Economic Impact of The Accounting Industry

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Did you know the largest four audit firms reported more than $113 billion in revenue worldwide for fiscal 2013 and counted between 150,000 and 200,000 employees and partners each on a worldwide basis?

By comparison, an October 2012 survey by American Lawyer of the top 100 global law firms published revenues, even for the top ten that were much more modest. The combined revenues of the top fifty global law firms, $55 billion, equals about half of what the largest four global audit firms report. The combined revenues of the top ten largest global law firms, approximately $20 billion, are still less than the reported revenues of the smallest of the global audit firm, KPMG.

The combined gross revenue for the Global 100 law firms grew by 3.8 percent in 2012 to a record high of $85 billion, still short of revenue for only four global audit firms. By comparison, according to a study by Mondanock Research published on my site, global non-audit advisory services of Big Four firms, including tax services, increased to $64.73 billion in fiscal 2013 a 5.47% increase over fiscal 2012 levels.

Take out tax and the consulting and advisory services alone of Deloitte, KPMG, PricewaterhouseCoopers and Ernst & Young, at $38.54 billion, still produce more than the top ten largest global law firms.

Those consulting and advisory services revenues enjoyed an increase of 6.8% over fiscal 2012. But Big Four fiscal 2013 growth was only about half that of last year in most other categories. That growth in advisory, however, contrasts sharply with just 0.25% growth in audit services. KPMG’s audit revenues actually declined for a second year by approximately 1%, joined by PwC, whose audit revenues decreased by 0.7 percent.

Lane Green writes in the Economist in September in a piece called, “Shape shifters”:

> ... at all four firms consulting has been growing much faster than the audit business in recent years. In fiscal 2012 Deloitte increased its revenues from consulting by 13.5% and from financial advisory by 15%—compared with just 6.1% for audit and 3.9% for tax and legal services”

At the end it, Green asked Deloitte CEO Barry Salzberg, “Do people perceive Deloitte as a consulting firm with an audit business rather than the other way round?” Salzberg replied: “We’re not going to take our eye off our professional responsibility with respect to either.”

I think it’s too late. Again.

What does the reemergence of the consulting business at the Big Four global audit firms mean for the quality of audits of public companies in the US, UK, EU and major industrialized countries you may invest in?

The **International Forum of Independent Audit Regulators** recently released its **Report on a 2013 Survey of Inspection Findings.** Lewis Ferguson, a board member of the PCAOB, the US audit firm regulator after Sabrbanes-Oxley, is the group’s Chair. He leads IFIAR’s 50 member regulators from countries in all over the world.

Two consecutive years' surveys of IFIAR Members' inspection findings indicate that auditors still need to improve performance in certain areas for audits of listed Public Interest Entities, including major financial institutions. The three inspection themes with the highest number of findings were:

- Fair value measurement,
- Internal control testing, and
- Adequacy of financial statements and disclosures.

The first two themes, fair value measurement and internal controls testing, above had the highest number of findings in both the 2013 and 2012 surveys. For audits of systemically important financial institutions (SIFIs), including global systemically important banks (G-SIBs), the three inspection themes with the highest number of findings, consistent with the 2012 survey, were:

- Audit of allowance for loan losses and loan impairments,
- Internal control testing, and

- Audit of the valuation of investments and securities.

These findings are consistent with the concerns expressed by the PCAOB for audits of US listed companies.

In a recent speech for the National Association of Corporate Directors, PCAOB board member Jeanette Franzel said that in 2012, 37 percent of engagements reviewed contained audit deficiencies, compared to 36 percent in 2011.

An audit deficiency is where PCAOB inspection staff concluded that the auditor failed to gather sufficient audit evidence to support the audit opinion. These deficiencies may relate to the opinion on the financial statements, or the opinion on the effectiveness of internal controls over financial reporting.

There were some changes among the firms. One firm had a significant drop in its percentage of inspected audits with Part I deficiencies, other firms had increases, which resulted in the overall percentage for the four largest firms remaining fairly steady.

In 2012, some of the more frequent findings of audit deficiencies noted in Part I included testing and evaluating

- internal control over financial reporting;
- revenues;
- inventory;
- business combinations; and
- fair value measurements and disclosures.

