Current Trends in the Audit Industry

Overview:

This paper provides background information for the panel session on the current trends in the audit industry being jointly organized by IFIAR's Investor and Other Stakeholders Working Group and Global Public Policy Committee Working Group. This session will be held in April 2015 in Taipei, during the IFIAR plenary meeting, which will further the dialog among audit regulators and audit firms on issues impacting audit quality and investor protection.

Audit firms provide an essential service to the capital markets. By promoting integrity in financial reporting and building a basis for confidence, auditors reduce financing costs, and contribute to an efficient allocation of capital to fuel economic growth.[1]

Changes in the economic environment and the market for audit services have impacted how the audit industry operates and how it is perceived by users and the general public. Important issues facing the audit industry include:

- Commoditization of the audit;
- The perceived value and relevance of the traditional audit including the auditor's responsibility to detect fraud;
- The impact of an increased focus by the larger audit firms to grow their non-audit services with a specific focus on advisory / consulting services; and
- The impact of advances in technology and greater availability of and access to data.

The paper first discusses the current state of and trends observed in the audit industry in six areas:

- Firm revenue and growth;
- Competition in the audit market;
- Governance within the global network structure;
- Partnership model and the threat of litigation;
- Quality and extent of resources in the labor market; and
- Impact of emerging technologies on the audit.

In each area, the paper poses questions for discussion.

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[1] A number of studies have documented that audits help companies to raise funds in capital markets. See for example, Minnis. 2011. *The Value of Financial Statement Verification in Debt Financing: Evidence from Private U.S. Firms*. Journal of Accounting Research, 49 (2) (analyzes a sample of privately-held firms and finds that audited firms enjoy an interest rate that is, on average, 69 basis points lower than the rate received by non-audited firms).

The paper considers the audit industry, with a particular focus in some areas on the global Big Four network firms given their dominance in many jurisdictions.[2]

It is hoped that this paper and the panel sessions at the plenary meeting will assist audit regulators in better understanding the potential implications of these matters for audit quality and investor protection.

In summary, the paper raises key questions including:

- What is the impact on audit quality of (1) the expansion and growth of advisory services being offered by the audit firms and (2) low growth in the traditional audit function?
- Do audit firms need to improve the transparency of their governance, structures and operations to improve market knowledge?
- Are the right people being attracted to and retained in the audit profession? What, if anything, should be done differently to ensure the audit profession has the right people to perform high quality audits?
- How will changes in how audits are staffed and where the audit work is performed impact audit quality and the development of people in the audit practice?
- Has the audit become a commodity? Might the current trends in audit fees create a challenge that audit firms may not earn a sufficient return to support the investments required to deliver high quality audits?
- How will emerging technologies change how an audit is performed (including the use of data analytics and big data)?

Factors influencing the current trends in the audit industry

Key factors reflecting and influencing the current trends in the audit industry can be broken down into the following:

A. Trends in Firm Revenue and Growth

The Big Four audit firms typically deliver three types of services: audit (or assurance), tax, and consulting (or advisory). While advisory services continue to be the primary source of revenue growth for the Big Four global networks, all three service areas experienced lower growth rates in 2013 as compared to 2012.

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[2] The Big Four audit firms are Deloitte Touche Tohmatsu Limited, EY Global, KPMG International Cooperative, and PricewaterhouseCoopers International Limited.

Big Four Global Network 3-Year Summary of Revenue *(US $Millions)*

Services	2011	2012	2013	% Change 2011 - 2012	% Change 2012 - 2013
Assurance[3]	$ 46,911	$ 49,267	$ 49,007	5%	-1%
Tax	$ 23,386	$ 24,904	$ 26,191	6%	5%
Advisory	$ 31,236	$ 35,769	$ 38,540	15%	8%
Total Revenue	$ 101,533	$ 109,940	$ 113,738	8%	3%

Sources: EY 2013 Global Review, Deloitte 2013 Transparency Report, KPMG 2013 Transparency Report, and PricewaterhouseCoopers 2013 Transparency Report.

Revenue from assurance services decreased in 2013 as compared to 2012. Assurance revenue now represents 43% of Big Four global network revenue in 2013, compared to 46% in 2011. According to some studies, firms are reporting downward pressure on audit fees due to the economic climate[4], users questioning the value of an audit ("the commoditization of audit"), and underbidding by rival firms.[5]

In managing the assurance practice, firms continue to explore ways to improve audit efficiency. This includes offshoring, establishing lower cost centres of excellence, outsourcing aspects of the audit and utilization of data technicians.[6] Big Four audit firms are also innovating in IT and systems – for example, some firms are integrating additional CAATs ("Computer Assisted Auditing Techniques") and data mining and analytic tools into the audit process with the objective of increasing the effectiveness of the audit and value of the audit to companies. At the same time, companies' operations, business models, transactions and product/service offerings have become more complex requiring auditors to exercise greater professional judgment and utilize specialized skills.

