EY Breakup

Introduction

Ernst & Young is leading the biggest shake-up of the audition industry since the collapse of Artur Anderson two decades ago. Towards the end of 2021, EY started discussing a possible split of its advisory business from the auditing operations. The goal of this transaction is to escape the conflicts of interest EY has been dealing with for years between the auditing services and consulting services provided to some corporate clients. Over the months, this proposal has gained traction, and the firm's partners will start to vote on it in November. The advisory team will undergo an initial public offering late next year and is expected to grow faster as an independent company, as EY's auditing clients would now be able to hire the independent consulting division as well. EY has been working with JP Morgan [JPM:NYSE] and Goldman Sachs [GS:NYSE] to consider various solutions. After a summer of internal disagreements on how to proceed with the split, EY's bosses have approved the planning for the IPO.

About EY

Ernst & Young is a multinational professional services partnership headquartered in London. EY is the result of several mergers of ancestor firms, the oldest of which was founded in 1945 in the U.K. as Harding & Pulling. The name Ernst & Young was first used in 1989 after the merging of two other firms: Arthur Young and Ernst & Whinney. Over the years, EY has expanded, becoming one of the Big Four accounting and auditing firms.

EY has four main business units: financial audit, tax, strategic consulting, and deal advisory. The audit and assurance business has consistently accounted for the largest percentage of total revenues, followed by tax and consulting services. Deal advisory has always been the unit producing the least revenue for the firm but, over the last decade, it is the one that experienced the greatest increase in revenue, up by 180% from 2010 to 2021. In 2021, EY reported $40bn in total revenues. The largest units by revenue are assurance, which amounted to $13.58bn and consulting with $11.14bn.

EY currently has 700 offices in over 150 countries which are grouped into three business regions: the Americas accounting for 44% of the total revenues, Europe, the Middle East, India, and Africa (EMEIA) for 39% and the Asia-Pacific region for 17%. Nonetheless, the area with the highest number of employees is EMEIA which counts 121,325 workers out of the 312,250 total. Ernst & Young is not a single entity, but it operates as a network of legally separated national member firms that each pay a fee for shared branding, systems and technology.

Industry analysis

Nowadays, the accounting industry is very concentrated with the Big Four dominating the market. Together they audit over 80% of U.S. public companies, and their combined revenue amounted to more than $167bn in 2021. They serve as auditors and consultants both for the largest public companies worldwide and for several private companies.

The largest firm of the Big Four by total revenues is Deloitte, which in the financial year 2021 achieved $50bn in revenue and is followed by PwC with $45bn. EY and KPMG respectively reported revenues of $40bn and $32bn. While PwC and EY generate the largest share of their revenue through their audit business, Deloitte and KPMG achieved the largest share of their revenue through their advisory and consulting units. Until the late 20th century, the industry was dominated by eight firms, called the Big Eight. However, this number reduced over the years because of the consolidation of some of these firms and due to the fall of Artur Andersen in 2002 following the Enron collapse. EY benefited most from this event, because it received most of Artur Andersen's clients. Over the years, the Big Four's dominance has made some label the auditing industry and oligopoly. For example, in the U.K. in 2011, it was reported that they accounted for the audits of 99% of the companies in the FTSE 100 Index.

It could be argued that there are not many firms around the world with the same business model as the Big Four that would pose a significant threat to them. However, each specific business unit of these powerful networks has its own competitors because several strong global firms only focus on auditing or consulting. For example, Accenture's [ACN:NYSE] total revenues of $50bn exceed the ones of the Big Four, but the firm only provides management consulting, technology and outsourcing services. Other firms that pose a threat to the consulting sector of the Big Four are the large consulting partnerships McKinsey, BCG, and Bain. Interestingly, the consulting branches of the Big Four firms are the four largest consulting firms in terms of revenue. For example, as of 2019, the smallest of the Big Four (KPMG) had 40% more revenue than the largest MMB (McKinsey). It is, however, worth mentioning that they offer different types of consulting. MMB provide strategy consulting. They support companies in seeking new opportunities and detect problems inside the business finding efficient solutions. On the other hand, the Big Four offer implementation consulting. The implementation project is conducted by larger teams that often include specialists. They work with a specific business unit inside the company to set up new systems, processes, or technology solutions.

Some professional services networks with similar business models to the Big Four are Grant Thornton, the largest accounting firm after the Big Four, and firms such as BDO Global, RSM Tenon, and Baker Tilly International that, over the last decade, have expanded through mergers and acquisitions.

Deal Structure

Following continued criticism over EY's conflicts of interest between its audit and advisory businesses, Di Sibio, EY's CEO, and the Big Four firm's other senior staff are planning to break up the two in a transformative deal for the industry. The planned split would create a partnership focused on audit and a separately owned advisory business comprising EY's current advisory, consulting, managed services and tax operations teams. EY then plans to raise $11bn through the public listing of a 15% stake in the new advisory business, with an additional $13bn in net debt to fund the transaction. The audit partnership would be comprised of about 6,200 partners and 120,000 staff, out of EY's nearly 312,000 employees. Furthermore, the audit business will retain some tax and advisory services, which will initially represent around a third of its revenues. The audit business will retain EY's name and brand, whereas the advisory firm will receive a new name and identity.

