Ernst & Young’s Attempt to Split Accounting and Consulting Services: An Unsuccessful Endeavor

Jacob Jovanovich
z1893366@students.niu.edu

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NORTHERN ILLINOIS UNIVERSITY

Ernst & Young’s Attempt to Split Accounting and Consulting Services: An Unsuccessful Endeavor

A Capstone Submitted to the University Honors Program

In Partial Fulfillment of the Requirements of the Baccalaureate Degree

With Honors

Department Of

Accountancy

By

Jacob Jovanovich

DeKalb, Illinois

May 2024
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ABSTRACT: This paper aims to address the reasons why Ernst & Young attempted to split their auditing and consulting services, the reasons why the split failed to materialize, and the resulting consequences. Research for the paper involved a literature review of relevant articles and subsequent discussion. This paper concludes that the attempted split was motivated by regulatory concerns regarding auditor independence and profitability gaps between assurance and consulting. This paper also concludes that the split was unsuccessful due to unfavorable economic conditions and the mechanics of partner compensation.

KEYWORDS: Audit; Consulting; Independence; Ernst & Young.

I. INTRODUCTION

In determining the accuracy and reliability of financial statements, auditors play the crucial role of capital market gatekeepers for investors, creditors, and various other stakeholders across global markets (AICPA, 2023). As of 2019, ninety-nine percent of all S&P 500 companies were audited by just four main professional services firms: Deloitte, Ernst & Young (EY), Klynveld Peat Marwick Goerdeler (KPMG), and PricewaterhouseCoopers (PwC). Known as the Big Four (Big 4), these firms have a staggering amount of global influence, as their audit work helps to maintain the foundations of the global market system. To provide an idea of the sheer size and scale of the Big 4, according to the Statista Research Department, in 2022 the Big 4 combined revenue totaled nearly 200 billion dollars (2023a).

Audit work has always been the focus of the Big 4, however, in recent years, consulting practices are bringing in the largest slice of revenue (Statista, 2023b). As a result, the Big 4 firms have begun to shift focus to the evermore lucrative consulting industry. However, as firms become more heavily involved in consulting work, limitations are becoming increasingly
Auditing is a heavily regulated business. Regulations and ethical restrictions are inherently limiting and are thought to stifle a company's ability to grow. As a result of such constraints, conversations regarding the separation of auditing and consulting services began in the 1980s (Leonhardt, 2000). Since then, regulations have only become stricter with the passage of laws such as the Sarbanes-Oxley Act of 2002 (SOX). The SOX Act prohibits firms from offering consulting services to their auditing clients, acting as a hindrance to the expansion of Big 4 consulting services (Thomsen & Norman, 2008). Since the passage of SOX, the status quo has been to continue operating consulting and auditing services in compliance with regulations.

On September 8, 2022, EY, one of the world’s most powerful professional services firms, decided to split their auditing and consulting services; hereafter referred to as "the split". In the official press release, Rachel Lloyd, director of media relations for EY, stated that the decision to, "separate into two distinct, multidisciplinary organizations" was reached to, among other things, "embrace the changing landscape," and "create exciting new opportunities". In other words, audit and consulting would be stronger, more profitable businesses on their own.

However, on April 14, 2023—just a mere seven months after the announcement of the split—Rachel Lloyd stated that EY would be canceling the split. The closest thing to an explanation as to why the split failed was, "We have always acknowledged the complexity of this ambition, but recognizing the challenges raised in recent months we are now unable to

\[^{1}\text{Auditor independence violations refer to situations where auditors compromise their impartiality objectivity, or integrity. Undermining their ability to provide a reliable audit opinion due to a risk of bias.}\]
The vague reasoning has left many to wonder, what were the mentioned challenges that doomed the split?

The purpose of this study is twofold: First is to provide a better understanding of the reasons that led EY to attempt to split their auditing and consulting services. This is accomplished through a review of events leading up to the public announcement, as well as providing historical context concerning allowable client services. The second is to identify the reasons for EY's cancellation of the split. This is accomplished through a review of the events leading up to and following EY's announcement to end the split.