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[3] The assurance revenue amounts reflect revenue from various services including, for example, statutory audits, internal audits, risk assurances, actuarial services and advice in connection with capital markets transactions.

[4] See "Declining Audit Fees Raise Risk of Restatements", CFO.com (March 3, 2014) ("In the last few years, publicly held companies have pressured their accounting firms to lower their audit fees. ...In many cases, this has worked, helped by the recession: Audit fees peaked at $592 per $1 million of revenue for accelerated filers in 2004 and 2005, according to Audit Analytics, but have fallen since, to $472 per $1 million of revenue in 2012.")

[5] In the United States, between 2006 and 2010, 48% of issuers in the Russell 3000 reported a decrease in audit fees (sources: Russell Investments, Audit Analytics).

[6] For a review of a panel discussion with representatives of each of the Big Four audit firms concerning the status of their offshoring operations see Daugherty, Dickins, and Fennema. 2012. *Offshoring Tax and Audit Procedures: Implications for U.S.-Based Employee Education*, Issues in Accounting Education, 27(3) (observing that "given the continuing pressure that audit firms face to make engagements more efficient, it is likely firms will continue to increase the amount of work they offshore.").

In the current environment audit fees appear to be flat or even declining in some regions of the world and there appears to be limited opportunities for growth in the audit practice on a global level. At the same time, the growth in the advisory business of the firms is expected to continue to increase at a faster rate than the assurance business through both organic growth and acquisition of other professional services firms. In general, the increase in advisory revenues is being driven by the provision of consulting services to non-audit clients.[7]

Revenue from advisory services now represents 34% of Big Four global network revenue, compared to 31% in 2011. Assuming advisory services continue to be the primary source of revenue growth, global network revenue derived from advisory may soon outstrip revenue derived from assurance. At the U.S. affiliates of the Big Four audit firms – which represent the largest source of global network revenues (approximately 35%)[8] – advisory revenue already exceeds assurance revenue. In three years, assurance revenue at the Big Four's U.S. affiliates dropped from 40% of total revenue to 36% while advisory revenue increased from 34% of total revenue to 39%.

Big Four Global Network Revenue Mix

Services	2011	2012	2013
Assurance	46%	45%	43%
Tax	23%	23%	23%
Advisory	31%	33%	34%
Total Revenue	100%	100%	100%

Big Four U.S. Affiliates Revenue Mix

Services	2011	2012	2013
Assurance	40%	37%	36%
Tax	26%	26%	25%
Advisory	34%	37%	39%
Total Revenue	100%	100%	100%

Sources: EY 2013 Global Review, Deloitte 2013 Transparency Report, KPMG 2013 Transparency Report, and PricewaterhouseCoopers 2013 Transparency Report.

As advisory becomes the largest service line the Big Four Firms will need to ensure there is an appropriate focus on audit quality, particularly as Big Four leadership believes that the reputation and brand of the firm's audit practice plays a significant role in the ongoing success of their advisory practices.

Acquisitions of consulting businesses are playing a prominent role in driving Big Four advisory revenue growth. In recent years the Big Four audit firms have been active acquirers of consulting businesses, growing their range of services to include legal, management consulting, immigration, technology, and other discrete specializations.[9]

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[7] Audit Analytics. July 2013. *Audit Fees and Non-Audit Fees: An Eleven Year Trend* available at: http://www.auditanalytics.com/0000/custom-reports.php.

[8] Sources: *EY 2013 Global Review, Deloitte 2013 Transparency Report, KPMG 2013 Transparency Report, and PricewaterhouseCoopers 2013 Transparency Report.*

[9] A review of press releases issued by the Big Four audit firms identified a total of 66 separate acquisitions of consulting businesses by Big Four audit firms from 2011 to 2013, with 33 acquisitions in 2013, 14 acquisitions in 2012, and 19 acquisitions in 2011.

Advisory businesses differ from audit in fundamental ways, including:

- The nature and identity of the client;
- The nature of competition and the strategies to compete;
- The role and pace of service innovation;
- The backgrounds, mind-set-and skill-set and experience of people rendering the service;
- The structure of teams rendering the service;
- The revenue model (typically one-time services rather than annuity-based; contingent based fees allowed);
- The cyclical nature of the business; and
- Prospects for growth and profitability.

Differences between advisory and audit businesses create stresses and conflicts within the firms, including some conflicts that could threaten auditor independence. In some jurisdictions there are prohibitions on the provision of non-audit services to certain audit clients. However, where the provision of non-audit services is permitted, a maximum percentage may be prescribed by a regulator's code of ethics to ensure no independence conflicts.

