



The Rise of Advisory Services in Audit Firms

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Thank you, Holly, for that introduction.

I appreciate this opportunity to initiate a dialogue about the rise of advisory and consulting services at today's largest audit firms and some of the risks such activity may pose to audit quality and investor protection in the future.

I believe this issue should be of concern to the corporate governance community, boards, particularly audit committees, and their counsels given that high caliber audits and auditor independence are so fundamental to the integrity of our capital markets and are a primary focus at the PCAOB.

As you know, the Board has limited authority in the area of corporate governance so I will confine my remarks to those where the Board has jurisdiction, which relate most directly to audit quality, investor protection and auditor independence.

At the outset, I must make the standard disclaimer that the views I express today are my own and do not necessarily reflect those of the PCAOB or other Board members or staff.

Background

As you mentioned, I chair the Investor Advisory Group of the Public Company Accounting Oversight Board and also the Investor and Other Stakeholders Working Group of the International Forum of Independent Audit Regulators ("IFIAR").

My interest in chairing these groups and hearing directly from investors stems from my work as the Staff Director and Chief Counsel of the Senate Banking Committee under Chairman Paul Sarbanes during consideration and passage of the Sarbanes-Oxley Act of 2002.

People tend to forget the trillions of dollars of investor losses that resulted from the failures of Enron, WorldCom, Tyco, Adelphia Communications and a host of other major companies at the time. All the major accounting firms were implicated in the slew of accounting irregularities and restatements during this period.

People also tend to forget that the stock market dropped over 22 percent, or over 2,000 points, in the 3 months preceding passage of the Act.

Overwhelming majorities in both the House and the Senate passed the Sarbanes-Oxley Act as a direct result of investor losses. The linchpin of the legislation, as you all know, established the PCAOB to end the era of self-regulation of the auditing profession.

My experiences before, during, and after the financial reporting crisis of 2002, and my subsequent work with the PCAOB have led me to draw the following three conclusions:

- First, independent audits are essential to our capital markets. It is hard to overstate the importance of the independent audit to a free, open and efficient capital market.
- Second, notwithstanding the fact that the company pays for the audit, the primary client of the independent auditor is the investor—both large institutional and small investors who indirectly invest through their retirement and other savings.
- Third, among the most important elements of competent auditing are independence, objectivity and professional skepticism. No matter how talented auditors are, if the capital markets do not believe in their work, the market could lose confidence in the information provided by the auditors.

Given that the first words of the law are "[a]n Act to protect investors..." and the mission statement directs the PCAOB "to protect the interest of investors," [\[1\]](#) it should come as no surprise that my main focus since coming to the Board has been not only on improving audit quality but also on protecting investor interests in improving corporate disclosures through informative, accurate and independent audit reports.

So, perhaps not surprisingly, today I would like to discuss a trend in the accounting industry — the rise of the advisory and consulting services within accounting firms — a concern that has been raised by both the PCAOB Investor Advisory Group and IFIAR's Investor and Other Stakeholders Working Group. And for the most part, I will reflect on their concerns.

To be direct, most members of both groups have suggested that auditor independence and audit quality could be threatened by the growth of the advisory and consulting services at the largest audit firms. And investors are concerned that the firms may not maintain their "public watchdog" "total independence" and "complete fidelity to the public trust" responsibilities — all of which were articulated by Supreme Court Chief Justice Warren Burger in *United States v. Arthur Young*. [\[2\]](#)

Historical perspective on the rise of non-audit services

Such concerns are not new and I believe that board directors, audit committees, and their various counsels should be extremely mindful of the issues I will be talking about, especially as the independent audit committees select their auditors.

Let me provide you some background regarding this issue.

Starting in the 1950s, the SEC raised concerns about the rise of non-audit services in the

largest firms.

Congress looked into this issue in the 1970s, and while it seriously considered limiting the non-audit services that independent public accountants could provide, no action was taken.

Congressional investigation continued in the 1980s, with then Chairman of the House Commerce Committee, John Dingell, conducting numerous oversight hearings directed principally to audit quality and independence.

In the late 1990s, in response to an increasingly complex web of business and financial relationships between auditors and their audit clients and the dramatic increase in the revenues from non-audit services to clients, the SEC took action by imposing certain requirements for auditor independence. [\[3\]](#)

The link between the rise of non-audit services in the 1980s and 1990s to the financial reporting crises preceding the adoption of the Sarbanes-Oxley Act in 2002 is somewhat unclear. But, the rise of advisory services is generally considered to have fundamentally changed the culture and tone at the top at the firms and had firm leaders focusing more on offering broader services to audit clients.

