited range of client choice, partnership instability and regulatory stress.

Liability-driven, the global accounting networks would disintegrate. Their separate national practices, already distinct legal entities under the requirements of their local laws, would act to protect their local partners and franchises, following the course taken in 2002 by the speedily unraveled Andersen global network.

Publicly-held companies would then be out of compliance with their securities regulators' requirements for audited financial statements. A single auditor's opinion on the consolidated financial statements of global companies would no longer be available, from any source or at any price.

In the United States, the SEC requires every corporate registrant of significant size — "large accelerated filers," defined as registrants with securities having public float of more than $700 million — to file audited financial statements within 45 days of its financial year-end. But this would not be possible post-collapse, because there would be no audit network capable of delivering the required report.

For companies typically having a calendar year-end, the bureaucrats' 45-day deadline could fall on Valentine's Day. But as would be known well before that dire day, the SEC and the stock

exchanges would — despite their understandable bureaucrats' distress at the prospect of comprehensive noncompliance — be forced to yield to the world's insatiable appetite for access to capital on a basis that is constant, liquid and seamless. The demands for uninterrupted daily trading would be a force too strong to consider denial.

Instead, market pressures would prevent regulators from restricting the right to trade in the securities of the world's largest companies — as was the case in 2001 with the destruction of the World Trade Center towers on September 11, which kept the New York Stock Exchange closed for only three days.

Customer pressure on the governance of the Big Board would impel it to brush aside the absence of a one-page regulatory filing as a minor nuisance. The stock exchanges would find a way to remain open for business on February 15.

From that day forward, investors would inflict a new form of risk premium on the capital costs of companies whose noncompliant financial statements left their doubts unsatisfied. They would continue the search, already well started today, for new forms of reliable assurance on financial information, to supplant the present low-value product.

And the fragmented accounting organizations that managed to survive the breakup of their global networks — having withdrawn from the statutory assurance market altogether — would have the opportunity to adapt, respond and reinvent themselves.

But for the evolution of the Big Four to redesign and evolve their services for the sake of survival, the present constraints of "independence" and the life-threatening liability exposures that currently inhibit the development or use of new and innovative reports would have to be lifted or dramatically modified. Only then, to avoid exposure to a further apocalypse of litigation, would the survivors deem it even remotely attractive to return to the assurance market.

With Big Audit leadership presently lacking visible participation in the search for a holistic and sustainable model for the future, the only alternative may be the obligation to design new forms of reporting and assurance after the collapse of the entire Big Four structure — itself the inevitable consequence of the disintegration of any one of them — a grim but real prospect almost too disruptive to contemplate.

Regulators along with the rest of the players would face a new future — where market influences would determine the content, value and pricing for new forms of financial reporting.

Perhaps the most comprehensive change would occur in the executive suites and the boardrooms. Corporate chief financial officers and audit committees would have new and critical roles. Today they are the *best* available resources from which to obtain company financial information. In the future, they may well be the *only* ones. They would have the responsibility to assemble and issue the best available assurance, with the assistance of the surviving national and niche accounting practices to emerge post-collapse.

In short, although until now it has been neither recognized nor openly discussed, a fundamental reordering lies ahead.

LESSONS FROM BIG AUDIT'S EARLY HISTORY: THE GREAT WESTERN RAILWAY — MR. DELOITTE'S FIRST AUDIT REPORT[12]

The origins of the learned professions are hidden in the mists of prehistory. There are no records of the activities or the identities of the first doctor or priest, lawyer or architect.

We can, however, come very close to fixing the birth date of the independent audit. On February 8, 1850, William Welch Deloitte, Accountant, opined on the half-yearly accounts of the Great Western Railway for the period ended December 31, 1849.

Great Western Railway.

GENERAL STATEMENT OF RECEIPTS AND PAYMENTS TO THE 31ST DECEMBER, 1849.