Despite the conflicts, there are reasons why firms are actively growing advisory services:

- Permits firms to grow and offer opportunity to firm personnel;
- Expands the scale and scope of the firm's brand;
- Builds out the firm's global footprint and deepens the firm's competencies, allowing the firm to better serve global clients;
- Leverages the trusted business advisor relationship that the audit partner has developed offering opportunity to increase profit maximisation opportunities from a client relationship;
- Creates more opportunities to cross-sell a wider variety of services to clients; and
- Creates a bigger firm that is less susceptible to shocks to its business.

Expanding advisory services may improve audit quality to the extent that the firm deepens competencies needed to perform audits and harnesses those competencies when conducting audits.

The Big Four audit firms do not report gross margin or profit information for their separate lines of practice. Therefore, it is difficult to determine the profitability of a firm's lines of practice and which line of practice contributes the greatest to the firm's overall profitability.[10]

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[10] It is unclear whether the advisory practices of the Big Four audit firms are more profitable than assurance. The U.K.'s Competition Commission recently reported that, on the basis of the firm's cost allocation choices, assurance has comparable margins to other service lines.

Questions:

- How can the improved capabilities in advisory services be leveraged to improve audit quality?
- What are the threats to audit quality of a large growing advisory practice? How can firms manage those threats or conflicts of interest issues?
- What measures should be envisioned to avoid a negative influence of the growth of the advisory practices on the independence of the auditor and, as a result, on the quality of the audit?
- Are the business models of firms, with less growing audit services and more growing advisory services under the different cultures of both services, sustainable in the mid and long term? What could be possible solutions for the sustainable business strategies of firms?
- Are audit fees flat or declining? If so, is this the case in all industries and jurisdictions? If not, what are the differentiating factors?
- In a low-growth environment for financial statement auditing, what are firms' plans to grow their assurance practices?
- Are entities (and their audit committees) prepared to pay higher fees if they perceive a firm to have higher quality? What effect, if any, will recent initiatives to provide observability into the quality of an audit, such as the development of audit quality indicators and revisions to the auditor's report, have on audit fees?
- To what extent are advisory practices of the Big Four audit firms reliant upon the reputational brand of audit?
- Does a growing advisory practice divert the attention of the leaders of the Big Four audit firms away from the assurance practice?
- Is it possible that an advisory practice would decide to separate from the audit practice and "go it alone"? What impact would an advisory spin-off have on audit quality?
- What, if any, effect does client and, more recently, regulator imposed limitation on fees for non-audit to audit clients have on pressures to sell non-audit services to non-audit clients?

B. Competition in the Audit Market

Audits play a vital role in the functioning of capital markets. The demand for audit services by public companies also is inelastic in that these companies must obtain an audit due to regulation, with no substitution for such services available.[11]

The number of firms performing audits of the largest publicly traded companies has declined in the past 30 years.[12] In the late 1980s, eight firms provided audit services to large corporations.[13] Through a series of mergers and the dissolution of one firm, four firms now audit the majority of the large publicly traded companies around the world.[14] The 2013 share of the global accountancy market by the Big Four audit firms was 67%.[15] Large companies perceive they may have little choice for auditors as they often do business with other major audit firms that would represent a conflict if that firm were to also become the company's auditor.

The mergers that took place in the 1980s and 1990s were in response to a need to grow in order to keep up with the growing size and international reach of their clients.[16] The firms were also taking advantage of economies of scale, expanding industry-specific knowledge and technical expertise, and increasing the capital base in order to spread risk.[17]

The fact that there is concentration in the audit market does not necessarily mean there is no price competition. Generally, pricing for auditing services is negotiated between the

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[11] OECD Policy Roundtables on Competition and Regulation in Auditing and Related Professions, 2009 (OECD Policy Roundtables Report), available at: www.oecd.org/regreform/sectors/44762253.pdf.

[12] See *Id*.

[13] See *Id.*

[14] See *Id.*

[15] Economia publication for ICAEW: http://economia.icaew.com/news/january-2014/deloitte-replaces-pwc-as-biggest-firm

[16] See "Point of View: Benefits of Scale", PwC, locate at: http://www.pwc.com/gx/en/audit-services/publications/regulatory-debate/benefits-of-scale.jhtml.

[17] See OECD Policy Roundtables Report citing the United States Government Accountability Office (GAO) report on Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action, published on Jan. 9, 2008.

firm and its clients with no government involvement.[18] Certain jurisdictions, however, have regulations that establish minimum fee levels or limit a firm's pricing practice.[19]

Audit firms compete on a number of factors, including (in no particular order) (i) reputation, (ii) global reach, (iii) price, (iv) technical and industry expertise, (v) level of resources and (vi) relationships with senior management and board members. Because competition for audit services for large multinational companies is among a small number of firms, reputation may play a more significant role than price.[20] There is evidence, however, that a change in a company's auditor often results in lower audit fees.[21]

The barrier to market entry is low for basic audit services, but extremely high with respect to audit services for large multinational companies. A number of factors have been identified as barriers to entry for audit services for large multinational companies, including:

- Market participants' preference for a Big Four audit firm, resulting in restrictions on a company's choice to the Big Four audit firms or imposing higher cost for capital when a non-Big Four audit firm is appointed;
- Level of staff resources, technical and industry-specific expertise, and global reach necessary to audit large multinational companies;
- Increased insurance costs and litigation risk;
- Expansion in infrastructure and access to funding for such expansion; and
- High costs of switching auditors, including costs of educating new auditors.[22]

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18 See OECD Policy Roundtables Report.