The layout of the remainder of this paper is as follows. First, an overview of the background of modern auditing, consulting, and auditor independence is provided. Next, a literature review highlights relevant documents that pertain to auditor independence, regulatory compliance, and the history of splitting auditing and consulting practices. Section IV concerns the establishment of research questions and the methodology deployed, followed by section V, which outlines the results and relevant discussion points. The paper concludes with a recap of the contributions to existing literature and possible future research opportunities.

II. BACKGROUND

Ernst & Young Global Limited is a globally renowned professional services company headquartered in London, England. Founded in the early twentieth century as a small accounting firm, EY has since grown to be one of the Big 4 accounting firms. Focused primarily on assurance (audit), tax, and consulting, EY is projected to finish the 2023 year with 49.4 billion dollars in revenue whilst employing nearly 400,000 people (Statista, 2023c). The accounting work EY does is extremely important for global financial markets.
Accounting is an essential function of any modern business. The Oxford English Dictionary (EOD) describes accounting as "the action or process of keeping financial records...it involves recording and summarizing business and financial transactions, analyzing, verifying, and reporting the results to various stakeholders...". The modern accounting profession has three distinct sectors: audit, tax, and consulting. Auditing involves conducting an independent and objective examination of an organization's financial statements to verify that they are represented fairly and accurately. Tax involves the preparation, analysis, management, and filing of tax-related matters for clients. Consulting involves providing expert advice and guidance to clients on various financial and accounting matters (Kmenke, 2021) such as strategic planning, technology implementation, cash flow forecasting, tax planning, et cetera. Together audit, tax, and consulting help to maintain the efficiency and accuracy of financial systems. Considering how important accounting is to financial systems, some rules must be stringently followed.

The accounting industry is a rules-based profession, and arguably the most important rule is independence (Guillaume, & Pierre, 2016). Independence in accounting refers to the state of being objective, impartial, and free of any potential conflicts of interest or implicit biases, and is extremely important to protecting public interests, as it ensures integrity and reliability in financial reporting (Objectivity, AICPA). Auditor independence is most seriously jeopardized when a firm performs consulting and auditing of the same company, as it provides a unique opportunity to run afoul of auditing regulations. To better understand why, consider the following: Auditors are paid to verify the accuracy of a company's financial statements; consultants are paid to provide advice. If a firm is auditing and consulting the same company,
auditors could end up auditing their consulting work\textsuperscript{2}, which is a clear conflict of interest and breach of objectivity; collection of consulting fees could also weaken an auditor's enthusiasm to deliver negative news, for the sake of maintaining friendly relations with the client and maintaining the source of revenue (Kmenke, 2021). Therefore, strict regulations have been put into place to prevent such conflicts of interest.

The audit environment is highly regulated due to the economic consequences involved. As a result of auditing regulatory constraints, the tax and consulting sectors have seen substantially greater growth in the last decade. Between 2012 and 2018, Big 4 consulting revenue grew by 44 percent compared to just 3 percent growth for their auditing services (Peccarelli, 2020). Although the demand for consulting and advisory grew substantially after the 2008 recession, a lot of the Big 4 consulting revenue has been the result of acquisitions of consulting practices (Imdieke, et al, 2020). The reallocation of resources towards consulting services has fueled debates concerning the priorities of Big 4 firms. As the prioritization of consulting over auditing could leave auditing services less prepared and poorly equipped to carry out quality audit work. According to Carmine Di Sibio, the Global Chairman and CEO of EY, revenues in EY’s audit wing grew by a total of 27 percent between 2012 and 2021, compared to 93 percent growth in tax and consulting (O'Dwyer, 2022).

III. LITERATURE REVIEW

Pre-2000s United States of America (USA) history of independence

Accounting experienced a massive demand after the Industrial Revolution when the explosion of growth resulted in a widespread need for financial services and bookkeeping

\textsuperscript{2} See enforcement release No. 105-2023-022 (PCOAB, 2023) for an example of such a violation.
(Byrnes, et al, 2012). Following the aftermath of the great depression, the passage of the 1933 Securities Act marked the beginning of independence in auditing and was the first instance of the government setting a standard for accountants to follow; it was the first example of the US Government requiring audits to be performed by an independent accountant.

