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**Before the
Advisory Committee on the Auditing Profession
U.S. Department of the Treasury
December 3, 2007**

Chairmen Levitt and Nicolaisen, and Members of the Advisory Committee on the Auditing Profession:

I am pleased to be here today to discuss concentration in the U.S. public company audit market. The effectiveness and efficiency of the audit market for public companies are critical to the functioning of our capital markets. Therefore, I commend the Secretary of the Treasury for establishing this Advisory Committee on the Auditing Profession to proactively evaluate the current and future auditing profession in the United States.

GAO's Current Study

GAO is currently completing an update of a 2003 GAO study of concentration in the U.S. public company audit market.¹ The 2003 study examined concentration in the largest public company market sector—the Fortune 1000 public companies. At that time, we found that although audits for large public companies were highly concentrated among the largest audit firms, the audit market of large public companies appeared competitive as measured by various indicators. We also concluded that the audit market was in the midst of unprecedented change as audit firms were adapting to new audit responsibilities, new independence standards, and a new oversight structure. In many cases it was unclear what the ultimate outcome of the changes would be, and we noted that the findings of the past might not reflect the future.

The objectives of our current study are to review (1) concentration in the audit market for public companies and the impact of this concentration, (2) the potential for increased capacity among smaller audit firms to ease market concentration, and (3) proposals that have been offered by others for reducing the risk of concentration in the audit market and the challenges faced by smaller firms interested in expanding their market share. Our current study includes surveys of public companies and auditing firms and interviews with market participants, including representatives of auditing firms, public companies, regulators, academics, and investors. To address these objectives, we collected data and analyzed changes in companies' choice of auditors and in audit fees, and computed concentration ratios, and other measures of concentration. We developed an econometric model to evaluate how various factors, including the level of market concentration, could explain the level of fees that public companies paid to their auditors.

My statement today includes some key observations from our current study that are relevant to the Advisory Committee's agenda. We expect to issue our final report early in 2008. When our final report is issued, it will provide additional insights relevant to audit firm concentration and the capacity of smaller firms to reduce concentration. In addition, my statement is based on

¹ U.S. Government Accountability Office, *Public Accounting Firms: Mandated Study on Consolidation and Competition*, GAO-03-864 (Washington, D.C.: July 30, 2003).

other relevant work we have performed, including our 2003 reviews of audit market concentration and mandatory audit firm rotation² and our 2006 study of the impact of the Sarbanes-Oxley Act on small business.³

Key Observations

My statement today focuses on four key observations

- First, although the audit market for large public companies remains highly concentrated, the smaller public company market has become significantly less concentrated.
- Second, the level of market concentration does not appear to be having a significant negative impact overall.
- Third, the concentration in the audit market of large public companies is unlikely to be reduced in the near term by the next tier⁴ and smaller firms.
- Finally, there was no general consensus for various proposals put forth for addressing concentration.

When examining market concentration and the auditing profession, it is important to be mindful of three often interrelated factors—auditor choice, audit cost, and audit quality.

Concentration within Different Segments of the Audit Market

Although concentrated overall, the market dominance of the Big 4 firms generally declines with the size of the public company. As shown in figure 1, the public company market segments with the largest public companies are still largely dominated by the Big 4. In 2006, the Big 4 auditing firms audited 98 percent of the 1,544 largest public companies—those with annual revenues of more than \$1 billion, and 92 percent of the 561 larger public companies with revenues from \$500 million to \$1 billion. Large companies reported to us that they prefer the Big 4 because of their capabilities in terms of size, geographic reach, technical expertise and industry specialization, as well as reputation.