19 According to the OECD Policy Roundtables Report, for example, in Greece, the pricing method of auditors' services is determined by article 18 of Presidential Decree 226/1992, which specifies that remuneration for performing an audit shall not exceed 1/10th of the audited company's or joint venture's aggregate revenue during the preceding 12 month financial year.

20 See OECD Policy Roundtables Report. See also, for example, KPMG UK Submission to the Competition Commission. Jan. 23, 2012. *Market Investigation into the provision of statutory audit services to large companies* available at: http://www.gov.uk/cma-cases/statutory-audit-services-market-investigation#responses-to-issues-statement.

21 From 2006 to 2010, 418 companies in the Russell 3000 Index changed auditors, 62% reported a decrease in audit fees. The 418 companies that changed auditors reported a median reduction in audit fees of 11.5% for the first year of the new engagement. Source: Russell Investments and Audit Analytics.

22 See OECD Policy Roundtables, citing the GAO report on Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation, published November 21, 2003.

Prior to 2014, large companies tended not to change auditors frequently.[23] Various jurisdictions have recently implemented certain measures to increase the competition in the supply of audit services to large companies. Among other things, the reforms are intended to benefit mid-tier audit firms through measures directed at developing a more dynamic and ultimately less concentrated market for audit services.[24] Certain measures include requiring or encouraging expanded joint audits,[25] imposing mandatory tendering requirements, and mandatory rotation, which some regulators hope will strengthen auditor independence.[26] As a result of changes in the UK, there has been an increased practice of audit tendering and changes in auditors among large listed companies; however, the changes appear to have had a limited impact on competition as most of the larger companies have continued to engage a Big Four audit firm as the auditor.

Innovation in the audit Industry has been low, relative to the pace of change in other industries. Factors that could dampen the pace of innovation may include:

- Buyers of audit services may be unable to perceive possible improvements in audit quality as much of the service is opaque to them. As such, auditors may perceive limited financial return for investments in innovation. Auditors may be more incented to innovate in ways that improve audit efficiency rather than audit quality; and

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[23] For example, in the United States, from 2006-2010 only 35 companies in the annual Fortune 500 lists changed auditors.

[24] European Commission. Apr. 3, 2014. *Reform of the EU Statutory Audit Market - Frequently Asked Questions* available at: http://europa.eu/rapid/press-release_MEMO-14-256_en.htm.

[25] For example, in France, entities issuing consolidated financial statements must appoint at least two auditors/or audit firms. The audit work is performed jointly by two (or more) audit firms, following a professional standard which prescribes the rules for sharing of the work and performing the cross reviews that are required to enable each auditor to form his own opinion on the financial statements. Audit reports are signed by all the joint auditors.

[26] For example, in Europe, in April 2014, the European Parliament approved a legislative package on audit reform intended, among other things, to strengthen the independence of auditors. For "public-interest entities" the European reforms require mandatory rotation of audit firms, prohibit the provision of certain non-audit services to audit clients, introduce a cap on the value of non-audit services that an audit firm may provide to its audit clients, and strengthen the role of the audit committee (including with respect to the appointment of the audit firm). Some European countries moved forward with reforms in advance of the finalization of the European legislative package. In the Netherlands, audit legislation was passed in December 2012 that aims to increase the independence of auditors of public interest entities by: (1) prohibiting audit firms from performing services other than audit services for their audit clients and (2) introducing audit firm rotation for PIE audits every eight years. In the United Kingdom, changes were made in September 2012 to the U.K. Corporate Governance Code – which applies on a comply-or-explain basis – to, among other things, state that FTSE 350 companies should put the external audit contract out to tender at least every ten years.

- Audit services are required and regulated, thereby commoditizing the product and reducing opportunities for differentiation.

<u>Questions:</u>

- Will recent initiatives to provide observability into the quality of an audit, such as the development of audit quality indicators and revisions to the auditor's report, change the way audit firms compete? Will they incent audit quality and innovation?
- Do measures requiring or encouraging joint audit have a beneficial influence on competition between audit firms around audit quality?
- Are there ways that the firms can increase the relevance of the audit (the focus to date appears to be on the reliability of the audit)?
- Is there a way to increase company choice in auditors without undermining auditor independence?
- Is there an increased risk that a major audit firm may withdraw from the audit market due to the regulatory environment and the growth of their advisory line of business?
- What are the consequences should a major firm fail?
- In case of potential failure of a major audit firm, what would be a possible recovery and resolution plan and what kind of consideration would be necessary in light of its large and global presence (*too big to fail*)?