The Securities Exchange Act of 1934 created the Securities Exchange Commission (SEC) and gave the commission the authority to establish accounting principles and auditing standards for public companies (Niemeier, 2007). In 1939, the American Institute of Accountants (AIA) issued the first-ever Code of Professional Ethics. The code provided the principles of professional practice and a baseline of rules to follow, such as auditor independence. In 1978, the SEC codified its general standard of auditor independence via the passing of Rule 2-01 of Regulation S-X. The Rule pertained to the qualifications of accountants, which provided insight into specific circumstances that may impair independence; financial interests, employment relationships, non-audit services, contingent fees, et cetera (Munter, 2022).

In response to a case involving the audit of Zapata Corporation by Arthur Andersen & Co., in 1988, the SEC issued Accounting and Auditing Enforcement Release No. 51 (AAER). AAER clarified the SEC's view on the general standard of independence which states that an auditor's independence is impaired if the auditor provides management functions or makes any management decisions for an audit client (SEC, 2003). Such management decisions include but are not limited to bookkeeping, internal audit, information systems design, appraisal, valuation, et cetera. This development was significant because it laid the groundwork for non-audit services that impair auditor independence.

In the wake of various high-profile audit failures and litigations, in 1994, the Public Oversight Board (POB) issued a report on Strengthening the Professionalism of the Independent
Auditor. The report made a variety of recommendations in hopes of improving the credibility and reliability of financial reporting. Such recommendations include but are not limited to implementing a five-year rotation requirement for audit partners and concurring review partners on SEC engagements, with a two-year cooling off period before they can return to the same client and strengthening auditor independence rules by prohibiting certain non-audit services to audit clients, such as management consulting, tax planning, internal audit outsourcing, and litigation support (Advisory Panel, 1994).

Arthur Andersen

Arthur Andersen was once one of the largest accounting firms in the world, in part because they were the first accounting firm to recognize the potential for profit in consulting (Auburn, 2015). Revenue generated from the consulting wing of the firm exceeded that of the auditing wing in 1984, and hence, the first-ever conversations about splitting auditing and consulting services began (Auburn, 2015). In 1989, five years later, the auditing and consulting wings began operating as separate entities to fuel more growth and avoid independence restrictions (Leonhardt, 2000).

However, according to Auburn (2015), hostility, secrecy, and infighting became regular occurrences as the auditing and consulting wings battled for clients. Tensions hit a breaking point in the summer of 2000 when during an arbitration hearing, the judge ruled that Andersen's consulting arm could operate independently from the accounting firm. The ruling marked the first legal split of a consulting arm from an accounting firm. The new company was named Accenture and continues to operate to this day. Less than two years after the split, Arthur
Andersen would collapse due to implications regarding its role in two of the most notorious corporate collapses in history.

Enron was once the seventh-largest company in the United States, and WorldCom was the second-largest telecommunications provider in the United States (Hayes, 2023). As of 2023, their respective collapses are two of the top ten largest bankruptcies in US history: WorldCom at #5 and Enron at #9 (Statista). Arthur Andersen was the primary auditor for both Enron and WorldCom at the time of their respective bankruptcies. The dissolution of Arthur Andersen was due to a failure to recognize fraudulent practices in both Enron and WorldCom. The audit failures were due in some part to breaches in auditor independence.

Arthur Andersen received 50 million dollars from WorldCom for consulting services but admitted that the 7.8 million dollars received for audit services was an underpayment. An SEC investigation discovered that "Andersen's work papers documented that its internal targets for audit fees were not met in WorldCom's case, but an Andersen senior officer nevertheless approved the continuation of the engagement." (Beresford, et al, 2003). Additionally, Arthur Andersen was found to have ignored whistleblower information that WorldCom was inflating profits via fraudulent accounting. Such findings support the idea that there was a clear audit failure. The SEC investigation also suggested that Arthur Andersen was giving WorldCom special treatment; potentially not approaching the audit with the required professionalism, and prioritizing profit and status over integrity. If sufficient fees were collected and proper attention allocated to the audit, then Arthur Andersen may have identified the 3.8 billion dollars of fraudulent balance sheet entries sooner (Betsey, 2021).

Regarding the Enron scandal, Arthur Andersen's involvement was so incriminating that they shredded audit documents for two weeks after a probe was launched by federal regulators
(Robbins & Huffman, 2006). Arthur Andersen performed internal auditing, external auditing, and consulting services for Enron. Arthur Andersen evaluated employees based on business brought to the company, leading to an unwritten policy of cross-selling services (Toffler, 2003). The financial environment at Enron was fraught with unethical conduct that resulted in fraudulent practices and the eventual failure of both Enron and Arthur Andersen.

