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## The Development of "The Big Eight" Accounting Firms in the United States, 1900 to 1990

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THE DEVELOPMENT OF "THE BIG EIGHT" ACCOUNTING FIRMS IN THE UNITED STATES, 1900 TO 1990

**Abstract:** This paper examines the growth and changing role of the accounting profession in the United States from 1900 to 1990 with special emphasis on "Big Eight" accounting firms. Major political, economic, and social events of the period and their influence on the accounting profession are analyzed. Each decade is examined in turn, and the historical consequences of the decade on "Big Eight" accounting firms in total and individually are presented.

The beginning of the Twentieth Century marked the beginning of public accounting as a profession for several reasons. In 1896, the State of New York passed a law restricting the use of the title "Certified Public Accountant" to those passing a state examination. This law was soon followed by similar laws in other states. The establishment of a required examination provided accountants with a more professional image, similar to the one provided lawyers by the bar examination. Furthermore, these laws helped ensure a market for the services of those passing the examination. The responsibility of many accounting firms expanded beyond merely handling bankruptcies and liquidations to auditing client financial statements. By 1900, six of the firms that would become "The Big Eight" had been founded. The establishment, survival and growth of these CPA firms, as well as the profession as a whole, was due to the rapid industrialization at the beginning of the Twentieth Century. During this time, the corporate form of ownership began its rise to prominence, along with a corresponding separation of management and ownership. Previts and Merino [1979, p. 129] emphasize the importance of these changes in A History of Accounting in America: "Perhaps the most important development, in retrospect, for the emergence of the public accounting profession, was the rise of financial capitalism."

In many respects, the accounting profession was relatively stable, conservative, and slow-growing during the first half of this century. Yet, at the same time, it faced major social and economic events that would drastically change its scope and direction. Two World Wars, the imposition of an income tax, world-wide depression, and major new social legislation all served to expand the role and responsibility of the public accountant. The second half of the century presented perhaps even greater challenges. Specifically, "Big Eight" accounting firms had to adapt to the internationalization of American business [Hall, 1987], an expanding service economy, the rapid growth of nonaudit services, an explosive growth in size, and the rise of a competitive environment for CPA services [Bernstein, 1978].

This paper serves to examine the growth and changing role of the public accounting profession in the United States from 1900 to 1990 with special emphasis on "Big Eight" accounting firms. Major political, economic, and social events of the period and their influence on the profession are analyzed. Each decade is examined in turn, and the historical consequences of the decade on "Big Eight" accounting firms in total and individually are presented.

### 1900- 1910 RECOGNITION OF A PROFESSION

The early 1900s saw a continuation of a corporate merger pattern that began around 1895. From 1895 to 1905, many mergers occurred that required experienced auditors to examine the books and financial statements of the companies involved [Littleton, 1962]. The role of the auditor in these mergers can be illustrated by an examination of the audit records of Jones, Caesar & Co., an agent for Price Waterhouse & Co. (and later a part of Price Waterhouse). In June 1899, J. P. Morgan & Co. combined several independent tube companies to form the National Tube Company. Jones, Caesar & Co. was engaged to audit the records of the component companies for ten years, prepare financial statements for these years, and prepare a system that would put all components on a comparable accounting basis. In the same year, Jones, Caesar & Co. was engaged to examine the merger of four companies that formed the Chicago Pneumatic Tool Company, and twenty-seven companies that formed the American Hide and Leather Company. To audit the companies involved, Jones, Caesar & Co. rapidly increased its staff. Fees grew at a corresponding rate, resulting in the firm having the best operating year since its founding in 1890 [DeMond, 1951].

As the corporate merger wave continued over the next few years, additional auditors were needed. Since the companies involved were often geographically diverse, accounting firms began to open branch offices. Haskins & Sells opened offices in Chicago (1900), London (1901), Cleveland and St. Louis (1902), Pittsburgh (1903), and Baltimore (1910) [Haskins & Sells, 1947]. Lybrand, Ross Brothers & Montgomery, founded in Philadelphia, had offices in New York, Pittsburgh, and Chicago by 1910 [Edwards, 1960]. Arthur Young & Co. had offices in Chicago, Kansas City, New York City, and Milwaukee by the end of the decade [The Arthur Young Journal, 1969].

Another change created by the corporate merger movement was an increased responsibility to third parties. In most merger situations, the accounting firm was not engaged directly by the audited company but by a bank or holding company overseeing the merger. For routine financial statement audits, auditors had traditionally been selected by the officers or directors of the company. However, United States Steel was the first major company to forgo this tradition. On February 17, 1902, the stockholders of the United States Steel Corporation elected Price Waterhouse & Co. as auditor for the firm. This change expanded auditor responsibility beyond or the corporate officers to the stockholders [DeMond, 1951]. Election of auditors by the stockholders quickly expanded to most major corporations in the United States.

In 1909, the United States took the first step toward an income tax. As recently as 1896, the Supreme Court of the United States had ruled that an income tax was unconstitutional. In order to evade this ruling, Congress passed a franchise tax — not an income tax — on corporations. However, the franchise

tax was based on corporate income as measured by cash receipts. With passage of this law, corporations found it necessary to set up accounting systems that would determine their revenues and expenses. Although most corporations had kept minimal accounting records, many had never set up a system to determine actual income. Therefore, corporations were often forced to rely on their auditors to set up the necessary system [Edwards, 1960].

The early 1900s was a period of notable change for two of the "Big Eight" firms. In 1900, John B. Niven left Price Waterhouse & Co. to form a partnership with George A. Touche (of George A. Touche & Co., London), under the name of Touche, Niven, & Co. for the purpose of public accounting in the United States [Swanson, 1972]. Three years later, two brothers Alwin C. and Theodore C. Ernst formed the accounting partnership of Ernst & Ernst in Cleveland, Ohio. One of its first clients was Thompson Ramo Wooldridge (TRW) and the charge for its first audit was \$25 [Ernst & Ernst, 1960].