C. Governance within a Global Network Structure

The Big Four audit firms are organized as international networks generally structured as associations of individual firms operating in different countries. Member firms share a common name, brand, and, for the most part, quality control structures and common audit methodologies but member firms are separate legal entities.

Big Four member firms are brought together under an umbrella entity (hereinafter referred to as "global network firm"). The relationship between the member firms and the global network firm is determined by a legal agreement between the two. A member firm, however, is not a legal partner of the global network firm or vice versa. A member firm cannot act as agent of the global network firm or any other member firm, cannot obligate the global network firm or any other member firm, and is liable only for its own acts or omissions and not those of the global network firm or any other member firm. Similarly, the global network firm cannot act as an agent of any member firm, cannot obligate any member firm, and is liable only for its own acts or omissions.

Pursuant to these agreements, member firms generally agree to be bound by the policies set by the global network firm. Some global network firms have different types of member firms structures. For example, some firms, particularly in developing markets, may be “affiliate firms” within a global network firm. Such firms carry out audit work on behalf of the network member firms, but may not necessarily be subject to the full policies of the network.

Unlike its member firms, a global network firm does not provide any services to clients. Rather, a global network firm’s purpose is to act as a coordinating entity for member firms in the network and develop and implement policies and initiatives among individual member firms. Currently, the global network firms are not subject to regulation themselves. Rather, member firms are regulated only by their country regulator.

Each of the Big Four global network firms is managed by a global board or council that has overall responsibility for the governance and oversight of the network member firms. The composition of these governance bodies are varied but generally include senior leaders from different service lines and geographic regions. Two of the current global CEOs/Chairs of the Big Four audit firms are from the audit practice; the two others are from the tax practice.

There is no pooling of profits at an international level. The amount paid to the global network firm by each member firm to fund the network’s running costs is based on the level of revenue that a member firm generates. As previously noted, U.S. member firms are the largest firms, generating approximately 35% of the revenues of the global network firms.

There were discussions in the early 2000’s about the Big Four audit firms eventually evolving into global partnerships.[27] Firms recognize the issues of serving global companies in global capital markets with a model of many affiliated network firms. As such, where useful for business purposes, firms have been creating regional trans-national structures or granting greater authority and resources to global coordination.

Questions:

- How effective are the firms’ current governance practices? To what extent should policy makers consider developing and/or enhancing guidelines with respect to audit firm governance at the global or individual firm level?
- How are the members of a global board and a local board in the individual firm selected? What sort of succession plan is advisable for the top management at the global and the individual firm level?
- What are the incentives and disadvantages for maintaining the current global network structure?

[27] AccountingWeb:, December 16, 2005: http://www.accountingweb.com/topic/education-careers/deloitte-head-predicts-single-global-partnership-structure-big-4

are likely next steps in that evolution?

- What are the implications for audit quality and innovation in audit due to the organization, size, and structure of Big Four audit firms?

D. Partnership Model and the Threat of Private Litigation

Many jurisdictions have regulations concerning the form of business for accountants or the ownership of audit firms. For historic, licensing and other reasons, the Big Four member firms are structured as private partnerships rather than as corporations in most jurisdictions.[28]

Under a partnership model, each partner has "skin-in-the game," which may increase incentives for partners to effectively monitor the activities of each other. The partnership structure limits an accounting firm's ability to raise capital.[29] Also, local laws may restrict ownership of economic interests in the firms to individuals who are licensed accountants.[30] Within the partnership model, audit personnel may serve different roles and responsibilities, such as (non-) executive board member and/or owner.

The partnership model provides audit firms flexibility in structuring their governance. Often, internal governance comes from various committees drawn from within the firm, whose members are elected or chosen by the partners or the chief executive officer of the firm.[31] In some jurisdictions, governance guidelines require large audit firms to involve independent non-executives in governance matters.[32] The intent of this practice is to increase transparency into the member firm and allow for greater objectivity in decision-

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[28] See PCAOB Investor Advisory Group Report from the Working Group on: The Global Networks and Audit Firm Governance, March 16, 2011 (PCAOB IAG Working Group Report), available at http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx, citing Former U.S. Securities and Exchange Commission Chairman Richard Breeden's testimony before the Senate Banking Committee (Feb. 12, 2002). However, in a number of jurisdictions, accounting firms are organized in a form other than a partnership.

[29] See OECD Policy Roundtables.

[30] Id.

[31] See PCAOB IAG Working Group Report.