Many investors voiced concerns that the auditor's interest in establishing or preserving a non-audit services relationship with their clients surpassed their interest in the audit relationship. Further, many asserted that certain types of non-audit services, when provided to an audit client, create inherent conflicts that are incompatible with auditor objectivity.

Addressing these concerns, Section 201 of the Sarbanes-Oxley Act enumerates a number of prohibited non-audit services by auditors to audit clients and charged Board's independent audit committees with carefully monitoring these activities. [\[4\]](#) We will be discussing the growing role and responsibilities of the audit committee at this afternoon's panel.

A Revival of Non-Audit Services within Major Public Accounting Practices

Following the passage of the Sarbanes-Oxley Act, three of the four major firms divested their advisory and consulting practices. Since then, however, each of these firms has rebuilt these practices.

The marketplace for such services has also changed in the intervening years. Most of these services are now provided to non-audit clients.

A few examples of the many advisory and consulting services some of the largest firms now provide their non-audit clients include, but are certainly not limited to, enterprise strategy, marketing and sales, corporate finance, mergers and acquisitions, government consulting, legal services, immigration, and a wide variety of risk management services, including financial, insurance, and IT risk management, cybersecurity, human resources transformations ... and the list goes on. In fact, a Big Four firm's foreign affiliate announced in March its ambitions to become a global top-20 legal services player within the next five years. [\[5\]](#)

Today, the advisory practices for the firms are growing much faster than the other service lines.

Regarding the scale of the issue: non-audit services at the four major global audit firms accounted for \$51 billion in revenue in 2009 and \$65 billion in 2013 — a rise of \$14 billion, or 27%, in four years. Contrast that with audit revenues, which only grew by \$3 billion in those same four years. In 2013, revenues from non-audit services represented 57% of the global revenues at those firms.

Domestically, advisory services alone represent 39% of total revenues across the major U.S. firms, now larger than audit's 36% share. Since 2011, advisory services' prominence has risen while audit's has declined. To provide some perspective, audit revenues represented 70% of the firms' total revenues in 1977, 34% in 1998, and about 30% in 2000.

Such disparities will become more prominent if this trend continues. Revenues for non-audit services have grown at an average rate of about 10% in recent years, while revenues for assurance services have grown at a modest 4%. Further, based on proxy statement fee disclosures, public company audit fees have been stagnant, so the growth in assurance revenue is coming from risk services or from audits in the non-public sectors.

These developments raise some fundamental concerns for investors; namely, investors wonder if we are returning to the era in which firms will focus more of their energies on building their consulting practices and revenues to the detriment of audit quality and auditor independence.

A high priority for investors is that the PCAOB continues to hold auditors accountable for audit quality, including maintaining the appropriate focus on independence, objectivity and professional skepticism. Audit committees should do likewise.

I believe, as do other audit regulators around the world, that this trend in the profession must be evaluated with considerable care. I know, for example, that it will be a major focus of the International Forum of Independent Audit Regulators this April, at their meeting in Taipei.

Possible threats from the rise of non-audit services in audit firms

Investors perceive a number of threats that a fast growing advisory and consulting practice could pose to audit quality and auditor independence. I will touch on four.

Potential distraction by the firm away from audit and its core values

Today, the Big Four firms dominate the world market for audits of large public companies. [\[6\]](#) In contrast, their share of the global advisory business remains small.

The firms are actively taking steps to expand their presence in that market through acquisitions of consulting companies or investments in technology. From 2011 to 2013, for

example, the Big Four global firms acquired 66 consulting entities.

Investors are concerned that this focus on growing the advisory practice may distract firm leaders from the needs of the slower-growing audit practice. This, investors fear, could result in lower investments in the audit practice in such areas as hiring of skilled personnel, training, technology, innovation and compensation.

Firm leaders assert that a strong consulting practice is actually a benefit for audit because it fosters expertise in specialty areas essential for quality auditing. They note that the need for specialists on audits has risen due to the increasing complexity of their clients' businesses. Having such expertise in house deepens competencies needed to compete for and perform audits. These may well be valid points.

Investors, though, are concerned that as the advisory practice grows, firm consultants who must regenerate work to survive will become less motivated to serve audit clients with limited follow-on work opportunities.