## 1910- 1920 THE GROWTH OF A PROFESSION

The years between 1910 and 1920 were very important in the history of public accounting in the United States. It was in this decade that the first federal income tax was passed. When the franchise tax was enacted in 1909, the rate was set at one percent of net income. Probably due to this low rate there was minimal opposition. Because of the lack of opposition to the tax, the government's need to raise additional revenue, and the Supreme Court's previous rulings that an income tax was unconstitutional, Congress proposed the Sixteenth Amendment to the Constitution. This Amendment was quickly ratified by the states, and became effective March 1, 1913 [Carey, 1969]. This Amendment permitted the enactment of "direct" taxes such as the federal income tax which Congress passed quickly in 1913. Although the initial tax rate was low (1 percent of income in excess of \$3,000 increasing progressively to 7 percent of net income beyond \$500,000), the law affected corporations as well as individuals who now had to measure their incomes, many for the first time. With the entrance of the United

States into World War I, the low tax rates of 1913 and the complexities of the tax laws quickly increased. Perhaps the "Excess Profits Tax", imposed on business in 1917, stimulated the demand for tax services from accounting firms to a greater extent than the 1913 Income Tax. This increased the need for CPAs was because "excess profits" had to be measured as well as the capital invested, and given the high tax rate on excess profits, the calculation was important.

One of the first accounting firms to develop a tax service was Arthur Andersen & Co. The firm's founder, Arthur Andersen, had been a professor of accounting at Northwestern University. It was his association with the University that led him to develop one of the first courses in Federal Taxation to be offered at the college-level. The course was offered during the academic year 1917-1918, and it attracted judges, bankers, lawyers, accountants, and business executives. Partially because of these courses, Arthur Andersen & Co. attracted new clients and became known for its expertise in the income tax field. The history of Arthur Andersen & Co., *The First Fifty Years: 1913-1963* [Higgins et al., 1963] states:

Our tax work for new clients often led to other engagements in the fields of auditing, systems work and business counseling. No small part of the increase in our fees to \$188,000 in 1919 and \$322,000 in 1920 was due to our early preparation and vigorous effort in the field of federal taxes, [pp. 23-24]

World War I had another major impact on the accounting profession. As a result of the War, the accounting firm became an advisor for financial affairs. During the war years, it was often the responsibility of the auditor to determine the cost of goods manufactured for the government and/or for other firms. In addition to these cost studies, accounting firms were engaged as efficiency experts with the responsibility of increasing the capacity and efficiency of war manufacturers. One of the most active firms in the expansion of services beyond the traditional auditing role was Arthur Young & Co. Arthur Young was engaged by the British government to determine the costs of manufacturing the new Enfield rifles. Furthermore, when the United States entered the war, the government called on Arthur Young &

Co. to conduct many of the special investigations of companies owned by foreign nationals [Edwards, 1960].

The decade of the 1910s was the first period in which a federal agency became involved in the establishment of accounting standards or procedures in the United States. In Britain, the government had played a fairly active role in the development of accounting through the passage of the Companies Acts. Accounting in the United States — although based largely on the British system — had not been guided or regulated by the government. In 1913, Congress established the Federal Reserve System and one year later the Federal Trade Commission. The Federal Reserve System had its first major influence on the public accounting profession in 1918 when it issued the pamphlet, *Approved Methods for the Preparation of Balance Sheet Statements*. This pamphlet presented the minimum auditing procedures that should be followed in any audit [Carey, 1969]. Although these procedures were only recommendations by the Federal Reserve, they hastened the establishment of minimum auditing standards by many accounting firms.

During this decade, three of the "Big Eight" firms underwent significant reformation. In 1913, Arthur Andersen and Clarence M. Delany purchased the net assets of a small Chicago accounting firm, The Audit Company of Illinois, for \$4,000 and the firm that became Arthur Andersen & Co. was founded [Louis, 1970]. In 1911, William Peat met James Marwick on a voyage to Europe, and by the time the ship arrived, they had agreed to merge the accounting firm of Marwick, Mitchell & Co. with the firm of W. B. Peat & Co. to form Marwick, Mitchell, Peat & Co. (later to become Peat, Marwick, Mitchell & Co.) [Wise, 1966]. In 1919, Ernst & Ernst decided it needed an overseas representative and a working relationship was established with Whinney, Smith & Whinney of London [Ernst & Ernst, 1960]. Fifty years later these two firms would merge to form Ernst & Whinney.

After World War I, many "Big Eight" firms experienced an increased demand for their services overseas and opened offices there. Of course, firms such as Price Waterhouse & Co. had been founded in Europe and already had offices throughout the Continent. However, other firms now felt the need to expand their operations beyond the United States in order to be competitive. The internationalization of numerous clients added impetus to this expansion. One of the first American firms to open a European branch was Haskins & Sells who opened an office in London in April, 1900. In 1919, Haskins & Sells opened a second overseas office in Shanghai, and in the following year, it opened offices in Paris and Havana [Haskins & Sells, 1947].

## 1920 – 1930 NEW SERVICES AND RESPONSIBILITIES

The decade of the 1920s was described by John Carey in *The Rise of the Accounting Profession: 1896-1936* [1969]:

The U. S. emerged from the War a creditor nation for the first time in its history. Then began a period of unparalleled growth and prosperity, characterized by industrial expansion, mergers, holding company empires and unfortunately, some unsound financial practices. This period ended abruptly in 1930. [p. 144]

For "Big Eight" accounting firms, much of this growth came from an expansion of the advisory services they offered clients. In addition to traditional auditing service, they began to move beyond tax return preparation by starting to offer tax advice and to help companies implement accounting systems necessary for proper generation of tax information. By the 1920s, most large accounting firms had a tax department or tax service. Aiding the expansion of advisory services was the growth of industrial companies and the merger of several smaller companies into larger ones. Much of the capital for expansion or merger came from investment bankers. These bankers often sought an independent firm to investigate corporate financial condition before they committed their funds. Importantly, many bankers

wanted more than just an audit of financial records. They wanted an investigation of all phases of the business. In order to meet these needs, accounting firms had to expand their operating methods. In *The First Fifty Years: 1913-1963* [Higgins et al., 1963], Arthur Andersen & Co. related the changes it made:

The firm developed financial investigation reports which went into many phases of a business other than financial and accounting, including labor relations, availability of raw materials, plants, products, markets, effectiveness of the organization and future prospects. The methods which were used in developing these reports involved a study of company policies and their effectiveness, and the performance of management in carrying them out. [p. 32]

Ernst & Ernst had an early entry into the management service area. Within five years after it was founded in 1903, it created a separate management service area known as its Service Division. In the early years of the company, the Service Division dealt mostly with accounting and financial matters, such as cost accounting procedures or the prospective results of a merger. However, in the mid-1920s, the emphasis changed. The new approach became: If we can identify a problem, why not offer a solution? Ernst & Ernst referred to this new emphasis as "constructive accounting." Armed with this outlook, Ernst & Ernst began to assist management in analyses of the entire business operation. It examined the organizational structure, delegation of duties, physical layout, departmental relationships, and many other areas. In addition to being an accounting firm, it was also now a management consultant.