[32] For example, firms subject to the Audit firm Governance Code in the United Kingdom are required to appoint independent non-executives to the governance body that oversees public interest matters. See Section C.1 of the Audit Firm Governance Code. The Code applies to seven audit firms that together audit about 95% of the companies listed on the Main Market of the London Stock Exchange. The Code is available at: https://www.frc.org.uk/Our-Work/Codes-Standards/Audit-and-assurance/Audit-Firm-Governance-Code.aspx.

making. One Big Four firm currently has independent non-executives at the global level on their advisory council.

Private partnerships are not generally required to produce audited financial statements, with the result that there is no public disclosure related to each firm's performance and economic structure. Certain jurisdictions require the Big Four audit firms to produce an annual transparency report, which contains non-audited financial information as well as other information regarding firm governance and operations. A limited number of jurisdictions require those audit firms serving large listed companies to produce audited financial statements and information concerning their governance and operations.[33] In cases where audit firms are set up in corporate structures, this may also include a requirement to publish financial information under company law. Despite these efforts, in most jurisdictions financial information about firms is not available.

Partner compensation at Big Four audit firms is generally a function of several factors that may vary by firm. Factors may include, among other things, the economics of an individual partner's book of business, the type of work handled (e.g. complexity, exposure), the performance of special roles (e.g., National Office-type functions), audit quality findings, "client satisfaction" scores and the overall results of their function and practice[34]. Based on the factors considered by a firm, losing a client may have negative personal implications for the engagement partner's compensation.

The Big Four audit firms, similar to other professional services firms are generally managing equity more actively in the current economic climate.[35] Similar to recent trends in other professional service firms, the Big Four audit firms appear to be setting tougher standards for partner promotion and moving more partners from equity to salaried status in the audit practices. There appears to be a trend by the Big Four audit firms to promote individuals to income partner status prior to naming the individual to equity partner. This may suggest that there will be more income partners than equity partners in the future.

Litigation against Big Four audit firms may relate to any of the services they provide, including the provision of audit services. It has been reported that class actions against the world's largest corporate auditing firms are spreading globally as governments bolster

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[33] For example, firms subject to the Audit firm Governance Code in the United Kingdom are required to publish audited financial statements pursuant to Section E.2 of the Code.

[34] Some member firms pool profits across all services of the practice; other countries limit partner profits only to their own function's results.

[35] For example, the U.K. Competition Commission recently reported that one Big Four audit firm admitted to restricting the growth of its partnership to prevent profit sharing shares shrinking. See, Competition Commission Statutory Audit Services Market Investigation working paper at 35. Sep. 12, 2012. *Firms' stated competitive strategies*, available at: http://www.gov.uk/cma-cases/statutory-audit-services-market-investigation#working-papers-a--- m.

investor protection laws in countries where the Big Four audit firms have previously not faced substantial legal risks.[36]

Because private partnerships are generally not required to produce audited financial statements there is relatively little public information about the total legal contingencies faced by Big Four audit firms and whether the firms have sufficient capital to withstand large legal judgments. Nonetheless, it is believed that litigation-related expenses are a significant component of auditing firms' cost structures.[37] The Big Four are generally hesitant to provide information about claims, settlements, and financial resources on an individual-firm and detailed-claim basis, which they assert could possibly increase their litigation risk.[38]

Insurance is one tool that audit firms use to manage the cost of litigation. To smooth out possible shocks of major litigation settlements, firms have established captive insurance vehicles. As such, captive vehicles offer financing options rather than true catastrophic insurance.

As noted earlier, each member firm within the Big Four global network is a legally separate affiliate. This structure somewhat insulates other members within the network if one national practice incurs significant litigation liability.[39]

<u>Questions:</u>

- Should independent non-executive membership be further considered in the governance structure of the firms and the global network structure?
- What implications does the partnership model have on the behavior of partners and the ability of firm leadership to foster desired behavior? Does the combination of roles which auditors may have in these structures (including board member, oversight and shareholders roles and responsibilities), sufficiently ensure that the fundamental changes necessary to increase audit quality are implemented timely and effectively? Does a partnership model allow for sufficient oversight, particularly where internal oversight is provided

[36] See, for example, Aubin. Mar. 21, 2013. *Knives out for auditors as class actions go global* available at: http://www.reuters.com/article/2013/03/21/us-usa-accounting-lawsuits-idUSBRE92K0QB20130321.

[37] See *Final Report of the Advisory Committee on the Auditing Profession,* Oct. 6, 2008 (ACAP Report) available at: http://www.treasury.gov/about/organizational-structure/offices/Pages/acap-index.aspx..

[38] See *id*.

[39] If a substantial litigation liability is incurred by one or more significant network member firm, the entire network may be adversely affected. For example, in the case of Arthur Andersen, the failure of the U.S. network member firm was catastrophic for the entire network.

through a committee consisting (whether or not partially) of active or retired partners?