Further, investor representatives question what will happen to investor protection and audit quality if the audit practice continues to decrease in the revenue mix of firms. As contribution of audit to total revenues diminishes, audit partners may lose influence within the firm. If that were to occur, it is possible that the values that should be at the core of the audit practice — its "public watchdog role," "total independence," and "complete fidelity to the public trust"— may also recede in importance.

As advisory gains greater influence in the firms, how will the audit practice be viewed? Will it be viewed as a mature government endowed franchise whose brand name serves primarily as a means to develop other business opportunities? Or, over time, will it be viewed as a traditional brand that drags on a firm seeking to redefine itself in a rapidly changing global environment?

Potential use of inappropriate performance measurements

If advisory and consulting services continue to grow, the risk rises that bottom line profitability and revenue growth become the primary measures by which partners are evaluated.

During the early years of our inspections, PCAOB inspectors observed instances where audit quality was not appropriately emphasized, or even appeared to be a significant factor, as compared to marketing or other activities of the firm in the partner evaluation and compensation determination processes. Further, PCAOB inspectors observed situations where partners' quality ratings were affected significantly by the profitability of their audits or their ability to increase revenues. [\[7\]](#) The firms took action in response to these concerns.

Nonetheless, investor representatives worry that performance measures for audit partners could once again emphasize the promotion of new business and profits over audit quality. This in turn could increase the risk that audit partners take short-term actions contrary to the investors' interests for high quality audits. Investors do not believe profits should be the dominant performance measurement in the audit profession.

Potential independence impairment

A third concern is that there may be greater risk of independence violations. This stems from two possibilities — insufficient monitoring of various services provided to audit clients and permissible tax consulting work that may cross the line.

Monitoring Independence

As firms expand their non-audit services globally, investors are concerned that auditors may perform prohibited services for audit clients, many with operations around the world. Investors want firms to remain vigilant that an affiliate does not provide prohibited services to an audit client or its subsidiary.

Investors' concerns stem from continued independence violations. For example, in 2014 the SEC concluded enforcement actions against several large accounting firms and individual audit partners relating to auditor independence matters. [\[8\]](#) And I would think that these enforcement matters would be of considerable concern to board directors, audit committees and their counsel alike.

Certain tax structuring services

Investors also are particularly concerned about certain kinds of tax-structuring services that firms provide to their audit clients. These services, investors fear, may put the audit firm in a position to act as management, audit its own work, or perform as an advocate for the client — factors considered by the Commission when evaluating whether an auditor-client relationship meets its independence requirement. [\[9\]](#)

Non-audit tax services in general are not prohibited under the Sarbanes-Oxley Act because lawmakers believed that such traditional tax services were appropriate and, unlike advisory services, had not appeared to be the source of serious problems.

While many tax services do not impair independence, advising audit clients on certain kinds of tax structuring transactions and implementing certain tax structures could. Depending on the nature of the tax advisory service, auditor independence could be undermined in the following scenarios.

- First, the auditor could effectively audit their own firm's work when he or she is auditing the company's tax accounts, which entails examining the effectiveness and accounting of the tax structures their firm designed and implemented.
- Second, the firm may be perceived as part of the management team when the tax structures are complex or the implementation extensive.
- Third, the firm may be advocating for its client when tax authorities challenge the tax structures the firm advised on.

A number of these concerns were raised in a report issued on April 1, 2014 by the Senate Permanent Subcommittee on Investigations relating to Caterpillar's Offshore Tax Strategy.

Audit committees and their counsels should be mindful of these matters when engaging their auditors for tax consulting services.

Potential rise of internal conflicts

A fourth threat arises from the potential emergence of internal conflicts between practice groups.

Investors are concerned that an expanding consulting practice could give rise to intra-firm friction and, in extreme cases, possible instability within that firm. This might result from (1) increasing conflicts between audit and advisory services and (2) non-audit service lines no longer needing the audit practice for brand recognition and business development.

With respect to the first point, many differences exist between the two practice lines that could engender conflict. They serve different clients — the audit serves investors and the other management; they face different levels of regulation and hence have different mind-sets; they face different levels of competition; and one's revenue is cyclical whereas the other is more stable.

As the advisory service matures and develops scale and scope, these differences may become amplified. And, while it may be true that the advisory practice views the audit practice and its brand name as a welcome incubator and partner, as it grows, that view may change. The advisory practice may instead seek to establish and accentuate its own distinct brand — a precursor to a possible separation from the firm. Haven't we seen this movie before?