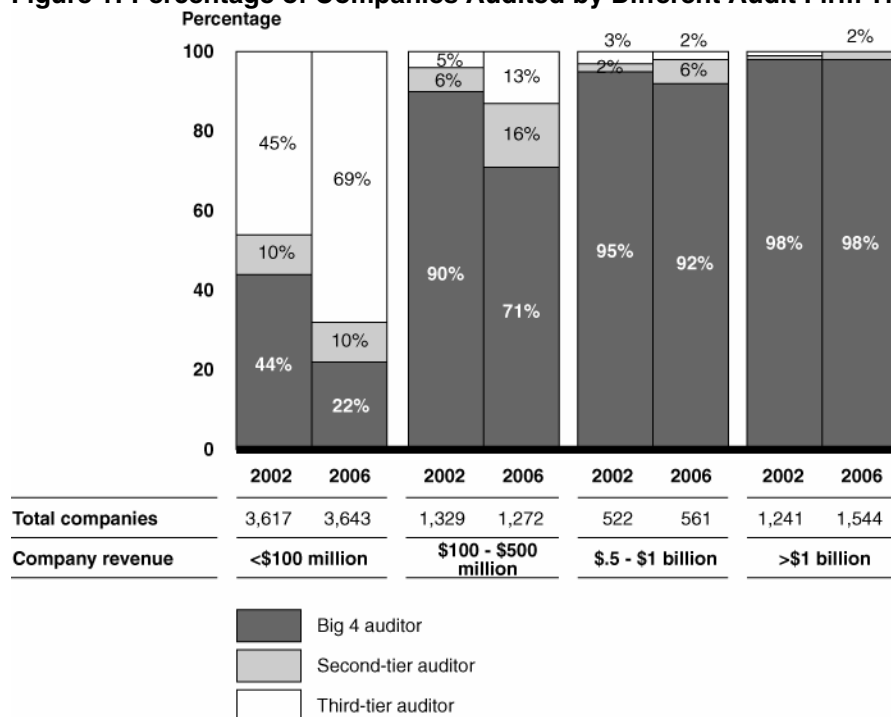
In contrast, the market has changed significantly for public companies with annual revenues of less than \$500 million. From 2002 to 2006, the portion of the smallest companies—those with revenues less than \$100 million—audited by the Big 4 fell by half, from 44 percent to 22 percent (fig. 1). And the Big 4 share of the audit market for companies with revenues between \$100 million and \$500 million also declined, from 90 to 71 percent, respectively, from 2002 to 2006.

²GAO-03-864 and U.S. Government Accountability Office, *Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation*, GAO-04-216 (Washington, D.C.: Nov. 21, 2003).

³U.S. Government Accountability Office, *Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies*, GAO-06-361 (Washington, D.C.: April 13, 2006).

⁴For our study, we divided firms in the audit market into three tiers. The four largest auditing firms performing—known as the Big 4—have thousands of partners, tens of thousands of employees, offices located around the world, and thousands of public company clients. (The Big 4 firms are Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP.) The next four largest auditing firms—the second-tier firms—operate nationally and to some extent internationally and audit more than 100 public company clients but have substantially fewer employees and partners than the Big 4. (For the purposes of this report, the second-tier firms are BDO Seidman LLP, Crowe Chizek & Company LLC, Grant Thornton LLP, and McGladrey and Pullen LLP.) All other auditing firms—the third-tier firms—audit regional and local public companies and have fewer than 100 public company clients.

Figure 1: Percentage of Companies Audited by Different Audit Firm Tiers, by Company Revenue



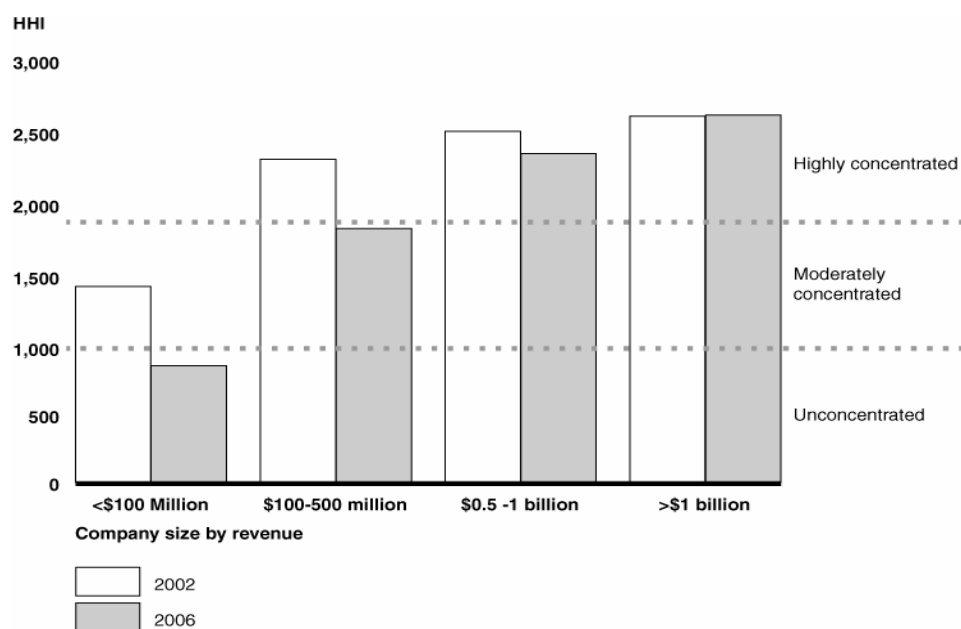
Source: GAO analysis of Audit Analytics data.
 Note: Percentages in Figure 1 may not add to 100 percent due to rounding.