- Currently, major audit firms provide audited financial statements in only certain jurisdictions around the world (i.e. UK, Ireland, the Netherlands, and Austria) for various reasons including audit regulatory requirements and their form of organization in the jurisdiction. Should audit regulators consider requiring audit firms to provide audited financial statements annually? Should the global audit firms produce global financial statements even if there is no legal requirement to do so?
- Outside of compensation, what other incentives and pressures do firms have to change behavior of partners and staff? How might audit partners be better incentivized to protect investors and perform a high quality audit?
- Is the partnership compensation model used by the Big Four audit firms effective in promoting audit quality?
- What implications, if any, does the partnership model have on firms managing conflicts and balancing professionalism vs. commercialism? What implications would other business structures have for managing this balance?
- Does the partnership model offer sufficient capital to fund adequate investment in audit quality?
- What effect have trends in the amount of litigation against audit firms had on audit quality?

E. Quality and Extent of Resources in the Labor Market

Globally, the Big Four audit firms cumulatively employed approximately 710,000 people in 2013.[40] This number includes partners, audit, tax, and advisory professionals and administrative staff. The past five years has seen the number of employed personnel by the Big Four audit firms increase by approximately 16%.[41] With the exception of 2010, the number of people employed by the Big Four audit firms has increased annually since 2009.[42]

Personnel data by service practice is not available for all of the Big Four audit firms. Based on information reported by two of the Big Four audit firms, on average, approximately 42% of Big Four audit firm staff are in assurance, 22% in consulting, 20% in tax, and the remaining in administrative roles. While the number of people employed by the Big Four audit firms has increased over the years, the percentage of staff in assurance as compared to overall staff levels has decreased. This may suggest that the

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40 Per information publicly reported by Big Four audit firms.

41 Per information publicly reported by two of the Big Four audit firms.

42 Per information publicly reported by two of the Big Four audit firms.

Big Four audit firms' hiring for their advisory practice exceeds those of the other practice areas.

Percentage of Staff for Two of the Big Four Audit Firms' Service Practice[43]

	2008	2009	2010	2011	2012	2013
Assurance[44]	46%	45%	43%	42%	43%	42%
Tax	17%	17%	20%	20%	20%	20%
Advisory	21%	22%	20%	21%	21%	22%
Administrative	17%	16%	17%	17%	16%	16%

Due to the growth in advisory and changing nature of financial statement audit work, the demand for experienced individuals with technical expertise by audit firms has increased. This has resulted in a tight market for experienced accounting and finance professionals. While the Big Four audit firms continue to hire students from the accounting programs of universities, hiring of students in other fields of study, including information technology, computer science, organizational change, finance, and statistics has increased in recent years although it is unclear how many of these individuals are being hired into the audit practice.

Audit firms traditionally operate on a pyramid staffing model with relatively few partners and managers, followed by many junior staff. The continued relevance of this staffing model is being questioned and re-examined, particularly given the growing complexity of audits and judgment areas involved, necessitating greater involvement and supervision by experienced auditors in the conduct of audits.

In addition, an increase in audit tendering and rotation in some countries is impacting audit resources as firms determine how to more frequently re-deploy potentially large, specialized teams when they lose or win a bid for a new audit engagement.

Changes to how audits are executed are also starting to emerge, specifically in relation to who is performing the audit and where the audit work is being done. Trends such as offshoring, outsourcing, the utilization of data technicians and performing work in centres of excellence have been noted in various jurisdictions worldwide. These alternative delivery models are being used not only for routine audit areas but also for highly complex processes, resulting in the growth of the "specialist" role. Changes to where work is performed and who is performing this work will have an impact on the experience that is gained by entry level staff and the development of professional skepticism.

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43 Per information publicly reported by two of the Big Four audit firms.

44 Assurance staff may participate in a variety of services including, for example, statutory audits, internal audits, risk assurances, actuarial services and advice in connection with capital markets transactions.

Questions:

- Are accounting curricula appropriate in light of the changing nature of the audit? What fields of study should universities add to their accounting programs and what aspects of the current curricula should be eliminated?
- In countries where accountants traditionally do not receive university training in accounting, what practices prove most valuable in training and developing staff?
- What implication does no or very slow revenue growth in the audit profession have on attracting and retaining talented individuals to the audit profession in favor of other professions or lines of practice? What can be done to encourage individuals with the necessary knowledge, skills, and abilities to embark on and remain in a career in auditing?
- What skills and knowledge do firms view as important in the current audit environment? Are these changing? If so, what are the firms doing to address this?
- Are the auditors of complex corporations adequately skilled today? What can be done to improve the education and training for auditors to adequately prepare them for the audits of complex corporations?
- Is a traditional pyramid structure an effective model to ensure high audit quality? Does the current complexity in financial reporting and judgmental audit areas increase the level of specialists and the need for more experienced auditors required to work on audits?
- Should the process for a professional chartered accountant to obtain licensing in other countries be reviewed and discussed?
- What impact will alternative staffing arrangements such as offshoring have on the training and building of experience in audit personnel? What impact might it have on the future of the partner pipeline if audit firms are adding fewer staff at all levels and more staff decide to pursue a specialist role?