In response to the Enron and WorldCom scandals, congress passed the SOX Act to address auditor independence and conflicts of interest, both of which played pivotal roles in the failure to recognize the frauds that took place (Betsey, 2021). Arthur Andersen's emphasis on consulting work in combination with their abysmal track record on auditor independence highlights the inherent risks associated with consulting and auditing the same client.

**Post-2000s USA history of independence**

The Enron scandal rocked public confidence in a variety of ways; capital markets and audit objectivity were under particularly high scrutiny. To re-establish consumer confidence, as well as prevent a similar situation from happening again, Senator Paul Sarbanes and U.S. Representative Michael Oxley sponsored a bill known as SOX to effectively end the long era of auditor self-regulation (Thomsen & Norman, 2008). President George Bush signed SOX into law in 2002, and its passing marked the beginning of a shift towards increased oversight of the auditing profession.

In passing the SOX Act, congress established the Public Company Accounting Oversight Board (PCAOB) to oversee the auditors auditing public companies. The job of the PCAOB is to inspect, enforce, and set standards for auditing firms to protect investors and public interest from another Enron-type situation. In collaboration with the SEC and other government agencies, the
PCAOB plays a monumental role in regulating the accounting industry (PCAOB, 2022). Moreover, the PCAOB plays a fundamental role in assessing compliance with auditor independence requirements via an inspection process that assesses compliance with federal regulations (Brown, 2020).

In addition to the creation of the PCAOB, the SOX Act had a variety of other key impacts on audit standards. As it pertains to independence, there were several key changes. One of which concerns the rotation of audit partners; the rule requires concurring audit partners to rotate every five years to maintain objectivity during audits. Another change resulted in top managers having to personally certify the accuracy of financial statements. Taking ownership of the financial accuracy of the documents increased accountability and ensured management could not deflect the blame for misstatements. Arguably the most important change was the refinement of the limitations of non-audit services. Changes involved the creation of a pre-approval service that required auditors to seek approval from the audit committee for non-audit services, as well as an updated list of prohibited non-audit services (SEC, 2003).

In 2020, after almost two decades of relatively sufficient oversight from SOX, the SEC decided it was time to update the auditor independence framework to better reflect modern practices. The SEC did so via amendments to the previously mentioned Rule 2-01 of Regulation S-X. The modernization of the rules regarding independence rule violations. The revisions to rule 2-01 reduced the strictness of the independence-impairing relationships of student loans and removed owning substantial stock from being considered a form of independence impairment. The lookback period concerning IPOs was also reduced from three years to one year (Smith et. al., 2020). However, creditor/debtor relationships spearheaded the amendments, with student
loans being used as an example to loosen current independence restrictions around loan payments (SEC, 2020).

IV. RESEARCH QUESTIONS AND METHODOLOGY

The purpose of this study is to determine the impetus for EY's initial decision to split its Consulting and Auditing practices and why they ultimately canceled the separation. These objectives can be summarized through the following research questions:

RQ1: Why did EY attempt the split?
RQ2: Why was EY's attempted split unsuccessful?
RQ2a: What were the consequences?

The methodology used to answer these questions consists of an analysis of the previously presented literature review along with specific information related to EY. The following results and discussions portion of the paper is where the research questions are answered.

V. RESULTS AND DISCUSSION

RQ1: Why did EY attempt the split?

Over the last two decades, the Big Four firms have experienced a dramatic shift in profitability, with roughly 70% of total Big Four revenues coming from non-audit activities, as opposed to only 40% in 2002 (Kmenke, 2021). The largest driver of this change has been the fact that the auditing market is not as attractive as the consulting market. Auditing is considered inherently risky for a few reasons; 1) the audit environment is highly regulated, and violations of regulations come with steep financial penalties and fines; 2) auditors who fail to detect financial misstatements and or fraud can face legal repercussions and financial penalties; 3) the auditing market is highly competitive, Big 4 firms have a monopoly of the audit market, leading to
limited growth opportunities (Sussman & Friedman, 2021). On the contrary, the consulting market is less regulated, less consolidated, more profitable, and carries almost no risk.