As the share of smaller companies audited by the Big 4 has declined, concentration in the audit market for these companies has eased significantly. By grouping public companies by their revenues and calculating Hirschman-Herfindahl Indexes (HHI)⁵ for these groupings, we found that while the audit market for larger public companies with revenues greater than \$500 million remains highly concentrated, the market for smaller public companies with less than \$500 million in revenue has become much less concentrated.⁶ As figure 2 shows, between 2002 and 2006, the HHI for the audit market for the smallest public companies—those with annual revenues of less than \$100 million—declined from a level of 1,400 to about 800. According to Department of Justice (DOJ) guidelines, a market with an HHI of less than 1,000 is considered to be unconcentrated, and no competitor would likely have the ability to exert market power. The audit market for public companies with revenues between \$100 million and \$500 million also became less concentrated as it went from being highly concentrated in 2002 to an HHI level considered to be moderately concentrated.

⁵The Hirschman-Herfindahl Index is one of the concentration measures government agencies, including Department of Justice and Federal Trade Commission, use when assessing concentration to enforce U.S. antitrust laws.

⁶Similar results are obtained when assets are used as the measure of size. Figures 1 and 2 do not include a number of companies with missing financial data. The category of companies with greater than \$1 billion in revenue roughly corresponds to the Fortune 1000 list. In 2006, the smallest company on the Fortune 1000 list had revenues just over \$1.4 billion. As a result, the \$1 billion and over segment shown in the figure includes the Fortune 1000 as well as other large companies.

Figure 2: Hirschman-Herfindahl Indexes for Public Company Market Segments Grouped by Company Revenues



Source: GAO analysis based on Audit Analytics data.

According to our survey of over 500 public companies, many larger public companies see themselves as having limited choice – meaning that their choice was limited to the largest audit firms – because they do not believe smaller firms have the capability to handle the size and complexity of their company’s operations and the breadth of their global network. The auditor’s technical capability with accounting principles and auditing standards and the need for industry specialization or expertise were also identified as important by a great majority of companies we surveyed. As a result, 80 percent of large companies reported having 3 or fewer auditing firms to choose from if they were to need to change their auditor, and over half reported that the number of choices was not adequate. Larger public companies’ preference for Big 4 firms was also evident in our analysis of auditor change data between 2003 and 2007, as 88 of the 95 large public companies that changed auditors moved from one Big 4 firm to another. Similar to the largest public companies, many companies below the Fortune 1000 also reported being limited to 3 or fewer firms if they had to choose a new auditor, but they were more likely to consider non-Big 4 firms. About 70 percent of small public companies thought that the level of competition for audit services for their company was sufficient.

The shift of smaller companies from larger to smaller audit firms can be attributed in part to changing demand for audit resources and changes in the audit environment. The Sarbanes-Oxley Act,⁷ its implementing regulations, and new and revised accounting and auditing requirements increased the scope of the audit to include the audit of the client’s internal controls over financial reporting. The Public Company Accounting Oversight Board (PCAOB) began oversight of auditors of public companies, including detailed audit inspections and required corrective actions for weaknesses found in audits. The new audit requirements and regulatory environment

⁷Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002).

created a demand for staff hours and expertise that added to the cost of audits. The Big 4 firms noted during our interviews that they have significantly increased the number of staff in their national technical offices due to the complexity of the accounting principles and auditing standards.