Audited and approved, 8th February, 1850. W. W. DELOITTE, *Accountant.*

Deloitte's assurance that the railroad's accounts were both "Audited and approved" may not have been the world's first report by an independent auditor.[13] But if not, this report by one of the profession's pioneers comes near enough to be worth close attention.

As cannot be done for the origins of law-making or healing or spiritual ritual, the birth of Big Audit and the very beginning of its history can be seen on one printed page, from which have followed over eight score years of practice in the assurance of financial information.[14]

For context, the roles and services of both accountant and auditor have supported commerce since the dawn of trade. The earliest known forms of writing are not romantic poetry or odes to military heroism, but inventory records, etched on clay tablets to document counts of livestock and measures of grain.

Accounting conventions were required as soon as transactions evolved beyond the most primitive and elementary. A simple agreement from before the time of recorded human history — "I will give you this stone axe today, for which your brother will give me a lamb in the spring" — implicates agreement on policies and principles involving timing, revenue recognition, transaction and credit and currency risk.

Assurance — the work of auditors — was also required early. Tax collections on behalf of king or pharaoh involved verification of crop yields, herd sizes and slave holdings. Some trusted functionary was needed, to do the counting.

Matters remained straightforward if evolving for centuries. Kings and princes in Europe financed their political and military ambitions through lenders in the Mediterranean city-states, sitting at their benches — the *bancs* — hence the modern term. And whether by ship or caravan, foreign trade ventures were one-off undertakings with simple bookkeeping. Promoters would sponsor and outfit the voyage. If it returned, pay off the crew, sell the goods and divide the profits. If it failed, take the write-off and absorb the loss.[15]

Came eventually the great works and ventures of the early Industrial Age — the landscape-changing railroads, mines, toll roads and canal companies with their voracious needs for access to investor capital.

Great Western was organized in 1835. In 15 years it had grown to an enterprise showing half-year revenue of £13 million and share capital of £8 million, with its locomotives logging 900,000 miles in the second half of 1849.

As had become typical for the early limited liability companies, its accounts were prepared in accordance with the requirements of the recently enacted Joint Stock Companies Act 1844. These had initially been scrutinized for the benefit of its proprietors and commented upon by "auditors" selected from among the shareholders themselves. It was then an entirely sensible governance proposition — although today questionably superseded as quaint and naïve — that an examiner holding a direct financial interest was best motivated to provide the most scrupulous achievement of useful assurance.

The two worthy shareholders of Great Western who performed that function, Messrs. John Dickinson and Richard Atkinson, have retreated into obscurity, but for their outreach to engage the assistance of the youthful Mr. Deloitte.

Deloitte's opinion on the 1849 accounts — "Audited and approved" — was terse and to the point. Not for him the ambiguities or equivocation that would creep into later years, of "true

and fair" or "in all material respects," or "in accordance with generally accepted standards."

And his audit scope, as recorded in the corporate minutes, was comprehensive: "Every item has been minutely examined by the Auditors, the vouchers and receipts have been inspected, and the purpose to which the payments were applied has been ascertained."

Again, notions of sampling, judgments as to scope of work, or limitations based on cost or effectiveness did not enter. Auditors in the earliest years really did count the stuff, and all of it.

As for the agonizing modern debate on the responsibilities of auditors to observe on systems of internal control, reflected in the significant costs and debatable benefits of Section 404 of the Sarbanes-Oxley law of 2002, Deloitte spoke directly on both the existence and the efficacy of Great Western's systems. As he put it, the auditors not only "authenticated the accounts," they "expressed their general commendation of the system itself, and the mode in which it has worked."

There is both good and bad news in the ability to trace the origins of Big Audit all the way back.

Deloitte himself was in the forefront on two issues of acute modern relevance. He was an innovator on both the form and content of financial statements themselves, and he argued in favor of a legislative framework under which corporate reporting would be required — a result of which was the 1867 English legislation leading to the routinizing of railroad reports. As the legibility of his work to a modern reader makes clear, he would need only a short seminar to be updated on the proliferation of financial complexity and professional vocabulary, to be at home in today's reporting environment.