While the number of Part I findings has been trending downward since 2010 in the areas of auditing financial instruments and fair value measurements and disclosures, fair value measurements and disclosures remains as an area of frequent findings, even if the numbers are lower. At the same time, there's been a spike in deficiencies related to internal control over financial reporting and business combinations. And audit deficiencies in the areas of revenues and inventory continue to be frequently cited in Part I.

PCAOB board member Steven Harris, in a speech to the American University stated the problem:

From June 2012 to November 2013, the Big Four global network firms and their affiliates announced more than 36 acquisitions of consulting businesses, with the Big Four U.S. firms accounting for 19 of those acquisitions.

In November 2013, one of these firms announced the creation of an investment fund with the aim to invest in, partner with, and acquire organizations that specialize in data and analytics tools and assets. Shortly afterwards, another firm announced that it had acquired a large consulting firm with practice areas in mergers and restructuring, corporate finance, digital technology and talent management. And, earlier this week, a Big Four firm's foreign affiliate announced its ambitions to become a global top-20 legal services player within the next five years.

At the same time, auditing firms are deriving an increasing share of their revenue from consulting services. Consulting revenue for the Big Four global network firms has increased over the past five years by 33 percent versus only 6 percent in audit revenue. Further, each of the Big Four firms is predicting double-digit increases in their consulting and advisory practices over the next 10 years, while their audit practices are expected to grow at a slower pace.

Ultimately, how these diversified lines of activity affect audit quality, auditor independence, conflicts of interest, and investor protection is something I believe the Board must carefully monitor and analyze.

The audit firms say that the acquisitions and investments they are making in their consulting and advisory practices improve their auditing capabilities. They say that the consulting practices are necessary to provide specialized resources and expertise to the audit teams.

I would direct your attention to the testimony given by the firms in the year 2000 that was footnoted when the SEC issued its final rules under Sarbanes-Oxley regarding the prohibitions on some consulting services by auditors:

Philip A. Laskawy, Chairman, Ernst & Young LLP (Sept. 20, 2000). Mr. Laskawy commented on this matter as it relates to information systems consulting:

We recently sold our practice in this area. We did so for a variety of reasons, but one reason certainly was that although **we did not believe independence was actually impaired by this service, we could understand that particularly with large fees that sometimes are involved an appearance problem could be present. I might note that now that we have sold this practice we have not discovered that we are somehow enfeebled, unable to perform effective audits or to maintain top-notch audit and tax practices. In fact, we have found more the opposite to be true. Without a large consulting practice to manage we are now more targeted and more focused on our core audit and tax business, and our audit and tax partners feel as though they, and not the management consultants, are in the drivers seat at the firm.** Moreover, from our clients' perspective, there actually may be an advantage in not having such a practice. **We have had a greater string of wins in obtaining new audit clients since we sold our management consulting practice than we had at any time in recent history,** four new Fortune 500 clients, including two Fortune 50 companies, just within the last six months.

Testimony of Douglas Scrivner, General Counsel, Andersen Consulting (Sept. 20, 2000) **("It is more likely that recruitment has been jeopardized by the actions of the accounting firms themselves. Some of the firms have diverted investment and resources out of the audit function and into non-audit services, thereby reducing the attractiveness of the audit function as a career path.** They have created the very environment in which accounting majors look elsewhere and audit staff move over to the consulting side as quickly as they can. It is important to note that audit firms do not provide consulting services to improve the quality of the audits, but rather for commercial considerations. A then CEO of one of the Big Five audit firms was quoted recently in Business Week saying `If I had to trade an auditing account for other business, I would do it.'".

Testimony of James J. Schiro, Chief Executive Officer, PricewaterhouseCoopers, before the Panel on Audit Effectiveness (July 10, 2000) **("[Our] restructuring will allow us to rededicate ourselves to our core principles.");**

Testimony of J. Terry Strange, Global Managing Partner, Audit, KPMG LLP, (July 26, 2000) ("In our view, **the restructurings that are underway are driven by market forces, not regulatory considerations.");**

Douglas R. Carmichael, the first Chief Auditor for the PCAOB in 2003 to 2006 and a professor of Accounting at Baruch College CUNY, testified in July 26, 2000, **"The counter argument that consulting improves audit quality is also unproven and does not provide a basis for eliminating the proposed restrictions."**);

But sentiments can be quite mutable.