The demerger has been described by some as the most complex transaction to ever take place, with over 2,000 internal and external advisors and executives working on the deal. EY has operations in about 150 countries, each having its own national member firm. The complexity of executing the breakup across the member firms has resulted in only the biggest 75 of them being included. The advisory and consulting businesses in the smaller member firms will remain linked to the global audit partnership. EY China is an exception, being the only top 15-member firm to not be included in the split. This comes after EY failed to create a deal structure fit for Chinese regulatory approval. The rest of the leaders of EY's 15 largest national member firms, accounting for 80% of annual revenues, have unanimously approved the plan after an intense period of internal debate and delays. EY US, the largest national member firm responsible for nearly 40% of EY's annual revenues, was initially reluctant to back the breakup due to concerns about how several billions of dollars of unfunded liabilities would be handled. Now that the break-up has been backed by EY's leaders, it will have to be voted on by its 13,000 partners, and then finally get regulatory approval.

Deal Rationale

EY's current advisory practices are restricted due to the potential for conflicts of interest with their audit business. Auditors play a crucial role in financial markets as they reduce asymmetric information between firm managers and shareholders, by checking firms' books and accounts. Truthful reporting can be threatened by the conflicts of interest which arise in accounting firms which provide auditing services and consulting/advisory services. Firstly, clients may pressure the accounting firm to distort their auditing judgement by threatening to use another accounting firm's consulting services. Moreover, auditors may be reluctant to find fault in the financial information from firms if their non-audit counterparts were responsible for some of the tax or financial advice. So despite profiting from economies of scale by providing both audit and advisory services, EY and many large accounting firms have been criticized for this potential for conflicts of interest. An example commonly referred to is Arthur Andersen, an accounting firm which was previously considered one of the "Big 5". The accounting firm was found guilty of shredding documents concerning its audit of Enron in 2002. The firm did so as they were heavily involved in Enron's scandal, being its main auditor. Furthermore, Arthur Andersen had likely untruthfully audited Enron on several occasions as the loss of their business would be devastating for the accounting firm. These conflicts of interest prevent EY's consulting and advisory businesses from working with audit clients, under the Sarbanes-Oxley Act of 2002. The planned break-up will allow the audit and advisory businesses to grow faster as separate entities, with a pool of newly available clients. The break-up will allow the advisory business to work with large tech groups such as Amazon and Google, which is currently not permitted. EY projects its audit company to grow at up to 7% annually and 18% annually for the newly formed advisory business.

The split is likely to be fruitful for many partners, with audit partners able to receive cash payments worth two to four times their annual salaries. This would aim to compensate audit partners for taking away the consulting and advisory services. The advisory and consulting partners, on the other hand, will receive shares in the new advisory business, but take significant cuts to their salaries, meaning the outcome of the split for them relies on the performance of the shares within 5 years, when they are allowed to sell them. The spinoff of the advisory business could also lead to numerous opportunities for partner promotions and rewards for the public listing. The potential IPO could cause stock windfalls of up to $8m per consulting partner. Moreover, it will allow the advisory business to heavily invest in technology to expand its offerings to clients. Furthermore, no longer being constrained by conflicts of interest and new financing from an IPO will allow the resulting advisory business to compete with larger independent firms such as Accenture, which separated from Arthur Andersen in 2000.

Evaluation & Outlook

The breakup will now require approval from EY's 13,000 partners, with voting taking place on a country-by-country basis starting in November of this year and concluding in the first quarter of 2023. Selling the breakup to partners is the first step, which may be difficult for EY's seniors due to the varied interests of partners from different countries and business units. EY's leaders may struggle to convince partners of the need for such an overhaul of the current structure which has just delivered a record $45bn in annual revenue. The break-up and following IPO may also affect the future incentives to advance to a partner position at the firm. Previously it was attractive to work hard and rise through the ranks to be crowned a partner at EY. Joining the partnership came with shares of the company which could later appreciate and be sold back for a nice amount. If EY proceeds with the IPO of the advisory business, however, consulting partners may not get the same level of ownership in the company, making it less appealing to work there. Furthermore, some may make the argument that the break-up will decrease the desirability for young graduates to join EY, as many join the auditing business with hopes of later on switching internally to the advisory side.

Additionally, if partners give their blessing, the firm will require approval from a large number of regulators across the globe, which would likely take several years. Goldman Sachs [GS:NYSE] and JP Morgan [JPM:NYSE] are acting as advisors to the accounting firm, with Rothschild, Lazard, and Evercore [EVR:NYSE] providing advisory services to member firms as they try to predict the impact of the split on their businesses.

The breakup of EY into two separate audit and advisory businesses would reshape the accounting industry which is currently dominated by the Big Four: Ernst & Young (EY), Deloitte, KPMG, and PricewaterhouseCoopers (PwC). The rest of the Big Four have stated that they will not follow in EY's footsteps and would rather keep their audit and advisory businesses together. However, Deloitte, KPMG, and PWC may be pressured by their partners to find a strategy to match EY's increasing profitability following the split. However, EY's CEO, Di Sibio, believes that the conflicts of interest are equally too big at the other Big Four firms and that they will eventually have to split up their businesses too. The break-up may also create increased competition for consulting firms such as McKinsey and BCG, as EY's advisory business gains a greater market share. PwC which is currently planning a large expansion of its workforce is seeking to profit from the uncertainty surrounding EY's breakup to poach senior managers and even partners. The other Big Four firms may look to do the same and capitalize on the opportunity, which could severely impact EY's plans for a clean split.