But suppose a prospective investor in a modern-day English company, doing due diligence by reading its accounts, were to encounter Deloitte's opinion, "Audited and approved." Unless told its date of origin, no reader today — with the possible

exception of a few professional insiders — would recognize it as anachronistic, or balk at the Great Western disclosure if dated in the 21st century.

What are the implications, that a document of such a venerable age would be so familiar as to arouse page-turning indifference?

For the historical context of Mr. Deloitte's pioneering report — Queen Victoria, age 30, had been on the English throne for twelve years. Charles Darwin was back from the voyages of HMS *Beagle*, although publication of his work on evolution was still a decade in the future. The discovery of gold in California was inspiring a rush of both prospectors and capital-intensive infrastructure investments, transforming the North American continent and reordering the world's economies.

Mr. Deloitte's contemporaries in other fields, whose industries have mutated and evolved beyond all recognition, would be utterly lost in today's world. Consider their dislocation:

- A Victorian train engineer, in the cockpit of a space shuttle.
- A typesetting pamphleteer, updated to CNN's global newsroom or a Facebook page or YouTube link.
- A telegrapher, confronting Skype or Twitter, Instagram or Snapchat.
- A surgeon, knowing neither anesthetics nor X-rays, beholding the tools of CAT scans or laser surgery.

While the transmutations wrought by science and technology mean that nothing else from the early Victorian era would be recognizable in today's culture of commerce, there are reasons to find it unsettling that Mr. Deloitte's work might still appear current.

Since then, railroads and the telegraph have begot commercial aviation and the computer, satellite communications and the Internet, cloud computing and drones and big data. In a globalized world, products and entire industries change beyond recognition in cycles measured in months.

No one would wish to go back. It would be a foolish and sentimental yearning, for the time of the slave trades, suicidal cavalry charges, and 30% infant mortality. But neither can time's arrow be deflected. Evolution cannot be stopped.

But mutation is subtle. Even while the last generation of dinosaurs disported around the tar pits, furry little mammals were multiplying, under foot and out of sight. So too, Detroit's Big Three auto makers took no notice while the Japanese and German carmakers were evolving from small-engine entry-level machines to leading positions of innovation, quality and market dominance.

The world's securities exchanges — global high-volume algorithmic electronic trading platforms spawned from the open-outcry bourses of the 19th century — are consolidating under collaborative systems of intergovernmental regulation. Newspapers are either dying off or migrating their business models to the world of the web and the smartphone. Blogs and videos, Pinterest and Instagram have displaced broadsheets as the information vehicles of popular choice.

Darwinian evolution means not just the survival of the fit, but the correlative extinction of the obsolescent. When the accounting profession successfully lobbied the American securities regulators in the 1930s to control the franchise of financial statement assurance, an unappreciated consequence was the acceptance of a regulatory straitjacket. With the form of reporting essentially unchanged since that crafted by Mr. Deloitte and his pioneering fellows in the 1850s, mutation adaptive to changing conditions has been stifled. Today's handcuffed auditors could not provide a more timely or valuable form of report even if they wanted to.

The tectonic plates under the auditors' franchise within Big Audit continue to shift, with ominous speed and expanding risk that the participants are barely able to acknowledge. The auditors themselves have little control over their most immediate threats. They can muster only limited attention, respect and influence among critics, politicians and regulators, leaving them hostage to

the uncertain assumption of their continued survival into the future.

Big Audit and the measure of its value to investors must change no less than the rest of the world of business. But down the road, it is unknown what financial statement assurance will look like, or who will provide it. The large firms that emerged under the leadership of Mr. Deloitte and his contemporaries have called for dialog on the need for a fundamental reengineering, toward a model of reporting in real time and utilizing the availability and power of "big data," and opening the prospects for a redesigned form of assurance.