Current Level of Concentration Does Not Appear to Be Having Significant Negative Impact Overall

Although highly concentrated markets typically raise concerns about the competitiveness of prices charged or quality of services offered, our analysis indicates that other factors appear to explain the increases in audit fees in recent years. Data on audit fees paid by public companies show that these fees have increased substantially. Between 2000 and 2006, median fees as a percentage of public company assets more than quadrupled (334 percent increase) for companies with less than \$100 million in revenue, more than tripled (239 percent increase) for companies with revenue between \$100 million and \$1 billion, and almost tripled (190 percent increase) for companies with revenue over \$1 billion.

Results of an econometric model we developed to assess the extent to which various factors could be influencing audit fees,⁸ indicated that, in general, public companies operating in industrial sectors with more concentrated audit markets were not paying higher audit fees than companies in sectors with less concentrated audit markets. However, for the largest companies, we found some evidence that audit market concentration within an industry does have a very small effect on fees.

Market participants and others cited factors other than concentration that have contributed to recent fee increases. The most significant factors that auditing firm staff cited in interviews were the increasing complexity of accounting and financial reporting standards and the additional requirements of new auditing standards which have increased the amount of work performed, the cost of providing audit services, and the need for technical expertise. Many market participants noted similar factors as impacting fees. Big 4 firms also cited the increased costs of attracting and retaining talented staff. Similarly, second- and third-tier firms that we surveyed listed the top four factors increasing their costs since 2003 as complexity of accounting principles and accounting standards, the additional requirements of new standards, the time and effort necessary to prepare for PCAOB inspections, and the costs incurred to hire and train staff.⁹

In studying the effects of concentration, we did not directly assess audit quality. However, the current level of market concentration does not appear to be negatively affecting audit quality as many market participants who commented on audit quality said that they thought audit quality had improved. We believe that comments regarding improved audit quality in recent years can be

⁸Our analysis is based on a panel data set compiled for over 12,000 companies from 2000 through 2006. The panel data set allowed GAO to use a number of techniques to increase the validity of the results including estimating “random-effect” and “fixed-effect” model specifications. The fixed-effects model helps to control for the potentially large number of unmeasured forces that might explain the differences in the audit fees paid across public companies. As a result the fixed-effects models were able to account for over 95 percent of the variation in audit fees. Time period fixed-effects are added to help control for Sarbanes-Oxley Act and other effects that impact the fees paid by all public companies.

⁹Auditing firm survey data in this statement does not include the responses of the Big 4 firms, or firms with four or fewer audit clients unless otherwise noted. Also, data for third-tier firms refers to survey respondents only and cannot be generalized to all third-tier firms because of low response rates for this group.

traced to related factors. The serious audit failures that began to emerge in 2000 were a serious jolt to the auditing profession, which was faced with the need to reestablish its credibility. The auditing profession's self-realization that audit quality has to stand center stage and the PCAOB's role in the audit standard setting and audit oversight process have been widely acknowledged as having an important positive impact on audit quality.

Although current concentration does not appear to be having significant negative impact overall, the potential risk of further concentration in the public company audit market does raise significant concerns. The loss of another large auditing firm from the audit market could significantly increase the market's existing high level of concentration. We performed analyses to simulate the effect of the failure or exit of the smallest of the Big 4 by assigning the firm's clients to other firms in the same proportion as the clients of Arthur Andersen were distributed after that firm dissolved. Under this scenario, the resulting HHI concentration level would rise substantially above the current overall level of the market, which is already considered highly concentrated, according to DOJ guidance. This higher concentration could increase the risk that the remaining large auditing firms would begin to exercise their market power to raise prices and coordinate action among themselves to the detriment of their clients.