Kayla Gillan was General Counsel of CalPERS on Sept. 13, 2000. She went on to be a founding member of the PCAOB. She served two terms on the PCAOB Board, leaving in 2008 to become chief administrative officer to RiskMetrics Group, Inc. (RMG), a then-newly public company. She joined the staff of the SEC in 2009 as former SEC Chair Mary

Schapiro's Deputy Chief of Staff. She left in 2011 to head a newly created Regulatory Relations Group at PwC. She's now head of PwC's Investor Resource Institute.

In 2000 she said, "The concept that an auditor who has a greater financial incentive to please management than to criticize it will tend to find ways to avoid negative comment is intuitive and obvious."

In 2012 she told the New York Times, on the occasion of Sarbanes-Oxley's 10th anniversary, that the law has done the trick: "independent auditors comply with stronger standards and also have an independent regulator to oversee their efforts on behalf of investors and other stakeholders…"

J. Michael Cook, former Chairman and Chief Executive Officer, Deloitte & Touche testified in July 26, 2000 that "A final assertion that **quality will ultimately decline because the `new audit profession' will be unattractive to the best and brightest people.** I cannot evaluate that possibility but would observe that **the audit-dominated firms of the future that today's leaders express concerns about are in many respects comparable to the firms that attracted them (and me) to the profession twenty or more years ago. Certainly much has changed in that time period, but I would**

expect the right leaders to be able to make such firms attractive once again.".

Cook is now an Audit Committee member who's never met a service from Deloitte he didn't like.

Cook helped PCAOB Board Member Jay Hanson provide a PCAOB update at the FEI CFRI conference in November 2012 I attended. Cook, the retired CEO and Chairman of Deloitte chairs the Audit Committee of Comcast, as well as serving on other boards. Comcast uses Deloitte as its auditor.

Cook responded to a question from the audience at FEI CFRI about auditors and non-audit services by saying they were fine with current levels of services by their auditors and didn't feel further prohibitions or scrutiny were warranted. In fact, he said, they liked using their audit firm for non-audit services because they were comfortable with them and their auditor knew management and the business best.

Comcast spent more than 10% of total fees to Deloitte on non-audit related and tax services in 2011 and 2010, for example. Some of Comcast's audit-related fees were for technical accounting consultations related to its merger with NBC Universal. Comcast even spent $500k in 2011 and $300k 2010 for "All other" services that are not explained. Since it’s not for tax and not audit-related it’s probably technology related.

So much for “checks and balances”.

Deloitte is the only Big Four firm that didn't sell its consulting arm in the US because of the independence pressures culminating in Enron.

Are PwC, EY and KPMG now saying they could not and did not perform quality audits during the period between 2000-2002 when they sold these businesses and 2007 or so when the non-compete agreements with IBM, CapGemini, and BearingPoint expired and they began rebuilding? That’s not what they said in 2000.

The Big Four firms’ consulting businesses have now recovered from the post-Sarbanes scare. Outside of the US, without the same restrictions for auditors on providing prohibited services, they continued to grow. Deloitte has been building its business all along including via acquisitions like the carcass of BearingPoint’s public sector business.

I reported in American Banker that PwC, who bought the industry side of BearingPoint in 2009 after its bankruptcy, had its most lucrative set of Advisory engagements ever on the four OCC/Fed mandated mortgage servicer foreclosure reviews. Those reviews are widely considered failures, stopped in their tracks by a quick and dirty settlement in January. But those engagements brought in more than $1 billion in revenue to PwC's financial services consulting with no requirement to deliver a final report to the regulator or final estimates of harm to Congressional authorities.

The New York Department of Financial Services recently banned Deloitte for a year for conflicts of interest in its consulting work for the state related to Standard Chartered Bank. PwC received a subpoena for similar issues.

There are numerous examples of audit firms still earning at least as much of their fees from audit clients, or multiples of their audit fees, from what are, in my mind, supposed to be prohibited services under Section 201 of the Sarbanes-Oxley Act of 2002.