With respect to the second point, due to independence rules, audit clients are off-limits to the advisory practice. Effectively that means a large part of the market, roughly 24% of the market on average, is out of bounds for any given firm's advisory practice. Hence, as the advisory practice grows, this prohibition may grow from a nuisance to a business obstacle.

Common Threats

In sum, some investors are concerned that history may repeat itself. As written in an editorial in the Chicago Tribune on March 14, 2012 with respect to the demise of Arthur Andersen:

"Over time, greed corrupted Andersen. Its leaders became more devoted to collecting hefty fees than keeping books straight. Clients paid a fortune for Andersen's consulting services, making its basic function of auditing into little more than an afterthought. The firm's most experienced accounting technicians, the sticklers who maintained its principles, saw their status plunge in the partnership's hierarchy.... Money trumped honest services."

Audit Firm management responsibilities

The threats resulting from an expanding advisory and consulting practice vary in urgency. Some exist today. Examples include risks to independence from certain tax structuring services, the risk of providing prohibited services, inappropriate performance measures for the audit practice, and distraction from audit. Other threats, such as potential turmoil and instability of the firm may be longer-term.

Firm leaders should consider taking steps to address these threats. Such steps might include, but certainly should not be limited to, ensuring the right tone at the top of their organizations; making sure that investor protection and audit quality are emphasized; ensuring that appropriate performance measures, which emphasize audit quality, are in place for the audit practice; and continuing to invest in their audit practice, including hiring skilled staff, training, processes, and technology.

Many view the largest public accounting firms as systemically important to the proper functioning of the capital markets. As such, I believe firm leaders should also consider publishing audited financial statements — as is done in other jurisdictions around the world — to ensure the necessary sunlight shines on their myriad activities. This would allow the free market the opportunity to analyze any potential catastrophic risks to their ongoing viability.

It is the PCAOB's role to monitor the firms' systems of quality control, including how firm leadership is managing all threats to audit quality. And, if the firms fail to manage these threats, take action to the full extent of our authority and influence.

Conclusion

In conclusion, auditors have been given an invaluable government endowed franchise under the federal securities laws. But this franchise is only as valuable as the public confidence investors have in it.

As firms grow their advisory practices and become ever larger multidisciplinary service organizations, firm leaders must never forget the "public watchdog," "total independence from the client," and "complete fidelity to the public trust" responsibilities of their audit practice.

As noted by John L. Carey, a former executive director of the American Institute of Certified Public Accountants, "[i]n the last analysis, therefore, it is his independence which is the certified public accountant's economic excuse for existence." [\[10\]](#) I would include as well audit quality and investor protection.

In my role as Chair of the PCAOB and IFIAR Investor Advisory Groups, I know that the issues raised by this trend in the profession are of concern to regulators and investors worldwide. I believe that all board members, independent audit committee members, and their various counsels should be equally concerned.

Thank you.

[\[1\]](#) Section 101(a) of the Sarbanes-Oxley Act.

[\[2\]](#) *United States v. Arthur Young*, 465 U.S. 805, 818 (1984).

[\[3\]](#) Securities Act Release No. 7919, Revision of the Commission's Auditor Independence Requirements (Nov. 21, 2000).

[\[4\]](#) Section 201 of the Sarbanes-Oxley Act prohibits the following services: (1) bookkeeping or other services related to the accounting records or financial statements of

the audit client; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; (8) legal services and expert services unrelated to the audit; and (9) any other service that the Board determines, by regulation, is impermissible.

[5] *The Lawyer*. PwC Legal chief: we can be a top 20 global legal services business in five years, By Yun Kriegler (March 18, 2014)

[6] For example, the Big Four firms in the U.S. alone audited approximately 98 percent of the U.S. market by capitalization in 2013.

[7] See PCAOB Release 2008-008, Report on the PCAOB's 2004, 2005, 2006, and 2007 Inspections of Domestic Annually Inspected Firms (Dec. 5, 2008).

[8] See, for example, Exchange Act Release No. 71389, *In the Matter of KPMG LLP* (Jan. 24, 2014) and Exchange Act Release No. 72602, *In the Matter of Ernst & Young LLP* (July 14, 2014).

[9] See Preliminary Note 2 to Rule 2-01 of Regulation S-X. Pursuant to its rules, the SEC will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issued encompassed with in the engagement. See Rule 2-01(b) of Regulation S-X.

[10] Professional Ethics of Public Accounting, by John L. Carey (1946).

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