Regarding "constructive accounting," A. C. Ernst, co-founder of Ernst & Ernst, [McAnly, no date] wrote:

The service of the able modern accountant does not stop with the development of a system or the making of an audit. His work, giving him in most cases an intimate knowledge of the operations and condition of a concern, makes him feel the natural responsibility on matters of organization, method and policy. [p. 294]

Along with the expansion of the scope of services offered, the accounting firm had to expand its employment practices. In addition to accounting personnel, it needed industrial engineers, market-research specialists, production and personnel experts. With this entry into management consulting and the expansion of its staff, the accounting firm entered a new era of opportunity and responsibility.

The 1920s brought a tremendous increase in the size of the accounting firms and their billings. One "Big Eight" firm that had particularly impressive growth was Arthur Andersen & Co. In 1920, Arthur Andersen & Co. had two partners and fifty-four employees; however, by 1930 the number of partners had increased to seven and the number of employees to three hundred and seventy-eight. Furthermore, in 1920 it had billings of \$322,000, and by 1929 its billings had increased to \$2,023,000 [Higgins et al., 1963], representing a growth in revenue of over 500 percent for the decade.

As in the previous two decades, the major accounting firms continued to increase the number of branch offices. In the 1920s, Lybrand, Ross Bros. & Montgomery opened offices in Chicago and Seattle (1920), Cleveland and Cincinnati (1923), and Baltimore, San Francisco and Los Angeles (1924) [L.R.B. & M. Journal, 1958]. In the same period, Arthur Young & Co. opened branches in Los Angeles (1920), Pittsburgh (1921), London, Paris, and Dallas (1923), and Tulsa (1929) [The Arthur Young Journal, 1969].

In addition to growth, this period was one of legal challenge to accounting firms. In 1926, the highest court of New York, the New York Court of Appeals, effectively ruled in *Craig vs. Anyon* that an auditor's legal liability was extremely limited as long as an auditor exercised "reasonable care" in performing the audit. The case involved Barrow, Wade, Guthrie & Co. (later to merge with Peat, Marwick, Mitchell) which had failed to discover a defalcation of an employee of its client over a period of nearly five years. In this decision, which predates today's burgeoning awards in tort actions for

negligence, the court awarded the plaintiff client only the restitutionary measure of damages, that is, the amount the client had paid for the accounting services, \$2,000 [Chatfield, 1977].

However, the year 1925 also brought the Ultramares case. The Stern Company, audited by Touche, Niven, & Co. was de-clared bankrupt, and in the following year, the Ultramares Corporation filed suit against the auditors charging them with negligence; later a charge of fraud was added. Over the next six years, this suit went through several appeals, before the Court of Appeals of the State of New York ordered a new trial in the case. Before the new trial could be held, there was an out-of-court settlement. It was not the trial itself that would be remembered, but the descriptive writing of Judge Cardozo of the Court of Appeals on the responsibility of the public accountant. In his decision, Judge Cardozo stated that third parties can recover damages from an accountant where fraud can be proved, and gross negligence is sufficient evidence from which one can infer fraud. This statement (strengthened by the Securities Acts in the next decade) brought forth a new principle: the liability and responsibility of an auditor to third parties [Edwards, 1960].

### 1930 – 1940 DEPRESSION AND REGULATION

During the preceding decade, most accounting firms had enjoyed rapid growth due to the increased importance of the federal income tax and the expansion of services they offered. By 1930, though, the Great Depression had started in the United States and accounting firms were not immune to its effect. As corporate profits and sales decreased, demand for management and financial services decreased. Furthermore, many companies failed during this period, and consequently had no need for auditors.

As mentioned in the previous section, in 1929 Arthur Andersen & Co. had fees of \$2,023,000. By 1932 these fees had decreased to \$1,488,000 [Higgins et al., 1963]. Arthur Young & Co. felt the Depression's effects even more acutely. From 1931 to 1933, the number of hours charged to clients were cut in half. Most accounting firms had increased their staffs during the 1920s, but were now forced to reduce personnel — and those who remained took pay cuts. The Depression also brought a sharp reduction in the cost of an audit. During this period, the average cost of an audit was between \$500 and \$700 [The Arthur Young Journal, 1969] approximately half of what it was before the Depression.

However, by 1933, changes began to occur that would have a profound effect on the growth of "Big Eight" firms. These changes principally resulted from the collapse of the securities markets in 1929 and the resulting losses to millions of investors. At the same time, it was revealed that massive fraud had occurred in Kreuger and Toll, a company listed on the New York Stock Exchange. This fraud had occurred between 1917 and 1932 without being detected [Higgins, 1965]. As a result, the NYSE announced on January 6, 1933, that companies applying for a listing would have to have an audit certificate for their financial statements and this audit must be performed by an independent certified public accountant. This announcement was followed by another on October 24, 1933, that required all companies to follow certain standard accounting methods. It also required that the scope of the audit not be less than that indicated in the pamphlet, *Verification of Financial Statements*, issued by the Federal Reserve Board in 1929 [Edwards, 1960]. With the requirement of an independent auditor and an increased audit scope, the NYSE helped create a new and larger market for major accounting firms.