Non-audit and audit-related fees and services in 2012 were, on average, 22.12% of total fees paid to the auditors, according to Audit Analytics. That's down from 50.87% in 2002, the last year before the Sarbanes-Oxley prohibitions on other consulting services to audit clients became effective but still high for firms that are not supposed to be swayed by other revenue from their client. 10 % is best practice according to corporate governance thought leaders.

I asked an NYU Stern panel in November 2012 on the reemergence of the consulting arms of the firms, “Are we to believe that auditors are the only market eunuchs, unable too be swayed by financial incentives to do the wrong thing?”

For example, auditors provide non-audit related advice on GAAP and SEC reporting for specific transactions, in particular M&A transactions, and get paid extra for it. Who goes back to check and see if they audited their own advice?

In spite of these impressive numbers, the four largest global audit firms are not, as Deloitte touts, “seamless service delivery” vehicles, for example to Chinese firms that want to get a US listing.

Notice how the language around Deloitte’s Chinese Services Group, headquartered in San Francisco, US is the exact opposite of what the firm argues when trying to isolate complaints about the Chinese firms in the reverse merger fraud issue from the involvement and control of the US firm.

> “Deloitte’s Chinese Services Group (CSG)

> coordinates with the Deloitte Touche Tohmatsu member firm in China and the appropriate subsidiary of Deloitte LLP to assist U.S. companies investing and operating in China. Whether contemplating market entry, M&A or optimization of existing operations, the CSG, in collaboration with the member firm in China, can help U.S. companies implement cross-border investment strategies and navigate the associated risks.
>
> The CSG also co-ordinates with the China firm and the appropriate subsidiary of Deloitte LLP to assist Chinese companies seeking to access U.S. markets – expanding operations, raising capital and/or engaging in M&A. Our national network of bilingual professionals works closely with colleagues in China to deliver seamless service to globalizing Chinese companies."

Note the words used to describe how the US professionals use "coordination", "collaboration", and "bilingual professionals [who] work[s] closely with colleagues in China to deliver seamless service…"

Seems like that would be pretty hard to do if you could not share documents or other "secret" information about Chinese companies across borders. But that's what the Big Four audit firms claim when they refuse to provide workpapers to the SEC in investigations of Chinese frauds. The SEC recently issued an Administrative order that would ban the Chinese arms of the Big Four for auditing US listed Chinese companies for six months but that order is still being litigated.

It's not surprising everyone, including most journalists, get confused about the roles and responsibilities of the firms when trouble starts. When HP announced it was writing down more than $5 billion, or almost half of the acquisition price of UK software firm Autonomy, because of "serious accounting improprieties, misrepresentation and disclosure failures" the scandal drew in all four global firms.

HP is audited by Ernst & Young. Autonomy was audited by Deloitte. KPMG supported HP with due diligence work on Autonomy before the deal was signed. PwC was hired by HP to investigate the fraud accusations against Autonomy and that investigation resulted in further downward restatements of Autonomy revenue an profits, bolstering HP's claims.

(Now PwC and HP are being sued by a third firm for joint theft of trade secrets. That lawsuit claim PwC and HP colluded, based on a global business alliance between the two firms, to cancel an order by PwC with the plaintiff's firm for technology to be used internally at PwC and shift the order to HP. The lawsuit asks if the hardware order, sold by HP to PwC at below cost, was a quid pro quo in exchange for PwC supporting HP's claims about fraud by Autonomy.)

A similar dog's breakfast of firms was involved in Caterpillar's write-off of goodwill from its acquisition of Chinese firm ERA where fraud is also alleged. Caterpillar is audited by PWC. Ernst & Young and KPMG helped Caterpillar with due diligence on the deal.

In almost every case, the firms are erroneously referred to by media, and even at times by the SEC, as the company's "accountants", not by their very distinct roles and responsibilities. The reemergence of consulting in the audit firms adds risk from misses and failures in those arenas to the reputation and integrity of the audit function and the public's confidence in the audit product overall.

It would help a lot if the US audit regulator, the

PCAOB, and its target, the audit firms, could agree on terminology. Actually, I don't think its necessary for the regulator to get the regulated entities' permission or agreement before monitoring and scrutinizing in whatever way it thinks is in the public's best interest. One of my biggest pet peeves with how the SEC and PCAOB regulate the audit firms is that they ask the firms'—and their clients the companies who are also the regulated entity for the SEC—opinion on standards, regulations and inspection methodology. The mission of these two regulators is to protect investors and the capital markets, not service the industry or protect its business model.