They assert that the accounting profession is ideally poised to lead and participate. But that position rests more on historic inertia than on presumptive necessity. The auditors have no more guaranteed tickets to survival than did the dinosaurs or the steam locomotives. Being under assault from regulators and shareholder plaintiffs does not *ipso facto* confer either virtue or a right to relief.

The challenge may be put this way: In the world of commerce and the capital markets, large-company assurance is essential. Its delivery by the Big Four is not.[16]

Entrepreneurial as he was, William Welch Deloitte would take pride that his work has survived virtually intact across this span of decades. But he would also be among the leaders sounding the call for Big Audit's redesign and renewal.

HP VERSUS AUTONOMY: HOW BIG AUDIT MIGHT SURVIVE THE FALLOUT

One hundred and sixty-one years following Mr. Deloitte's opinion on Great Western, a partner in the Cambridge office of the Big Four firm bearing his name and legacy signed the firm's report

dated February 22, 2011, on the 2010 financial statements of UK-based software company Autonomy.

Autonomy was acquired the following October by Hewlett-Packard, for $11.1 billion. A year later the deal imploded — on November 20, 2012 — with the announcement by HP's CEO Meg Whitman of an $8.8 billion write-off, of which $5.5 billion was attributed to massive accounting irregularities.

As one of the many real-world examples that provide the building blocks for this narrative, a lesson in the many perceived shortcomings in the current financial reporting and assurance model of Big Audit lay under the toxic cloud of charges and counter-charges:

- Whitman's claims of pervasive accounting fraud were derided by critics as a mask for HP's faulty due diligence, gross overpayment and post-transaction mismanagement, and have been vigorously denied by Autonomy's ex-CEO Mike Lynch.[17]
- Lawsuits followed promptly — by HP's shareholders against the company for its self-inflicted wound; derivatively on behalf of HP and by shareholders as a class, against the entire range of usual targets including Deloitte as Autonomy's statutory auditor in the United Kingdom and KPMG in its due diligence role for HP; and by HP itself against Autonomy's leadership — the last a UK-based suit, said to be one of the largest individual claims in the history of the British courts.

The dust-settling process will be years in coming — including the eventual litigation exit price that would predictably be paid by Deloitte when trans-Atlantic teams of lawyers concluded their inevitable settlement negotiations[18] and finalized the allocation of responsibility around Autonomy's revenue accounting and HP's due diligence.[19]

As to the implications for the Big Four collectively, pointed questions arose that go to the structural heart of the traditional auditor-client relationship:

- Floyd Norris in the *New York Times*, November 29, 2012: "*'Where were the auditors?'…They were everywhere.*"
- Francine McKenna, *Re: The Auditors*, December 1, 2012: "*'To the victor's auditor go the audit spoils'… is not how the Big Four audit industry is played now that consulting is again King.*"
- Tom Selling, *The Accounting Onion*, December 2, 2012: "*If Autonomy's accounting practices were too aggressive, would Deloitte's staff have had the gumption to push back given the stakes?*"

Meaningful confrontation of these questions, which have evaded resolution for decades, includes two essential issues:

First, because Autonomy's accounting and reporting and Deloitte's issuance of the standard commoditized auditor's report were targeted as unsatisfactory, just when critically most important, the question was raised yet again:

> *"What good are models having the appearance of utility, only up to the point of their unexpected exposure as insufficient, when suddenly they seem not to have worked at all?"*

Second, the finger-pointing at Deloitte's business alliance relationship with HP and the scope of its nonaudit services for Autonomy raise again the unresolved obsolescence of the notion of "appearance of independence."

Regulators have long had the large accounting firms' expansion of nonaudit services in their sights. For example — at the AICPA's SEC-PCAOB conference in November 2012:

- Then-SEC Chief Accountant[20] Paul Beswick: "*I question whether accountants' expanding practices into areas unrelated to their primary competencies weakens public trust.*"

- PCAOB Chairman James Doty: *"Audit practices have shrunk in comparison to audit firms' other client service lines — not all of which are schooled in, or depend upon, the fundamental exercise of skepticism. This threatens to weaken the strength of the audit practice in the firm overall."*

To much the same effect, PCAOB member Lewis Ferguson, quoted at a press conference in April 2014, on the auditors' rapid expansion into the applicability of Big Data to the practice of auditing, called it "a source of great concern to all regulators around the world," and "rais(ing) serious concerns about differential levels of profitability in these businesses, differential rates of growth, where the economic incentives are and to what extent does audit quality *suffer* as a result" (*emphasis added*).