Another change that resulted from the collapse of the securities market was the passage by Congress of the Securities Act of 1933 and the Securities Exchange Act of 1934. The purpose of the Securities Act of 1933 was to provide full and fair disclosure of information relating to the issuance of securities sold in interstate and foreign commerce. The 1933 Act required that, before securities are sold, a prospectus be provided to potential investors. Furthermore, under the Act; officers, directors, underwriters, and accountants could be held liable for any loss that resulted to an investor from material omissions or misstatements in the prospectus. The Securities Exchange Act of 1934 had the stated purpose of

regulating the securities exchanges and the over-the-counter market operating in interstate and foreign commerce. The administration of both Acts was given to a new Securities and Exchange Commission. The 1934 Act required that all financial statements filed with the SEC be certified by an independent public accountant. Enactment of both Acts resulted in increased prestige for the public accounting profession, and enlarged their responsibility to shareholders and to the general public alike. Not only did accountants have a social responsibility to the public, but they now had a potential legal liability to that public as well. The importance of these Acts to accounting firms can be seen by a statement in *The First Fifty Years: 1913-1963* [Higgins et al., 1963], in which authors of the history of Arthur Andersen & Co. stated:

As was probably true of many of the national firms, our practice increased materially from the many cases where the firm was asked by new clients to examine their financial statements which were to be included in prospectuses issued in connection with registering their security offerings. [p. 44]

Although the Securities Act of 1933 and the Securities Exchange Act of 1934 increased the billings of the major accounting firms, the importance of these firms was already well established by 1932. In two articles, "Architects of the U. S. Balance Sheets" and "Certified Public Accountants," published in June, 1932, *Fortune* examined the role and size of the major accounting firms. At the time of the articles, companies listed on the NYSE were not required to have statements "certified", but in its examination, *Fortune* reviewed the 701 companies that did have their financial statements certified by public accountants. Using audited NYSE companies as its criteria, *Fortune's* eight largest firms were: Price Waterhouse & Co.; Haskins & Sells; Ernst & Ernst; Peat, Marwick, Mitchell & Co.; Arthur Young & Co.; Lybrand, Ross Bros. & Montgomery; Touche, Niven & Co.; and Arthur Andersen & Co. Although their names would change in subsequent mergers, each of these firms maintained or expanded their leadership position in the public accounting profession, eventually being referred to as "the Big Eight".

As the number and size of their clients increased, accounting firms also changed. In the 1930s, one of the most important changes made was industry specialization. A leader in this respect was Arthur Andersen & Co. Mr. Andersen decided early on that it was not possible for one person to have adequate knowledge to furnish needed management and financial services to all companies. Instead, he maintained that accountants should concentrate their efforts on particular industries and become specialists. Therefore, when faced with a management service or auditing problem in a specialized industry, expert knowledge would be available [Higgins et al., 1963]. The concept of industry specialization continued to grow and eventually most "Big Eight" firms developed reputations for expertise in specific areas.

#### 1940 – 1950 A TIME OF CHANGE

As the 1940s began, the effects of the Depression on the accounting profession could still be seen. Many firms' billings were little more than they had been ten years previously, and many clients were still trying to minimize accounting services in order to reduce costs. With the beginning of World War II, this changed.

As in World War I, one of the first government actions was the imposition of an excess profits tax. In addition to the imposition of new taxes, the government imposed new regulations for cost determinations and new bidding procedures for defense contracts. These regulations required companies to keep accurate and current financial records, and many relied on their accounting firm to help ensure this need was met. Accounting firms thus became involved with the day-to-day operations of their clients in contrast to the audit-only relationship that existed in years past. In many cases, a close working relationship developed between the corporate client and the accounting firm, and the relationship continued after the war [Ernst & Ernst, 1960].

Although firms were pleased that the volume of work was greater due to the new taxes and regulations, many firms had problems coping in that substantial numbers of their employees were being drafted into the armed forces. This shortage resulted in the entry of many women into accounting and auditing positions. Women had been employed by many firms for years, but primarily in secretarial positions. Because of this need for larger staffs, firms increasingly sought women for professional positions. One firm that actively recruited women was Price Waterhouse & Co. In the spring of 1943, Price Waterhouse began to recruit recent female college graduates for a special eleven-week course in accounting and auditing at Northwestern University. Upon completion of this course they were assigned to the Chicago office. In the spring of 1944, other special courses were offered to women who were to be assigned primarily to offices in Chicago and New York. In addition to this special recruitment, many individual offices recruited women as accountants, so that in several of Price Waterhouse's offices 30 to 40 percent of the accounting staff were women during the war [DeMond, 1951]. When the war ended, however, most women working for major firms were replaced by men. It would be the late 1960s before a significant number of women would again enter the public accounting work force.

Another major accounting change occurred during World War II. As John Carey [1970, p. 54] states: "Perhaps the most important impact of the war on the practice of public accounting was the application of mathematical and systems approaches to the logistics problems of the military." These mathematical solutions to military problems would develop into what is now called "operations research" or "scientific management". However, more important to many firms was the fact that these services could be offered to clients. During the war, good working relationships and respect had developed between many corporations and their accounting firms. So, when offered these services, many companies accepted them.

Although most "Big Eight" firms offered management services prior to World War II, it was only after the war that many firms established separate divisions or departments for these services. Ernst & Ernst, for example, established a Special Service Division several years prior to World War II, but this division had been generally restricted to tax advice and management consulting. In 1948, Special Services was reorganized into a division called Management Service. The purpose of the Management Service Division was to provide knowledge and expertise to both the firm itself and corporate clients in the area of data processing, operations research, organization and personnel, accounting and budgeting, and marketing. With this expanded service, the firm became an active participant in all facets of corporate decision making and contributed greatly to the accounting firm's potential billings. From 1940 to 1949, the billings of Ernst & Ernst more than doubled, and much of this increase was due to management services [Ernst & Ernst, 1960].

This expansion of management services led to criticism both from within and outside the profession regarding the ability of public accountants to maintain independence and objectivity while auditing the clients to whom they also provided management consulting. Critics argued that an inevitable conflict of interest results from providing the two services. Mednick and Previts [1987, p. 227] concluded, however, that "there was no conclusive evidence to support such an assertion, and . . . the market seemed to be looking for 'one-stop shopping,' or a convenient professional service package of all three activities — attest, tax and consulting — in which CPA competency clearly provided a comparative benefit." This conflict was far from resolved, and continues today [Hodges, 1987].