In a recent speech, PCAOB Board member Jay Hanson said he was "troubled" by the PCAOB's use of the term "audit failure" in its inspection reports. He thinks the term confuses users of the auditor's opinion. Hanson said:

"…calling every such deficiency an "audit failure" appears to have caused confusion among investors, audit committees and others, some of whom have interpreted our findings as meaning that the financial statements are misstated or that there is a problem in the company's accounting or internal controls. In fact, however, only very few of our inspection findings ultimately can be linked to a problem in the company's financial statements, and restatements arising out of our inspection process are rare, although they do occur."

I ask you: Should audit and auditor failure be solely defined by identified material misstatements that result in restatements, and catastrophic internal control failures?

We know that formal restatements are way down, after hitting highs right after the passage of the Sarbanes-Oxley Act in 2002. Research firm Audit Analytics keeps telling us so. But are restatements down because there is less corporate accounting and disclosure fraud? Many think so but I definitely don't. The SEC agrees with me and reinstated its Accounting Fraud and Disclosure Task Force last year. That's the team dismantled by former SEC Enforcement Director Robert Khuzami who used the deceptively low formal restatement numbers as his excuse.

The SEC has also established another initiative, Operation Broken Gate, targeting auditors, lawyers and directors who enable corporate accounting and disclosure fraud. In addition, in fiscal 2013 accounting and disclosure fraud was the largest percentage of the SEC's Dodd-Frank whistleblower tips, the second year in a row. So, maybe the SEC and PCAOB need to question the increase in characterization of misstatements as non-material and fixes made only on a go-forward basis.

Why do I think restatements are declining?

- Auditors make the final call on the necessity of a restatement under pressure from executives and their lawyers. It’s in all parties’ best interest to minimize restatements.
- Making fewer restatements reduces the likelihood auditors will be named as a defendant in a shareholder lawsuit.
- Compromising on the requirement for a restatement by downgrading the materiality of errors or misstatements reduces the likelihood auditors will irk executives by setting them up for SOx or Dodd-Frank clawbacks claims. A restatement is required to force reimbursement under both laws.
- Fewer restatements means auditors can argue with PCAOB that a significant inspection deficiency didn’t result in “restatement” and therefore can be left out of its public inspection report. Likelihood of additional follow-up by the SEC resulting in sanctions or fines is also minimized.

How many actual recent material misstatements and civil charges and criminal indictments for fraud and other illegal activities have been viewed as “auditor failure”? How often does the auditor keep its job in spite of what Jay Hanson and the industry claim are true “audit failures”, material misstatements resulting in restatements?

Let me give you a few examples where the auditor is still on the job in spite of what Hanson and the industry define as audit and auditor failure.

JPM: JPM gets credit for booking the largest financial restatement of 2012, $21 billion in fines for illegal activities in 2013 alone including the “whale” fraud and $13 billion in criminal penalties by the Justice Department for mortgage related fraud and PwC is still the auditor, on the job since 1965.

AIG: Multiple material restatements over the last ten years, lawsuits against executives and PwC as auditor for frauds and a takeover by the federal government during the most recent financial crisis. PwC is still the auditor, on the job since 1980.

Dell: In 2007 Dell said it would restate its financials for fiscal 2003 through fiscal 2006, and for the first quarter of fiscal 2007. The restatements were the result of a yearlong investigation by Dell’s audit committee, which found evidence of manipulation that was made to hit financial targets. The SEC charged Dell chairman and CEO Michael Dell, former CEO Kevin Rollins, and former CFO James Schneider for their roles in the disclosure violations but no Section 304 clawbacks were required. PwC was a defendant in shareholder lawsuits because of the restatements but the claims were dismissed. PwC has been Dell's auditor since 1986.

GE: GE has made multiple restatements for accounting fraud and manipulation, been sued by shareholders and had an adverse opinion on its internal controls. GE's restatement for 2007 was the largest one that year. Other large fines and penalties for civil and criminal activities have been imposed over the years, and now an SEC investigation for auditor independence violations over multiple years. KPMG has been GE's auditor one hundred years. *(More examples of bullet proof auditors at the end of the post.)*

When fraud and significant misstatements occur, what is the typical auditor response? Deaf, dumb, and blind.