The accounting profession may survive what would otherwise be another generation under this radioactive rhetorical cloud; to make it so, fundamental adjustments are in order.

A priority would be a robust defense of the "client-pays" model. However much criticized, it dates to the invention of independent assurance in the 1850s, and is the *only* approach ever to stand the test of actual adoption and use.

"Client pays" being irreconcilable with "independence in fact," however, the HP-Autonomy fiasco is a reminder of the profession's long-standing inability to articulate intellectually stable support for "independence in appearance."

For which, it is worth anticipating here in summary (*see* Part II) the reasons why the sacred cow of auditor independence should be led off and humanely put out of its misery:

- The concept of auditor independence does not serve the interests of investors.
- Audit performance — and more immediately, the survival of the large firms to serve their global clients and the capital

markets — would be better achieved if the current independence requirements and constraints were scrapped altogether.

- Auditors should be free to provide their clients with any services within their skills. The only thing that should be required is comprehensive disclosure of all relationships, to be evaluated and decided by the voting power of the marketplace.

At the same time, clearance of the radioactive debris of independence inhibitions would free the Big Audit marketplace from the entire sterile debate over permissible services by auditors.

The community of financial information users is capable of defining, engaging and valuing the scope of services available from its gatekeepers — whether bankers, lawyers, rating agencies, or auditors.

The public users' trade-off — to release the large accounting firms from the constraints of a system that has long lost its value — would involve a downward reassessment in the asserted value of their traditional core product. That would only acknowledge a reality long suppressed or denied in any event — an exchange that would be worth making.

Sidebar: Counting the Beans — Facts and Figures on Big Audit

	Deloitte	EY	KPMG	PwC
Global revenue ($ billions)[a]	36.8	29.6	25.4	35.9
Global personnel (thousands)	244	231	189	223
Global partners	11,122	11,599	9,843	10,803
Practice line revenue ($ billions):				
Assurance	9.4	11.3	10.1	15.3
Tax (and legal)	6.9	7.8	5.6	9.1

(*Continued*)

	Deloitte	EY	KPMG	PwC
Advisory/consulting[b]	20.5	10.5	9.7	11.5
Profit per partner (UK) (£thousands)	837	662	582	706

[a]Global figures are from the 2016 annual reports on the Big Four's global websites. UK partner profits are from their audited UK accounts or news reports. Global growth rates reported for 2016, year-on-year, are: Deloitte + 9.5%, EY + 9%, KPMG + 8%, and PwC + 7%.
[b]Includes consulting practices variously described as Transaction, Financial and Enterprise Risk.

For context and comparison with the Big Four's global revenue — all together some $128 billion — the latest available combined annual total revenue of the next six largest networks, associations and alliances, reported by those organizations or the International Accounting Bulletin, totaled some $28 billion — a *total* amount falling roughly between the size of the two smaller of the Big Four:

BDO ($ billions)	7.6
Grants	4.6
RSM	4.6
Praxity	4.5
Baker Tilly	3.8
Crowe Horwath	3.5

Examples of the Extent of Large-Company Audit Concentration

United States

Of the large companies comprising the Dow Jones Industrial index, all 30 were audited by the Big Four in 2016: Deloitte — four, EY — six, KPMG — five, PwC — 15. All but a handful of the companies in the S&P 500 index are likewise Big Four audit clients.

The Big Four today

United Kingdom

In the United Kingdom, according to the report of the Financial Reporting Council in July 2016, the Big Four audited all but two of the FTSE 100 companies — a list significantly dominated by PwC's 37 engagements. As reported, the Big Four also audited 228 of the next FTSE 250 companies.