In 1947, an important realignment of "Big Eight" firms occurred. George Bailey joined Ernst & Ernst in 1912 upon graduating from college, and by 1922 was managing partner of the Detroit office. Over the next several years, differences developed between Bailey and A. C. Ernst who had founded the firm in 1902. By 1947, these differences had increased to the point that Bailey left Ernst & Ernst accompanied by another partner, John McEachren, and eleven associates and started the firm of George Bailey & Co. [Swanson, 1972]. Because Chrysler Corporation would only agree to follow Bailey to his new firm if



there was a nationwide organization to service its account, Bailey quickly combined with two well-established firms — Allen R. Smart & Co. and Touche, Niven, & Co. Allen R. Smart & Co. was started in the United States in 1927 while Touche, Niven & Co. was founded in the United States in 1900. On August 27, the partnership of Touche, Niven, Bailey & Smart was announced, and the realignment was complete [Swanson, 1972].

## 1950 – 1960 GROWTH THROUGH MERGER

As American corporations became larger, more complex, and international in scope, auditing them became more difficult. By 1950, most major accounting firms had offices in major U.S. cities, but they did not have offices in the smaller cities where their clients were located or in the foreign countries to which their clients were expanding. Furthermore, the expansion of management services required more personnel, often resulting in shortages in the audit staff. An answer to these problems was afforded by mergers with smaller local accounting firms. A merger enabled a large firm to obtain an accounting office in a city where its client was located, and at the same time, to obtain experienced personnel familiar with local practices.

An examination of Haskins & Sells gives a good example of the merger pattern of the 1950s. Between 1923 and 1952, Haskins & Sells merged with only three firms. However, between 1952 and 1960, it was involved in nineteen mergers expanding its operations to: London and San Francisco (1952),

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New York (1953), Portland and San Diego (1954), San Juan and Cincinnati (1955), Los Angeles, Rochester, Honolulu, Omaha, and Birmingham (1956), Seattle (1957), Hilo and Rochester (1958), Phoenix and Salt Lake City (1959), and San Diego and Dallas (1960) [Haskins & Sells, 1970]. Haskins & Sells was not alone in this merger trend. During this period, most "Big Eight" firms used mergers as means of growth and expansion.

Of the many mergers in the 1950s, the most important one occurred on November 21, 1950, and would be today's equivalent of a merger of two "Big Eight" firms. On that date, Peat, Marwick, Mitchell & Co. merged with Barrow, Wade, Guthrie & Co. under the former's name. Barrow, Wade, Guthrie & Co., established in 1883, was probably the first national accounting firm in the United States, and at the time of the merger was nearly equal in size to either Arthur Young & Co. or Touche, Niven, Bailey & Smart, both "Big Eight" firms [Wise, 1982]. Through this merger, Peat, Marwick, Mitchell & Co., already one of the largest accounting firms in the United States, expanded its client base and grew even larger.

As clients grew larger and more complex, the traditional audit had to be expanded to meet this challenge. In *Touche Ross: A Biography*, Theodore Swanson [1972] wrote of the change:

During the eventful decade of the fifties, the Touche Ross accounting and auditing practice developed its present distinctive character and form . . . The growing complexities of auditing, and the burden of documentation, invited what could have become an undue emphasis on mechanics — a regimented organizational approach which would leave little room for individual judgment and personal development. The problem . . . was how to extend the area of judgment so as to develop "thinking auditors" . . . it meant that Touche Ross auditors would have to be trained and equipped to audit not merely the books but the business. [p. 28]

This last sentence is very important, for it emphasizes the enlarged scope of the 1950s audit, to consider the whole business entity, not just its financial records. Auditing the whole business involved a study of the company's internal control system. For the first time, accounting firms truly appreciated the fact that the strength of a firm's internal control determined the scope and depth of the audit itself. A new term, "integrated audit program", developed in this decade and reflected the recognition that an accounting

firm could no longer audit only financial records, but had to examine the corporation as an integrated system.

By the end of the 1950s, "the Big Eight" were national firms with offices in every major city and many smaller ones. Based on U.S. revenues, the two largest "Big Eight" firms were Peat, Marwick, Mitchell, & Co. and Arthur Andersen & Co. with estimated billings of more than \$40 million each. Next in size were Ernst & Ernst, Price Waterhouse & Co., and Haskins & Sells with billings estimated at more than \$30 million each. The sixth and seventh firms, Lybrand, Ross Bros. & Montgomery and Arthur Young & Co., reported billings of more than \$25 million; while the smallest firm, Touche, Ross, Bailey & Smart (formerly Touche, Niven, Bailey & Smart), had estimated billings of \$17 million [Wise, 1960].

## 1960 – 1970 CONTINUED GROWTH AND INTERNATIONALIZATION

In many ways, the period 1960-1970 was similar to the previous decade. The major accounting firms continued the merger patterns started in the 1950s. As previously noted, Haskins & Sells merged with nineteen accounting firms between 1950 and 1960. In the next decade, Haskins & Sells merged with yet another nineteen firms. As before, these mergers were geographically diverse — from Boston to Memphis to San Antonio [Haskins & Sells, 1970]. The merger strategy was seen as the best way to obtain needed personnel and offices.

Arthur Young, on the other hand, had resisted the merger trend prevalent among other "Big Eight" firms throughout the 1950s. However, during the 1960s Arthur Young realized that to be competitive, it needed to expand. Mergers with geographically diverse firms offered the solution. Merger activity during this decade increased the number of Arthur & Young partners from 100 in 1960 to over 250 by 1970 [The Arthur Young Quarterly, 1980].

The expansion of the major accounting firms was not limited to the United States. Several of "the Big Eight" firms were founded in Britain or Scotland and had been international firms since the early 1900s when they opened offices in the United States or in Continental Europe. By the 1960s, most of the firms founded in the United States had offices in other countries or had established working relationships with foreign accounting firms. Ernst & Ernst, for example, expanded internationally by establishing a working relationship with Whinney, Smith & Whinney. Through this relationship, they opened four offices in Canada, five in South America, one in Central America, twelve in Europe, and one in Japan during the 1960s [Ernst & Ernst, 1960].