The primary reason for the split was to address regulatory concerns regarding auditor independence. In recent years, EY has faced several penalties for auditor independence violations. For example, in the summer of 2021, three EY audit partners were charged with auditor independence misconduct for the "soliciting and receiving" of "confidential competitive intelligence and confidential audit committee information" from a company's chief accounting officer (SEC, 2021). During the hearing, Charles Cain, the chief of an SEC Enforcement Division emphasized that "Auditor independence is not merely an obstacle to overcome, it is the bedrock foundation that supports the integrity, transparency, and reliability of financial reporting". Ironically, EY did view auditor independence as an obstacle to overcome.

EY viewed the independence regulations and ethics requirements as a constraint on their ability to grow. Auditor conflict of interest rules act as a bottleneck for firms with both auditing and consulting practices; they cap which client firms can work with, which limits the realization of potential profits for firms' consulting wings (Iacone, 2021). The decision to split was also supported by a profit forecast; EY projected that by separating their auditing and consulting firms, they would unlock increased growth for each; a projected 7-8% growth for auditing and tax compliance, and a projected 20% growth for the new consulting and tax advisory (Bramwell, 2023).

Thirteen months after the SEC case, EY announced the decision to split its assurance and consulting services. EY leadership codenamed the endeavor "Project Everest"; an accurate depiction of how difficult the feat would be. The plan to split would result in two distinct, multidisciplinary organizations: Assureco, which would retain the audit and tax compliance
wings; and Newco, which consisted of the consulting and tax advisory wings. Assureco would retain the EY name and be the standalone audit firm and was initially valued at 20 billion; Newco would be the consulting with a dedicated tax advisory practice and was initially valued at 25 billion (O'Dwyer, 2022).

**RQ2: Why was EY's attempted split unsuccessful?**

To take advantage of the growing market, Big 4 firms have been artificially improving their consulting practices via acquisitions (Donelson, et. al., 2020). Regulators and industry leaders are concerned that the shift in priority is at the overall expense of the audit industry. As previously mentioned, the auditing industry plays a pivotal role in global financial stability, adequate manpower, new talent, and financial backing are crucial for conducting quality audits. However, with Big 4 firms shifting more resources towards consulting, there is a real risk that auditing services could be stripped of the necessary resources. EY's split was a bold attempt to break from the pack and realize maximum, unrestricted profitability from the consulting market.

On April 14, 2023, Rachel Lloyd published a press release that stated: "We are stopping work on Project Everest, which set out to separate the EY businesses". She cited the complexity of the challenges faced, and reassured clients and stakeholders that EY would "...continue the focus on providing exceptional service to clients". Come to find out, the initial announcement of Project Everest resulted in bitter infighting amongst EY leadership throughout the organization, and ultimately led to the project's downfall.

Seven months prior, in September of 2022, US audit leadership mounted a strong response to the initial announcement of the split. Their concerns were that Assureco would lose access to critical tax expertise required to perform high-quality audits, as Newco was set to take
away a majority of the tax personnel (Foley & O'Dwyer, 2023). Having already experienced a re-distribution of resources from assurance to consulting leading up to the split, US leadership lacked confidence about EY’s ability to effectively manage resources irrespective of the split; sentiment among US audit leaders was that the split would all but guarantee a shortage of workers and expertise.

Funding for the split also played a pivotal role in the cancellation. Finding the money necessary to make all parties involved happy turned out to be extremely difficult. The acquisition of capital through bank loans was thought to be the main source of capital, but the rise of interest rates left leaders torn, the rising interest rates also slowed down the rapid growth of private equity markets, a major source of income for consulting services. These two issues in particular "soured the financial math underpinning EY's planned split" to an unjustifiable level (Eaglesham & Saeedy, 2023). The inability to acquire the necessary capital was an issue, but restructuring the financial structure came with many challenges; employee compensation proved the most difficult.