Growth in Smaller Firms Is Unlikely to Ease Concentration

Growth in the capacity of second- and third-tier audit firms is unlikely to reduce concentration in the audit market for large public companies in the foreseeable future. Our survey and interviews with representatives of second- and third-tier auditing firms suggest that over 70 percent are not interested in serving this market segment. Possible reasons for this include concern that they would face additional risks and would have to give up new opportunities to provide nonaudit services to companies of all sizes. Firms that do want to audit large public companies continue to face challenges to expanding the number of large public companies they audit. Chief among these challenges is having adequate capacity (e.g., staff and geographic coverage) to audit large public companies, acquiring the needed technical capability and industry specialization, and developing name recognition and a reputation for this kind of work.

To meaningfully reduce concentration in the audit market for large public companies, second- and third-tier firms would need audit staffs large enough to serve multiple large public companies. However, these firms face challenges in recruiting and retaining staff. As we reported in 2003, it is not uncommon for an audit of a large national or multinational public company to require hundreds of staff, and most second- and third-tier firms do not have the resources necessary to commit hundreds of employees to a single client. As table 1 illustrates, the Big 4 firms have significantly more capacity, in terms of staff and partners than second- and third-tier firms.

Table 1: First, Second- and Third-Tier Auditing Firm Capacity, 2006

Firm	Partners	Professional Staff	Offices
Big 4			
Deloitte	2,654	26,960	98
Ernst & Young	2,100	17,200	83
PriceWaterhouseCoopers	2,069	21,409	84
KPMG	1,664	14,038	89
Second Tier			
RSM McGladrey ^a	775	4,567	125
Grant Thornton	444	3,575	48
BDO Seidman	240	1,803	34
Crowe Group	129	1,458	20
Third tier^b			
Average of sample of third-tier firms	46	332	8

Source: Public Accounting Report, 2006-2007

^aRSM McGladrey and McGladrey & Pullen are affiliated through an alternative practice structure. Number of offices includes those for RSM McGladrey, which is a subsidiary of H&R Block and performs tax and consulting services and for McGladrey & Pullen, which performs audit services.

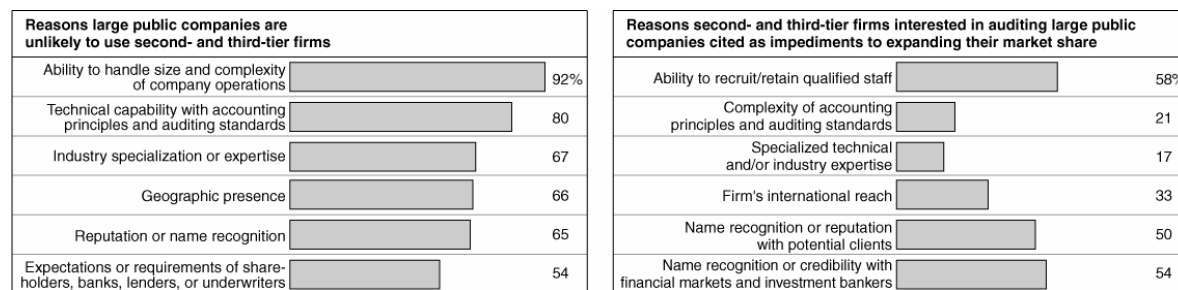
^bSample of 3rd tier firms that audit at least one public company—some of the smallest are not represented.

To approach the capacity of the Big 4, second- and third-tier firms would have to grow significantly. The gap between the Big 4 and the second tier noted in table 1 is significant. Combined, the 4 second-tier firms still have about 2,600 fewer professional staff than KPMG, the smallest of the Big 4 firms. The likelihood that the growth of second- and third-tier firms will reduce concentration in the audit market for large public companies is also limited by constraints on these firms' geographic reach. Large multinational companies in particular need auditors to have a presence in all of the countries in which they operate. While many second- and third-tier firms join with other independent firms to expand their geographic reach, some company officials we interviewed said that most of the international networks these firms belong to are not extensive enough to meet their companies' needs. Also, the level of technical capabilities and specialized industry knowledge of second- and third-tier firms that want to enter the large public company market can have an impact on their ability to enter the audit market for large public companies and reduce its concentration.