The decade witnessed a tremendous increase in billings for members of "the Big Eight". This increase was due to several factors, including: growth through merger, an increase in services offered, client growth, an increase in nonprofit accounting, and rising inflation. In 1968, Fortune estimated the United States billings for members of "the Big Eight" as follows [Louis, 1968]: Peat, Marwick, Mitchell & Co. (\$125 million), Arthur Andersen & Co. (\$100 million), Ernst & Ernst (\$95 million), Price Waterhouse & Co. (\$95 million), Haskins & Sells (\$80 million), Lybrand, Ross Bros. & Montgomery (\$65 million), Touche, Ross, Bailey & Smart (becoming Touche Ross & Co. in 1969) (\$60 million), and Arthur Young & Co. (\$57 million). A comparison of these billings with billings a decade earlier shows the dramatic increase that occurred. For example, Peat, Marwick, Mitchell & Co.'s estimated billings increased from \$45 million in 1960 to \$125 million in 1968 while Ernst & Ernst's billings increased from \$36 million to \$95 million. Each of these firms almost tripled their billings in just eight years.

One "Big Eight" firm that published its financial statements during this period was Arthur Andersen & Co. An examination of the year 1970 illustrates the growth that occurred in the decade of the 1960s. In 1970, Arthur Andersen reported worldwide billings of \$190,154,000 and earnings of \$47,937,000. The 1970 earnings were greater than the firm's United States billings (\$40 million) for 1960 [Arthur Andersen Annual Report, 1979].

The 1960s also brought problems to "the Big Eight" firms. Of paramount importance was an increase in lawsuits. The de-cade witnessed an unprecedented deluge of lawsuits against "Big Eight" firms. Several of these suits were successful; others were settled out of court. Of special significance to accountants was a change in the viewpoint of the courts regarding the responsibility of the auditor. Up to this time, courts were reluctant to question an auditor's use of "generally accepted accounting principles," and auditors' adherence to these principles was usually a strong defense. In 1968, however, in the Continental Vending case, U. S. District Court Judge Walter R. Mansfield ruled that adherence to generally accepted principles is not an adequate defense if the court finds that further disclosure was needed [Louis, 1970]. This case brought a new awareness of the potential liability of auditors.

## 1970 – 1980 A TIME OF CHALLENGE

Prior to the 1970s, accounting firms were basically conservative entities, content to wait for clients to come to them. In the early 1900s, Ernst & Ernst advertised for clients and had actively solicited new accounts. These actions resulted in conflicts with other firms. The Ohio Society of CPAs responded by redrawing its rules to greatly limit solicitation of clients [Ernst & Ernst, 1960]. For the next several decades, the accounting profession discouraged, and the AICPA's Code of Ethics prohibited, active solicitation of clients from other accounting firms. However, in the late 1970s this changed. After several court cases involving other professions and an implied suit by the Justice Department, the AICPA's Code of Ethics was modified to allow advertising and client solicitation [Hermanson et al., 1987]. The political and economic climate of the late 1960s and early 1970s served to foster changing attitudes towards competition by many in the profession. By 1978, the heretofore non-competitive world of accounting had altered to the extent that Fortune published an article by Peter W. Bernstein entitled "Competition Comes to Accounting." In this article, Bernstein analyzed the changing environment [p. 89]: "The big accounting firms have not yet taken to the streets with sandwich boards to hawk their wares, but a fierce competitive struggle is transform-ing their once-staid behavior."

The trend of growth through merger continued for the "Big Eight" firms during the 1970s. Two are particularly noteworthy. Ernst & Ernst, an American firm, had had an informal working relationship with the British firm, Whinney, Smith & Whinney, since the 1920s. In 1979, these two firms formally merged, cre-ating Ernst & Whinney, an international firm with offices in 71 countries and billings in excess of \$500 million [Wall Street Journal, 17 January 1979]. Similarly, in 1978, Deloitte, Plender, Griffith & Co. merged its United States practice with the British firm of Haskins & Sells to formalize a long-term affiliation and establish Deloitte Haskins & Sells [Wall Street Journal, 10 Janu-ary 1978].

By the 1970s, most "Big Eight" firms were large international partnerships; moreover, they often were larger than the companies they audited. Arthur Andersen & Co.'s financial re-ports illustrated the growth experienced by "Big Eight" firms during the 1970s. In 1970, Arthur Andersen & Co. had operating fees of \$190,514,000. By 1975, billings had increased to \$386,341,000, and by 1979, were \$645,433,000. Impressively, in just nine years, operating revenues had more than tripled. Furthermore, its earnings increased from \$47,937,000 in 1970 to \$139,422,000 in 1979. The changing sources of these fees is also noteworthy. In 1970, accounting and auditing services generated 68 percent, tax services represented 18 percent, and administrative services were 14 percent of billings. In 1979, accounting and auditing services decreased to 58 percent while tax services increased slightly to 19 percent of fees. On the other hand, administrative services, increased from 14 percent to 23 percent of the total fees generated in 1979 [Arthur Andersen Annual Report, 1979].

It was during the 1970s, however, that questions were raised about "Big Eight" firms and their possible dominance of the accounting profession. Many of these questions were raised in the most comprehensive study that Congress had conducted of the accounting profession since its investigations in the early 1930s. This study was prepared by the staff of the Subcommittee on Reports, Accounting and Management of the Committee on Government Operations of the United States Senate. The study,

entitled The Accounting Establishment [1976], has commonly been called "the Metcalf Report" after Senator Lee Metcalf who chaired the Subcommittee. The report was very critical of the "Big Eight" alleging that it controlled the AICPA and its committees, greatly influenced the FASB, dominated the auditing of large corporations, and dominated the practice of accounting in the United States and probably throughout the world. The report's recommendations included: greater oversight by Congress of accounting practices, establishment of financial accounting and auditing standards for publicly-owned corporations, public reporting by the fifteen largest accounting firms of their financial data and earnings, and consideration by Congress of methods to increase competition among accounting firms.

