July 2003

PUBLIC ACCOUNTING FIRMS

Mandated Study on Consolidation and Competition

GAO Accountability•Integrity•Reliability

Highlights

Highlights of GAO-03-864, a report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services

Why GAO Did This Study

The audit market for large public companies is an oligopoly, with the largest firms auditing the vast majority of public companies and smaller firms facing significant barriers to entry into the market. Mergers among the largest firms in the 1980s and 1990s and the dissolution of Arthur Andersen in 2002 significantly increased concentration among the largest firms, known as the "Big 4." These four firms currently audit over 78 percent of all U.S. public companies and 99 percent of all public company sales. This consolidation and the resulting concentration have raised a number of concerns. To address them, the Sarbanes-Oxley Act of 2002 mandated that GAO study

- the factors contributing to the mergers;
- the implications of consolidation on competition and client choice, audit fees, audit quality, and auditor independence;
- the impact of consolidation on capital formation and securities markets; and
- barriers to entry faced by smaller accounting firms in competing with the largest firms for large public company audits.

www.gao.gov/cgi-bin/getrpt?GAO-03-864.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Davi M. D'Agostino (202) 512-8678 or d'agostinod@gao.gov.

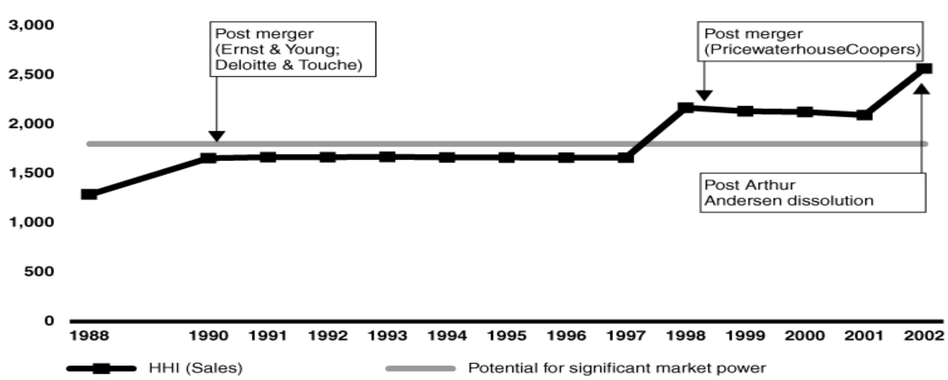
What GAO Found

Domestically and globally, there are only a few large firms capable of auditing large public companies, which raises potential choice, price, quality, and concentration risk concerns. A common concentration measure used in antitrust analysis, the Hirschman-Herfindahl Index (HHI) indicates that the largest firms have the potential for significant market power following mergers among the largest firms and the dissolution of Arthur Andersen (see fig. below). Although GAO found no evidence of impaired competition to date, the significant changes that have occurred in the profession may have implications for competition and public company choice, especially in certain industries, in the future.

Existing research on audit fees did not conclusively identify a direct correlation with consolidation. GAO found that fees have started to increase, and most experts expect the trend to continue as the audit environment responds to recent and ongoing changes in the audit market. Research on quality and independence did not link audit quality and auditor independence to consolidation and generally was inconclusive. Likewise, GAO was unable to draw clear linkages between consolidation and capital formation but did observe potential impacts for some smaller companies seeking to raise capital. However, given the unprecedented changes occurring in the audit market, GAO observes that past behavior may not be indicative of future behavior, and these potential implications may warrant additional study in the future, including preventing further consolidation and maintaining competition.

Finally, GAO found that smaller accounting firms faced significant barriers to entry—including lack of staff, industry and technical expertise, capital formation, global reach, and reputation—into the large public company audit market. As a result, market forces are not likely to result in the expansion of the current Big 4. Furthermore, certain factors and conditions could cause a further reduction in the number of major accounting firms.

Hirschman-Herfindahl Indexes, 1988-2002



Source: *Who Audits America*, 1988-2002.