Our surveys of second and third-tier audit firms and public company audit committee chairs identified a general consensus on questions related to the likelihood of second and third-tier firms' increasing the number of large public companies they audit. According to our survey of the 118 non-Big 4 auditing firms with at least 5 public company clients, all of the second-tier firms and 79 percent of the third-tier firms indicated that they expected to increase the number of public companies they audited in the next 5 years, but 73 percent of the second and third-tiered firms said that they were not interested in serving the audit market for large public companies. Also, our survey of audit committee chairs found that 86 percent of large public companies¹⁰ were not likely to consider using a second-tier firm and none were likely to use a third-tier audit firm if they were selecting a new audit firm.

¹⁰In conducting our survey of almost 600 public company audit committee chairs, we defined large public companies as those that are members of the Fortune 1000.

Figure 3: Second and Third-Tier Firms’ Challenges in Auditing Large Public Companies



Source: GAO survey.

In our surveys, large public companies unlikely to use a second- or third-tier audit firm were asked about their reasons. We also asked second- and third-tier firms interested in auditing more large public companies about impediments they face. Of the companies responding, a firm’s ability to handle the size and complexity of their company’s operations (92 percent) and technical capability with accounting principles and auditing standards (80 percent) were cited most frequently as being of great or very great importance in their choice of firm (see fig. 3).¹¹ For firms, their ability to recruit and retain qualified staff was—at 58 percent—the reason most frequently cited as being of great or very great importance as an impediment to their auditing additional large public companies. There was apparent agreement between large companies and second- and third-tier firms regarding firm reputation or name recognition. Sixty-five percent of companies indicated that reputation or name recognition was of great or very great importance for ruling out smaller firms, and 54 percent said that the expectations or requirements of shareholders, banks, lenders, or the broker-dealers that help the company raise capital were of great or very great importance. Firm responses roughly paralleled those of the companies, with 50 percent giving name recognition or reputation with potential clients great or very great importance and 54 percent indicating the same for name recognition or credibility with financial markets and investment bankers.

Proposals Made by Others for Addressing Concentration Have Significant Disadvantages

Over the years, academics, industry groups, and other market participants have offered a range of proposals that are designed to reduce the risks of current and further concentration or address the challenges facing second- and third-tier audit firms. We considered a number of these individual proposals and found that while each was associated with some identified benefits, each also presents some significant disadvantages, and there was no general consensus among market participants for any individual proposal we identified for addressing concentration.

For example, some academic and industry sources have suggested that requiring public companies to periodically change auditors could reduce the current level of concentration as well as provide additional benefits in terms of auditor independence. Such mandatory audit firm rotation would limit the number of years that an auditing firm could serve as the auditor for a particular public company. Currently, about 40 percent of public companies have used their current auditor for at least 5 years, according to our survey results, and almost a quarter for at

¹¹Public company survey statistics are accurate within 12 percentage points, unless otherwise noted.

least 10 years.¹² Mandatory rotation could create more opportunities to change auditors, giving smaller firms a chance to compete with the Big 4. For example, 44 percent of second- and third-tier firms responding to our survey stated that mandatory rotation would be at least a somewhat effective way for their firms to gain more public company clients, while 52 percent of respondents¹³ thought that it would be only slightly or not at all effective.

Our 2003 report¹⁴ raised other concerns about the effects on mandatory audit firm rotation, including increased costs and loss of auditor expertise or specific audits. Our 2003 surveys found that more than 67 percent of large public companies and audit firms that audited more than ten public companies expected that mandatory audit firm rotation would increase audit firm's initial-year audit costs by more than 20 percent over subsequent year costs. Also, more than 67 percent of large public companies and audit firms we surveyed in 2003 expected that public companies would incur higher audit support costs – equal to at least 10 percent of the new firm's initial year audit fee - in orienting the new audit firm to the companies' operations, systems, and financial reporting practices. While the firm gains knowledge about the client, the risk that an auditor will not detect existing problems is elevated. Finally, recently implemented statutory changes requiring audit partner rotation every 5 years may have already provided the benefit of auditor independence that audit firm rotation would otherwise provide.