This report was followed by a series of hearings held by the Subcommittee on Reports, Accounting and Management in April, May, and June of 1977. During the hearings, testimony was offered by members of the accounting profession which attacked the conclusions and recommendations of the Report. The general consensus of the rebuttals was that large international firms were necessary to audit large industrial clients and the accounting profession with "Eight" competitors was, in fact, more competitive than nearly any other major industry. After a review of the Staff Report and eight days of hearings, the Subcommittee on Reports, Accounting and Management issued its report. Although the follow-up report was not as critical of the "Big Eight" as the Staff Report, it urged an increase in competitive aspects of the accounting profession.

#### 1980 – 1990 BIRTH OF THE "BIG SIX"

Although some firms had offered management consulting since the early 1900s, it was in the 1980s that consulting became as important or more important than auditing for many "Big Eight" firms. Fueling this growth was the increased competition among the "Big Eight" firms that began in the 1970s. As firms competed for the same major audit clients, price cutting became an important marketing tool to attract new clients (or maintain existing ones). As a result, many firms emphasized their management services in order to obtain the larger profit margins provided by these services.

In 1978, it was estimated that between 7% and 21% of the total revenues of individual "Big Eight" firms were generated by their management consulting practices [Bernstein, 1978]. By 1988, the percentage ranged from 14% (Deloitte Haskins & Sells) to 37% (Arthur Andersen) [Public Accounting Report, March 15, 1989]. For the fiscal year ending August 31, 1989, Arthur Andersen & Co. reported that \$1,441.7 million of its \$3,381.9 million worldwide revenues were generated by its consulting arm, Andersen Consulting [Public Accounting Reports, November 15, 1989]. This reflects the reality that 42.6% of the firm's revenues was generated by consulting in contrast to 19.8% by the tax area and 37.6% by the accounting and audit area.

As consulting became more important to the major firms, it also created problems. Partners in the consulting area complained they were not adequately represented on important committees in the firm. Another major complaint was that the formula for distributing partnership profits did not give enough consideration to the amount of profits created by each area (auditing, tax, consulting) or the amount of revenues each partner generated. Although consulting is a major profit area, it requires a high level of capital investment in such things as expensive computer programs. Consulting partners complained that the firms were not reinvesting enough profits to ensure the area's future success.

As noted, Arthur Andersen & Co. has for many years been the "Big Eight" leader in the consulting area. However, over the last few years, Arthur Andersen has also exemplified the growing power struggle between audit and tax partners on one side and consulting partners on the other. The extent of this struggle was illustrated in November 1988 when seven consulting partners quit to form their own consulting firm. As a result of these defections and a major self-study completed in January 1989, the partners of Arthur Andersen voted for a reorganization of the firm. The firm was divided into two

operating units — the auditing/tax area and the consulting area, each responsible for its own operations and staffing. A new compensation system was also initiated that increased compensation to the consulting partners and limited the consulting revenues that had to be shared with the other area [Chicago Tribute, 13 April 1989]. As other firms expand their consulting areas, they may well be faced with problems similar to those experienced by Arthur Andersen.

This growth in management consulting during the 1980s, combined with highly visible corporate failures and financial institution collapses, resulted in renewed public concern regarding the profession's ability to regulate itself and maintain independence when providing both consulting and auditing services. The House Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, chaired by Rep. John D. Dingell, conducted hearings to investigate concerns about the accounting profession. In May 1985, in an interview with reporters of Management Accounting, Rep. Dingell indicated that the committee had no specific agenda, "other than that it is becoming rather clear to us that the regulatory process is not being well served in many instances by the work being performed by auditors and accountants" [p. 22]. He went on to indicate concerns regarding the issue of independence:

We have accountants who are going into the business of being financial advisors as well as accountants. A lawyer would regard this as a rather clear conflict of interest were he supposed to scrutinize the behavior of a client and report on it and at the same time advise that client on how it is supposed to behave, [p. 53]

During this same period, the National Commission on Fraudulent Financial Reporting ("the Treadway Commission"), sponsored by the major professional accounting organizations, met to study the issues of increased fraudulent financial reporting. The profession responded to issues raised by both the Dingell Hearings and the Treadway Commission. In 1985, the Auditing Standards Board issued ten exposure drafts of professional standards aimed at closing the "expectations gap" between the public's and the profession's assessment of the auditor's responsibility. Eventually, nine Statements on Auditing Standards were issued, representing the most guidance ever released at one time [Journal of Accountancy, July, 1988]. These standards set forth the auditor's increased responsibility to detect fraud and illegal acts, to communicate important matters to the audit committee of the issuer, to apply analytical review procedures and evaluate internal controls on every engagement, as well as a revision of the standard auditors' report to more clearly convey the responsibilities of the independent auditor.

The decade witnessed a number of other significant changes within the profession. In the 1980s, the number of women entering public accounting rose dramatically, a trend that had started in the early 1960s. Although the number of women in accounting doubled between 1960 and 1970 and again between 1970 and 1980 [Wescott, 1986], it was not until the 1980s that most public accounting firms became aware that their future success depended upon recruiting and retaining women.

In the 1970s, the major accounting firms began to hire women, but only in small numbers. During the late 1970s and early 1980s, though, the need for professional accountants grew. The supply of male accountants remained level, but an increasing number of college women selected accounting as their major. By the mid-1980s, nearly half of all accounting students were women and by 1988 women comprised 52 percent of the accounting majors [Accounting Today, October 24, 1988]. More importantly, an even higher percentage of the "outstanding" accounting graduates (those meeting criteria typically sought by the "Big Eight" firms) were women. "Big Eight" firms responded to this reality by actively recruiting women.

During the 1980s, the number of women hired as a percentage of new CPAs increased until today most "Big Eight" firms hire nearly an equal number of men and women. However, the number of women holding manager and partner positions still remains small. Although the number of women partners in

"Big Eight" firms doubled (69 to 157) between 1983 and 1986 [Hooks & Cheramy, 1988] less than 4 percent of all "Big Eight" partners are women [Public Accounting Report, November 15, 1989].