All Big 4 firms follow a similar employee hierarchy and rank progression. Although responsibilities and requirements for promotion may vary, the general employee structure is as follows: Associate, Senior Associate, Manager, Senior Manager, Director, and Partner. For the most part, associates through Directors are salaried positions, allocating the capital necessary to pay them is straightforward (Lykken, 2022). On the other hand, Partners are not traditional employees and involve substantial capital investments. Partners are part-owners of their respective firms. They receive a base salary plus a slice of the revenue generated by the firm—tying compensation to equity.
Upon retiring, partners receive pensions and benefits that reflect the scale of their contribution to the firm. Most partners receive a 401k type plan, but there are two other main compensation plans for retired Big 4 partners. The first is a pension plan that is based on the average of the partner's highest earning years, a performance-based compensation. The second plan results in partners receiving equal shares of their respective firms' net proceeds (Vandenhaute et al., 2020). The financial structuring required to pay for these plans varies between Big 4 firms.

A primary reason for the failure of the split concerned partner compensation. There were major disagreements regarding the financial structure and funding of pension plans. Active US auditor partners as well as pension-drawing (retired) US partners argued that the split would leave the auditing wing, what would have been Assureco, less competitive and substantially weaker than Newco. This would pose a direct impact on the funding of partner pensions, as EY had "an unfunded pension liability of 7.5 billion dollars" in 2022 (Foley, 2023a). Lower revenue would weaken EY's ability to pay out pensions, and if Assureco failed to meet expectations, a decrease in revenue could lead to lower payouts.

There was an attempt to persuade audit partners by offering a one-time cash payout of two to four times their typical compensation, however, consulting partners were expected to take away seven to nine times their compensation through equity in the new business. The specifics were never able to entirely play out, as arguments regarding the divide of the tax practice tanked the split before the compensation agreements were met (Foley, 2023a).

**RQ2a: What were the consequences?**

Considering the recency of the failure of the split, the scope and severity of the consequences have yet to be fully realized. However, there are still many repercussions that have
come to light. The most notable is that all in all, project Everest has forced EY into a 500-million-dollar cost-saving program in hopes of avoiding partnership pay cuts (Foley, 2023b). Unfortunately, as part of that plan, just six days after the press release regarding the failed split, EY leadership announced the need to cut 3,000 employees—a whopping 5% of its workforce—due to "the impact of current economic conditions." (Reuters, 2023).

The split undoubtedly caused widespread internal dissatisfaction within EY. Partners and various leaders argued for months regarding Project Everest; with some being accused of prioritizing personal payouts at the expense of the firm's decades of work and global reputation (Foley, 2023a). The consulting partners who were genuinely concerned about independence rules have also been left disappointed and likely mending across-service relationships. Justification for the project and treatment of salaried employees throughout the debacle has likely left low-level employees unhappy.

EY clients have also raised concerns, and although it is too early to know the scale of the damage, there will likely be notable negative impacts on client retention and EY's reputation. Most notably, a 2.7-billion-dollar lawsuit was filed by a London hospital operator over concerns that the split could have reduced EY assets and future income so much that it would jeopardize their ability to pay potential legal fees (Tobin, 2023). While the plaintiff argues that EY breached agreed terms or duty, EY's lawyer described the filing as "premature and unnecessary".

VI. CONCLUSION

The attempted split of EY’s assurance and consulting services was the result of regulatory concerns regarding auditor independence and disparages in the profitability of assurance and consulting. The split was unsuccessful due to objections from audit leadership regarding resource
management, funding failures due to unfavorable economic conditions, and complications with partnership compensation and pension plans. Although the endeavor was incredibly complex, self-serving reasons were certainly involved, and only further complicated the situation.

Unfortunately, it seems that the split has left EY much worse off than it was beforehand. Lawsuits and reputational damages will play out for years to come, and thousands of salaried employees have lost their jobs for the sake of mitigating losses that have arisen because of the debacle. History will likely look back on EY’s attempted split as a waste of time, energy, and capital that would have been better spent invested into the company, rather than put towards splitting it up.

**Limitations and Future Research**

Considering the recency of events, the availability of information is limited. Consequently, this article contains limited information regarding the reasons leading to the split failure and the consequences resulting from the split failure.

Regarding future research, the rate at which the Big 4 are pooling resources into consulting services has led people to wonder whether the shift from auditing towards consulting is a sign of a culture shift towards commercialism. Research could be done into this topic to determine if there is any quantitative data to support such a claim.
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With a total revenue of $63.2 billion in 2022.