- We didn't hear anything because we weren't there. Financial statements are responsibility of management.

- We were either incompetent or unintentionally complicit even though we are professionals charging high fees for our services. We were duped. If management gives us bad or false information we can't be held responsible.
- We're blind men who can't see. When executives collude even the best audit won't uncover the fraud.

There's also the cost benefit argument:

- We can't afford to do more. More extensive testing to go beyond the "reasonable assurance" standard means more time and more money. Companies and investors won't pay for it.

And finally the negative proof fallacy:

- We're not perfect but look at all the things we catch and deter that you'll never know about.

You should never count on restatements to signal an audit failure because auditors control the form and frequency of restatements and they, with their clients the executives of public companies and their boards, have enormous self-interested reasons to make those numbers look low.

So, I like the PCAOB definition of audit failure.

Finally, I would remind you that the basis premise we are now operating under for regulation and enforcement against the largest audit firms is “too few to fail”.

You might think the implosion of Arthur Andersen in 2001 would have scared the daylights out of firms’ leadership and the regulators who are supposed to monitor them. Instead, they are more arrogant more indestructible, more impermeable, and more immune from serious scrutiny than ever before.

It took the KPMG tax shelter scandal in 2005 to bring regulators to the uncomfortable realization there is no contingency plan. The audit firms can continue to push the envelope on legality, ethics and self-interest with impunity even with a new regulator, the PCAOB, in town.

We can no longer depend on “professional” disdain for reputation risk to promote self-policing within the firms and within the accounting profession. Just look at the Scott London KPMG partner inside trading debacle. If there was ever an argument for why corporate ethics training does not work it is London. 30+ years as an employee of KPMG. Started at the firm right out of college. CPA who rose to become the regional audit practice leader of KPMG in Southern California responsible for many important clients, hundreds of partners and thousands of staff. And yet, the guy was passing client confidential information to a golf buddy for years, finally caught in a sting in a Starbucks parking lot accepting an envelope full of cash.

The necessity in 2005 for regulators to make a decision that could cause another audit firm's demise came much too soon after the messy dissolution of Arthur Andersen in 2001. I've written previously that when Attorney General Alberto Gonzales decided not to criminally prosecute KPMG he effectively established the "too few to fail" doctrine for the major public accounting firms that is in effect today.

The Big Four are not "too big to fail". Being as big as they are is a necessity, they say, to performing audits of global multinationals, of which they have the overwhelming share, in the way they are required by law to be produced now. It's a labor-intensive process that takes a global village, member firms all over the world tied to together in a loose marketing confederacy that hang together as long as one of them doesn't screw up. When problems occur they are suddenly separate legal entities not responsible for the other's actions.

The Big Four are "too few to fail" because there doesn't seem to be any discussion of, or contingency plans for, the risk that regulatory actions such as the threat of de-licensing in a major hub country. It almost happened to PwC three times recently, in Japan, Russia and India, for example. A threat to the viability of a firm will cause disruption in the audit services supply chain for multinationals. That's what everyone shoud be worried about if they cant get the Chinese arms of the Big Four to tow the quality line. Knocking out the supply of audit services from a major country is certainly one tool the PCAOB and SEC could use to limit the impact of bad auditing in China – although the prospect of de-registering all China-based auditors because of the regulator's inability to inspect them and the SEC's inability to get them to cooperate in a fraud investigation now seems more remote than ever.

Ever since the US DOJ effectively enacted its "too few to fail" doctrine, barring criminal prosecutions of audit firms after the Andersen debacle and its close call with killing KPMG during the 2005 tax shelter case – the US thinks it can control the risk of one firm losing the confidence of the market and being unable to serve its clients as a result of a failure or legal action in a US jurisdiction.

I'm not so sure they can control forever what goes on outside the US, in particular. What might happen to global audit services supply if one or more of the legal cases an of the Big Four firms are involved with all over the world, including in the US, disables another firm – financially or as a result of regulatory sanction?

I shudder to think…

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