As measured by Adviser Rankings Ltd., of the UK public companies audited by the top ten firms, the Big Four audit more than 98% by both market capitalization and profits.

Under rules in the United Kingdom issued by the Financial Reporting Council and the Competition Commission starting in late 2013 — discussed at more length in Part IV — the United Kingdom has experienced a flurry of audit tenders — including some retentions of incumbents and a larger number of replacements.

While issues of limited auditor choice and cost and inefficiency of the re-tender process continue — as ancillary challenges to the still-unproven proposition that lengthy audit tenure is somehow causally related to audit quality — those who advocate auditor replacement as a means of advancing increased competition from the smaller audit firms confront the evidence that *none* of the announced FTSE 100 switches in the United Kingdom has involved replacement of a Big Four firm with a firm outside that quartet.

France

France is the single large country that follows the practice of joint audits. Of the companies in its large-company index, the CAC 40, all use at least one Big Four firm, and 27 use two. No CAC 40 company uses two audit firms from outside the Big Four.

Of the companies in the CAC 40 headquartered outside France, and free to follow the French practice of joint auditors, none does so — each chooses to use a single Big Four firm.

Germany

All of the large companies comprising the DAX 30 index are audited by the Big Four — 18 are clients of KPMG, and nine use PwC.

As an indicator of the uneven geographic distribution of audit resources even among the Big Four, KPMG's dominant position in Germany is contrasted with the fact that it holds only eleven audit mandates under the joint-audit regime applicable to the CAC 40 in France, edged out by the 13 mandates held by the Mazars firm, a member of the Praxity alliance and the single player outside the Big Four in the French large-company market.

NOTES

1. Arthur Andersen's leaders made two branding decisions in the firm's last year. First, they shortened the global name to "Andersen" — a convention followed here unless context requires otherwise. They also chose to replace the long-familiar "Doors" logo, modeled on the mahogany entrance to the firm's original Chicago office, with a red-and-orange ball of uncertain provenance. Leadership at the time lacked the perspective, now provided by hindsight, to appreciate that those decisions, separating the firm from its historic roots, were symptomatic of deeper issues at the core of the firm's values.

2. *Arthur Andersen LLP v. United States* (2005).

3. Meanwhile, the remaining shell of the Andersen organization used what was left of its resources to wind down its litigation inventory. As a

defendant in the WorldCom civil litigation, for example, in which a group of investment banks agreed to settlements totaling over $6 billion, Andersen eventually contributed the relatively paltry sum of $103 million.

4. From there the stock has bumped up and down, to 215 *p* in October 2016 — just before the outbreak on November 7 of a massive hacking of customer accounts at Tesco Bank that sent the stock reeling afresh.

5. The tumultuous finale to the 2017 Academy Awards ceremonies caused by the Best Picture envelope mix-up put PwC and its responsible partner under the harsh spot-light of an avoidably ill-managed process. While the partner lost his role for the future, the firm will retain its 83-year relationship with the Academy, and there is little prospect that PwC's greater reputation among clients in the global-scale professional services market will be affected.

6. Ben Affleck's eponymous star turn in 2016's hit summer film *The Accountant* only proved the rule — operating as he did out of a seedy strip mall and an Airstream trailer, not as a large-company statutory auditor, but with a unique solo practice combining tax, forensics, and deadly force.

7. George Bernard Shaw, *Major Barbara* (1905).

8. *Financial Times* (September 28, 2005).

9. The large accounting firms have engaged in sustained competition, to the astonishing degree that active price-cutting still survives from the days of the Big Eight. But the idea that one firm should emerge triumphant, as happens in those great spectacles of American college sport, the NCAA basketball tournaments, is beyond contemplation. As will be discussed, the uneven concentration of resources and the constraints on client choice are already disruptive. Because a three-firm system is unworkable, the next Big Four failure would bring down the entire structure. The slang of a basketball tournament has provided a label that is colorful but inapt. The better if ominous gaming metaphor is "Russian roulette."

