With the “Big Four” holding the monopoly on corporate auditing, can we trust the quality and accuracy of companies’ reported financials? asks Forbes Magazine’s Portfolio Strategy columnist and Fisher Investments chief executive Ken Fisher

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Big Four: do not pass go

I should have seen this coming but I didn’t. Then again, it is always the worst things that no-one notices. This one is not bad enough by itself to trigger a bear market but it makes the stockmarket worth less than otherwise. After all, think how much higher the FTSE 100 index would be if you had faith in each company’s reported financials.

Over the past 20 years, corporate audit quality slowly deteriorated as the US government fostered a collusive auditing oligopoly. Since 2002 it has mushroomed and today it is everywhere. Real audit competition virtually does not exist.

Rarely can a corporation fire and replace its auditor. There is nowhere to go. Despite being in our face, no-one sees it and corporations are afraid to talk about it for fear of retribution. Without competition, as in any other field, quality deteriorates fast. Today’s quality is a very bad joke.

Recall the so-called “Big Eight” of yesterday, plus regional auditors competing all over the globe. The Big Eight banded each other and the regions snipped smaller auditors off the bottom. By 2002, government-encouraged acquisitions had shrunken the grouping to the “Big Five” and just two material regions – BDO Seidman and Grant Thornton – with a mere combined 1% market share. Then, the US government wrongly killed Arthur Anderson, creating the “Big Four”.

You cannot float an offering today without a Big Four audit – it completely controls access to capital markets. PricewaterhouseCoopers is the biggest auditor in Britain with a 38% market share, followed in order of size by KPMG, Deloitte & Touche and Ernst & Young. Together they have a 98% market share on a capitalisation-weighted basis of the UK audit market. It is 99% in America. Think of any field in history where four firms have had that and ask yourself whether good or bad things happened later? Always bad. Without competition quality stinks.

In countries such as Germany, New Zealand, Norway, Finland and Spain, two auditors will have more than 75% market share. And that is true for many industries. Usually, in any major city, for example London, the senior industry practice audit partner from the biggest auditor has been friends for decades with his peer at number two.

They talk. Effectively they collude. Accounting industry standards – which, after all, they themselves created – require that, if a corporation fires one auditor and wants to hire another, the two auditors get to chat and share information openly, supposedly so the corporation cannot hide “bad” information from the new auditor.

What really happens is they make sure the new one will not take on the account without some serious penalty – hence the corporation is stuck. In any other field this would be illegal and the government would break them up into the “Big 14” – including, maybe, three firms called “Delo”, “Itte” and “Touche”.

Regulators seem to like it this way – club-like, easy to monitor and it makes them all feel important. This will not go away so you should focus on stocks with enough quality and cheap enough that you need not fret financials that are phoney or 35% fictional. Here are a few like.

Germany’s Schering AG is ripe to be taken over. Strong in four areas of drugs, it is not big enough to justify independence. It is cheap enough to be acquired while boosting the buyer’s earnings per share. It is also among the rare good-sized firms not using a Big four auditor – it uses a German affiliate of BDO Seidman.

Quest Diagnostics is the leader in the clinical lab testing market in the US, carrying out 250 million lab tests yearly. This market is fragmented but Quest is reaping operational economics of scale and is growing through acquisition as a consolidator. With a price/earnings ratio of 18 it could be consolidated itself.

Eaton is a diversified electrical equipment manufacturer. Cheaper than most peers, it is extremely well-run, albeit growth is modest and it has heavy exposure to autos and trucks. However, at 90% of annual turnover and 12 times earnings, it is too cheap not to rise nicely or be taken over.

Dito for Canada’s Manulife Financial at 13 times earnings. It is North America’s second-largest life insurer but also does health insurance, pensions, mutual funds and more (including annuities, which I hate). Meanwhile it has a 1.7% dividend yield.

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