Funding the Future

Why do the Big 4 accountants survive?

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I was asked very recently why it was that the big 4 firms of accountants survive. This is an issue I have been considering with Len Seabrooke and Saila Stausholm at Copenhagen Business School. The academic paper on the subject is in progress. Let me offer a plain English perspective for now.

Like much of political economy, this is a story of power. In the first instance this was professional power. The big firms did, as professional institutes developed, have the means to dominate them. They were in the capital cities where those institutes were usually based. They had the means to release partner time to manage those institutes' affairs. They had the motive to do so. That was ring-fencing their profit. The big firms, then, used their power to set the rules for their professions.

Leading the way at a technical level as well, in a profession lead from these firms and not by either government or academia, these firms also innovated in ways that ring fenced their market. I suspect that this may have provided the strongest incentive for the creation of consolidated accounts - which were not a universal requirement for group companies until the 1940s. When consolidated accounts required that multinational groups be treated as single entities their auditors, who I strongly suspect sold its benefit to governments who then made it a legal requirement, could in turn demand that they were the sole group auditor. The global spread of a select few firms was guaranteed. The rise of the global firm was the consequence.

These firms succeeded. The firms then sold consultancy advising other companies to copy the success of their global company clients by also becoming global using a structure that guaranteed market growth in auditing for the big accountants. The market for the big audit firms was reinforced.

As this was happening in the 50s and 60s another phenomena was growing, which was the tax haven. Slowly at first, but steadily as the British empire (in particular) receded, the opportunity to hide nefarious activity, as well as profits and so tax bills in such places, grew. Did the big firms go there before their clients? Or did they have to go because some clients had already gone? It's a question to be answered. But if the firms were to maintain their demand that they must be sole auditor, worldwide, at least in name, then if the global entities they were helping spawn moved to tax havens then they too had to go there.

And they did not miss the opportunity. Already used to lobbying and forming opinion on legislation in the countries from which they originated, and well aware of the coercive power this gave them over their clients, the governments of new tax havens must have seemed easy pickings to the big accountants of the day. And so they were. Whole rafts of legislation were influenced by such firms as they peddled in tax havens the secrecy that opposed the transparency they sold elsewhere. The opportunities must have seemed unlimited.

But the timeline has now reached the 70s, and life was not so good for accountants. Airlines failed back then, with people noticing that their accounts gave no hint that they owned or used planes. In contrast, aeroplane engine makers were claiming that they had value when the products they were developing at enormous cost for the time were unlikely to push anything into the sky. Accounts were not providing a true and fair view.

In the face of significant threats to the profession from an outraged public (well, at least those parts losing money as a result of these failings) the big firms reclaimed the initiative. Accounting standards - supposedly written in the public interest and for the benefit of all stakeholders - were created and governments that were too trusting by half gave them the force of law. The power of the big accountants was reinforced, rather than diminished, by the accounting debacles of that era. Now they could write the rules; say they had the power of law; force them onto their clients and the rest of the profession; and in the process pull themselves ahead of the competing pack. They could do that by advising on the very rules they had created; by claiming to be the only people who could audit them; and by making sure that because some only applied to larger enterprises the knowledge of their use did not trickle down into the profession as a whole.

And they exploited this to the full. The era of capital market liberalisation and globalisation simply provided greater opportunity to do this, whilst the new and more relaxed ethics of this period promoted the use of tax havens in ways previously unforeseen, and the firms jumped with both feet into this market as well, producing tax avoidance schemes by the bucket load.

And things only got better. Although the accountants failed miserably to deliver what they promised when accounting standards were first developed, because they entirely ignored the needs of almost all users of accounts, their capture of the process was so complete that when the European Union was looking for a set of single accounting standards they adopted the Big 4 created International Financial Reporting Standards as quasi law, which has now led to their adoption in more than a hundred countries worldwide, with a parallel process taking place in the USA, Japan and other influential markets. The ability of these firms to control the world’s view of capitalism appeared complete, and they reaped the rewards.

And then some cracks appeared. There was a global financial crisis, which accounts had not anticipated. And there was a global loss of tax revenue, which accountants appear to have facilitated through tax havens. And rather annoying people pointed out both failings. You would have thought that the fundamental failure of their product, in the form of accounting standards, and the fundamental failure of their ethics, evidenced by their use of tax havens and sale of tax avoidance products, would have done for these firms. Nothing, however, could be further from the truth, hence the question I was asked. How are they surviving?

Let me reiterate how we got here, because the clue is in the process.

They captured the profession, long ago.

Then they captured government, and used it to create laws that suited their purposes in influential countries like the USA and UK.

They used this law to reinforce their own audit market.

And as a result they also created the image of the modern firm, which they then sold to aspiring rivals, who were required to replicate it, and so provide yet more fee income to these firms.

In the process they captured the tax havens and their legislatures, and used them for their own purposes.

So complete was the capture that their accounting standards became de facto law. And when the EU wanted to extend that right to create de facto law with regard to accounting standards, the big accountants were again given the chance to write the rules.

The result is that the big four are now integral to company law, auditing law, accounting law, the law of many tax havens, the structure of the accounting profession and the structure of many of its clients. Their desire to protect their ability to make supernormal profit has created a situation where the entire process of law surrounding companies has been captured for their benefit, and the behaviour of whole markets has been distorted in their favour as a result.

But what they did to achieve this result was display an ability to innovate. Whenever under criticism, they delivered an alternative. When their ethics were questioned, they produced a supposed new standard. When the market demand that they change, for example post Enron, that’s what they appeared to do, enough to keep people at bay. And all the time, chameleon like, they emerged from each threat with their power reinforced because they are so integral to the process of corporate regulation that government has effectively abandoned to them.

That is how they have survived.

But that also suggests how the process is changed.

Government has to reclaim this process.

It has to audit.

It has to create company law.

It has to say for whose benefit company law is created, and that is not the accountants any more.

And it has to determine who will write the alternatives.

None of that will be easy. But with adequate investment it is entirely possible.

These firms have captured significant parts of the processes of capitalism for their own ends.

If we are to still have mixed economies, and I think we should, then this process of capture has to be disrupted, in the public interest.

It is only by doing so that the power of the Big 4 will be challenged. Nothing else will change it.

That’s the issue we face. And since there is no challenge right now the Big 4 will go on. And on. Which is right now just as they want it.