10. Because of reference from time to time to the "standard" auditor's report, included as appendices are both the pioneering report of William Welch Deloitte dated February 8, 1850, on the financial statements of Great Western Railway for the half-yearly period ended December 31, 1849, and a modern version — the report by EY on the 2016 financial statements of Apple Inc. — whose market capitalization as of late-spring

2017 of over $800 billion pairs it with Alphabet as America's largest public companies. Readers might readily find language identical to EY's by digging out a version from one of the annual reports forwarded from their brokers — assuming they had not immediately been tossed into the trash.

11. While the audit opinion language in the United States has borne the compliance-oriented qualifier, "in accordance with" accepted accounting standards, the early English reports originated the plain language of a "true and fair view." That distinction is now essentially lost, with the British use of the International Financial Reporting Standards; it is in any event looked on by users, if at all, as a distinction without a difference — inconsequential to the investing public and of academic interest only to those counting the number of angels on pin-heads.

12. Presented in an earlier form as a paper for the American Accounting Association's August 2008 meeting, Anaheim, California.

13. Although an affirmative claim of primacy is always subject to discovery of an earlier example, diligent inquiry with historians of the profession has so far not yielded up a competitor for the position.

14. In the sprawling modern complex of Britain's National Archives, in the suburb of Kew on the outskirts of London, documentary history spanning a thousand years is directly accessible to the interested civilian, through a beguiling combination of highly automated data retrieval and manual techniques that would be familiar to medieval clerks and scriveners. A researcher picks up a reader's card. "Pencils only in the reading rooms, sir — no pens or highlighters allowed." Into a locker go all banned and dangerous instruments of potential defacement. Intensely earnest scholars and amateur family genealogists pad around in appropriately hushed and reverential attitudes. Research librarians help refine searches and log in requests. A staff of helpful clerks fetch a stack of Victorian-era ledgers and minute books. There are indeed needles to be found in this vast field of haystacks.

15. Incidentally, if the ship sank, investors resorted to another recently developed trade-based sector, lodging their claims under maritime insurance policies written with the specialists tracing their new activities to the 17th century gatherings at Edward Lloyd's coffeehouse in the City of London.

16. Nor should the inhibitions on the Big Four's innovation capabilities be a surprise. Uber was not the invention of taxi fleet owners eager to

redesign the industry by destroying the value of their portfolios of medallions; Airbnb was not the brainchild of the hotel chains, nor Amazon of the bricks-and-mortar bookstores.

17. At this writing it is premature to assess the impact or eventual outcome of the November 2016 criminal indictment in California of former Autonomy CFO Sushovan Hussain, on federal fraud charges for conduct designed to manipulate Autonomy's stock price.

18. In the spring of 2015, HP and Deloitte signed a "standstill agreement" — a convention suspending the effect of statutes of limitations that would have fixed a deadline by which HP would have been obliged to sue Deloitte — a means of preserving amity between the parties and an almost-inevitable signal that the ultimate resolution will be at a level modest enough to be inconsequential.

19. Largely peripheral to the story here, except for its impact on the remaining legal maneuvers in the United Kingdom, HP's own litigation exposure took some peculiar turns. In the summer of 2014, the judge supervising shareholders' suits against HP in San Francisco rejected a proposed settlement, under which HP would have paid nothing, but would have engaged the very firm of *plaintiffs'* lawyers who brought suit against the company, to migrate the pre-trial record they had built against HP itself over to support for HP's claims against Autonomy's former executives. In June 2015, a settlement was announced under which HP would pay $100 million in resolution of shareholder claims — an outcome including the typical language, that "While HP believes the action has no merit, it is desirable and beneficial to HP and its shareholders to resolve [to] settle the case as further litigation would be burdensome and protracted."

20. At the time, Acting Chief Accountant, and since departed for the private sector.