In addition to mandatory audit firm rotation, the other proposals we considered included the following:

- Require auditing firms that audit public companies to disclose detailed financial information, such as their own revenues and profits, to help market regulators and others evaluate whether firms are charging prices above competitive levels.
- Require one or more of the Big 4 firms to spin off a large portion of their operations to create more than four firms with the capacity to audit large public companies to ease current concentration.
- Place caps on auditors' potential liability as a means of reducing the risk of litigation that could lead to the loss of another large audit firm.
- Have regulatory or enforcement agencies target their efforts against responsible audit firm partners rather than entire firm to reduce the risk of litigation that could lead to the loss of another large audit firm.
- Change how auditors attest to the fairness of financial statements.
- Create financial statement insurance that would be provided by existing insurance companies that would appoint and pay audit firms to attest to the accuracy of financial statements.
- Allow outside parties, including public shareholders or private equity funds, to own or invest in audit firms to increase these firms' financial resources for expansion.
- Create a shared entity staffed with accounting and auditing experts with specialized technical and industry expertise to supplement smaller firms' technical capabilities for performing public company audits.
- Establish an auditing firm accreditation program to help second- and third-tier firms' reputations by providing companies and investors with additional information about their audit capabilities.

¹²Large companies were more likely to have retained their auditor for at least 10 years (47 percent) compared to small and midsize companies (20 percent).

¹³The word respondents refers to the second- and third-tier accounting firms that responded to our survey.

¹⁴ GAO-04-216.

Each of the individual proposals we considered were associated with some potential benefits. But each also presents some significant disadvantages, and there was no general consensus among market participants supporting any individual proposal we identified to addressing concentration.

Concluding Remarks

Our ongoing study provides several bottom line observations that we think will be useful to the Advisory Committee. The audit market for large public companies remains highly concentrated while the audit market for small public companies has become significantly less concentrated since 2002. We did not identify any significant negative impacts of concentration on public companies' audit cost or quality. However, most larger companies see themselves as having limited choice. The highly concentrated audit market for large public companies is unlikely to be reduced in the foreseeable future because of smaller firms' limited interest in adding larger companies and the challenges that expansion would bring. However, the potential risk of further concentration in the public company audit market does raise concerns. Finally, while individual proposals we identified for addressing concentration have potential benefits, there was no general consensus for any individual proposal we considered. While we did not identify any significant negative impact, we continue to believe that the risk of potential negative impact on choice, quality, and cost remains at existing concentration levels and would likely increase if further concentration were to occur through the loss or departure of one of the largest audit firms from the market. Therefore, it is important that audit market concentration continue to be monitored and any significant future concentration be evaluated for potential impacts on choice, quality, and cost.

The auditing environment has seen significant changes since 2002, and it will continue to evolve. Capacity in the audit profession has been and continues to be a pressing issue as audits have become more complex and new requirements have been put in place. Audits have grown more complex in response to evolving business structures, operations, and transactions, as standard setters issue new guidance for accounting and auditing corporate financial operations. As U.S. public companies have increasingly expanded into global markets, their need for auditing firms with global reach and technical expertise has also increased. Many U.S. public companies have diversified and increased the complexity of their operations and financial transactions, and these changes have increased their need for auditors with increasing industry-specific and technical expertise. In addition, since 2004, public companies with market capitalization of greater than \$75 million and their audit firms have had to implement a major expansion of the scope of their audit and financial reporting work to deal with assessing and reporting on the effectiveness of internal control over financial reporting—a challenge that public companies with market capitalization of less than \$75 million and their audit firms will have to fully address for 2008.

In studying the effects of concentration, we did not directly assess audit quality. However, the current level of market concentration does not appear to be negatively affecting audit quality because most market participants who commented on audit quality said that they thought audit quality had improved. The auditing profession's recent realization that audit quality had to become center stage and PCAOB's role in the audit standard setting and audit oversight process have been widely acknowledged as having an important positive impact on audit quality. Although the current level of concentration does not appear to be having a significant negative impact, the current situation carries risks which should be monitored over time, as should audit quality. The effectiveness and efficiency of the audit market for public companies are critical to the functioning of our capital markets. Again, I commend the Secretary of the Treasury for

establishing this Advisory Committee on the Auditing Profession to proactively evaluate the current and future auditing profession in the United States.

Mr. Chairmen, I would be pleased to respond to any questions that you or the Advisory Committee may have at this time.