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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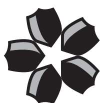

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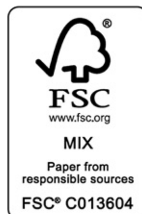

INVESTOR IN PEOPLE

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.