Other "minority" groups have achieved even less representation in the profession. Blacks, for example, make up over 3% of doctors and 2% of lawyers, but less than 1% of CPAs in the United States. Mitchell and Flintall [1990] estimated that only 50 of the 9,000 partners in the largest public accounting firms are black.

Firms continued to expand through merger in the decade of the 1980s. In 1984, Price Waterhouse and Deloitte Haskins & Sells discussed the possibility of merging as a way of increasing their competitive advantage in auditing while also increasing their consulting opportunities [Business Week, September 24, 1984]. However, the merger plan failed when the agreement was rejected by the British partners of both firms.

Thus, the first major accounting firm merger of the 1980s joined the "Big Eight" firm, Peat, Marwick, Mitchell & Co., and the international firm, KMG Main Hurdman. KMG Main Hurdman had been created in 1979 by a merger of accounting firms from West Germany, Netherlands, Britain, Canada, and Australia and the American firm of Main Hurdman & Cranstoun [Wall Street Journal, 26 July 1979]. Through this merger, Klynveld Main Goerdeler, (KMG) aspired to be a major firm in the United States. However, by the mid-1980s this goal had not been achieved. Then in early 1985, KMG began merger talks with Peat, Marwick, Mitchell [Berton, Wall Street Journal, 24 September 1985]. Because of the existence of structuring problems and doubts expressed by some of the KMG partners, these discussions terminated [Berton, Wall Street Journal, 25 September 1985]. In 1986, KMG Main Hurdman again decided a partner was necessary for it to gain a stronger presence in the United States. Ernst & Whinney made a formal merger offer to KMG, but it was rejected. KMG then renewed talks with Peat, Marwick, Mitchell. This time the discussions were successful. As a result, KPMG Peat Marwick, the largest accounting firm in the world was created with over \$2.7 billion in worldwide revenues, nearly \$1 billion more than the second ranked firm,

As leading "Big Eight" firms continued to grow, increased their audit market shares, and expanded their services, some analysts suggested that smaller "Big Eight" firms such as Deloitte Haskins & Sells and Touche Ross should no longer be included among the first tier accounting firms. As in past decades, these smaller firms looked to mergers as a way to provide the growth necessary to continue to compete as first tier firms.

In 1989, Ernst & Whinney and Arthur Young merged to form Ernst & Young. Importantly, it was the need to grow and compete "into the 1990s and beyond" that was emphasized when Ernst & Whinney and Arthur Young announced their merger in 1989 [Journal of Accountancy, July, 1989]. The combined firms hold the number one audit position throughout most of the world [Business Week, July 24, 1989]. It is interesting to note that an "anonymous delivery" of the Ernst & Young prospectus to Accounting Today disclosed many heretofore unavailable facts about these firms. Robert Crane [1990] suggests that the significantly larger earnings per Ernst & Whinney partner, together with analysis of other data, "suggest that the deal was not the 'combination of equals' portrayed in the public relations campaign vigorously carried on by the two organizations" [p. 13]. In 1989, Ernst & Whinney's conformed accrual earnings per partner were \$263,000 while Arthur Young's were only \$191,000, which Crane sees as representing an effective "buy out" of Arthur Young by Ernst & Whinney.

After the breakdown in merger talks between Price Waterhouse and Deloitte Haskins & Sells, Deloitte began discussions with Touche Ross. Again, the idea of being able to compete with the other firms was emphasized as an important consideration [The New York Times, 7 July 1989]. As previously mentioned, Deloitte Haskins & Sells had traditionally concentrated its marketing efforts on its audit area. It was a leading auditor of manufacturing firms. In contrast, Touche Ross had concentrated on auditing

and consulting in retailing and financial industries. Both firms hoped that a merger would provide the opportunity for expansion of consulting. Voluntary disclosure by Deloitte & Touche indicated the merger between these two firms was "considerably closer to a 'combination of equals' than the merger of Ernst & Whinney and Arthur Young" [Crane, 1990, p. 13]. In fiscal 1989, Touche Ross disclosed accrual earnings of \$245,000 per partner, and Deloitte Haskins & Sells con-firmed \$241,000 of earnings per partner.

Thus, by 1989 "the Big Eight" had been reduced to "the Big Six". In fact, it was almost reduced to the "Big Five". In July, 1989 Price Waterhouse and Arthur Andersen announced that they had begun talks aimed at merging the firms. This merger would have created the world's largest accounting firm with total revenues approaching \$5 billion [Berton, Wall Street Journal, 7 July 1989]. However, almost immediately the differences in firm culture became problematic. Price Waterhouse had the image of a conservative auditor of "blue chip" companies and had only recently actively entered the consulting area. On the other hand, Arthur Andersen had for many years aggressively marketed both its auditing and consulting services. In late September, 1989, talks between Arthur Andersen and Price Waterhouse broke down and merger plans were terminated [Berton, Wall Street Journal, 27 September 1989].

As the 1980s ended, major United States accounting firms, as in the past, were changing in response to the changing environment in which they function. Historically, they have adapted well. They have grown from small local partnerships to large international firms that measure their revenues in billions of dollars. They offer dozens of different services to thousands of clients. However, as the accounting profession enters the 1990s, for the first time in over sixty years, the term "Big Eight" accounting firm is no longer appropriate. Now, whether a company is in Japan, England, Italy, or the United States, it can be audited by one of "the Big Six" firms.

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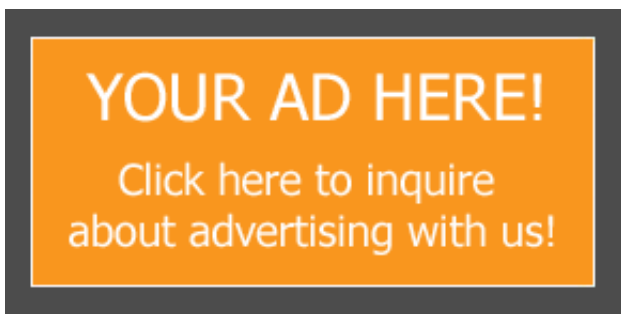




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