F. Impact of Emerging Technologies on the Audit

Firms expect that technology advancement will significantly impact the future of the audit and audit professionals. Utilization of emerging technologies (currently focused on, but not limited to, mining large amounts of data ("big data") and developing sophisticated data analytics) may increase the value of the audit to stakeholders (by providing deeper insights into and foresight about the organization's operations) and increase the efficiency of the audit. For instance, the use of technology may allow auditors the capacity to examine 100 percent of a client's transactions and to sort entire populations of transactions to identify anomalies, making it easier to focus in on areas of potential concern and drill down on those items that may have the highest risks.

Big data also has the potential to provide auditors with greater situational awareness and predictive indicators of an organization's internal and external environment by helping to better track and analyze trends and risks, and benchmark an organization against sets of data organized by industry, geography, size and other factors. The outcome could allow auditors to make more informed decisions and assessments throughout the audit process and increase the value of the audit for organizations and investors.

The Big Four audit firms have indicated that they are currently making significant investments to investigate ways to redesign their audits to take advantage of the opportunities provided by emerging technologies. However, there is little evidence at this time showing the results of these investments on audit quality, investor protection, the effectiveness/efficiency of the audit, and relationships with stakeholders.

Questions:

- How are developments in technology, in particular information technology and data analytics, changing the nature of skillsets required for auditors?
- How might technology affect the composition and structure of audit teams?
- How can the firms be more innovative in leveraging big data and data analytics in the audit to improve audit quality and better protect investors?
- What changes to auditing standards might be required to support the use of big data and data analytics in the audit? What might the timeline be for these changes?
- With increased use of data in audit, what will be the challenges facing audit firms in areas such as data security, privacy and completeness and accuracy of data?

Potential Implications of the Current Trends in the Audit Industry for Audit Quality and Investor Protection

The following table identifies certain potential implications of the current trends in the audit industry for audit quality and investor protection that may arise from the current state of and trends in the audit industry discussed above.

Potential Implication for Audit Quality and Investor Protection
A. Trends in Firm Revenue and Growth
• Assurance leadership may play a less significant role in the governance of the firm at the global and local network level. This could impact (a) the level of investment in the audit service line and/or (b) the culture of the firm and the value placed by leadership on maintaining independence, objectivity, and professional skepticism. • The acquisition of and investment in firms/professionals that provide advisory services may provide access to specialized skilled individuals by the assurance

practice, thereby increasing the firm's auditing capabilities and synergies in practice.

- Assurance practice may be pressured to keep pace with growth in advisory revenues or profits, which may result in firms accepting new clients with riskier profiles and/or in industries that the firm has no or limited experience, or take short-term actions that are contrary to audit quality.
- Ever expanding advisory services could overwhelm professional interests with commercial interests within the firm. It could also define management as the primary client of the firm rather than the Board, investors and other stakeholders.
- In the event of a choice between advisory or audit, firms may elect to pursue consulting arrangements instead of audit engagements due to regulatory and independence requirements, lower risk and higher margins.
- Firms may be unable to effectively manage compensation and cultural challenges between different lines of practice, potentially destabilizing the firm and/or causing a significant and/or disruptive change in the organizational structure of the firm.
- As advisory services grow and represent a larger portion of revenues, firm leaders and audit partners may focus greater attention to the advisory line of business rather than the assurance practice.

B. Competition in the Audit Market

- Competition for business based on audit fee may result in the auditors attempting to scope the audit work to match the audit fee as opposed to the audit risk.
- Management's familiarity with the Big Four audit firms and fear of a new auditor taking a different position on a difficult or controversial accounting matter may serve as incentives for maintaining the same auditor and serve as an additional barrier to entry for mid-tier firms.
- Conflicts of interests created by expanding advisory services can reduce company choice for auditors to fewer than three international Big Four networks.
- Lack of innovation and focus on relevance/value of the audit may undermine the role of the profession.
- Low visibility into audit quality may undermine innovation and incentives to improve audit quality.
- In an environment where competition is not strong, there may be less incentive to improve audit quality.

C. Governance and Structure of Global Network Firms

- Differences in local business practices and cultural norms among member firms may result in varied level of focus on audit quality and practices among network firms possibly resulting in inconsistent audit work within the network.

- As individual firms within the network grow, global network leadership's influence and monitoring over an individual firm's actions and focus on audit quality may weaken.
- Individuals with limited or no assurance experience may lead the audit practice of the local network firm, diminishing the influence of assurance leadership at the global governance level.
- The global network board or council may have additional resources to provide assistance, where necessary, to individual network firms to improve their assurance practices or address identified audit quality concerns.
- Misaligned incentives among member firms may cause local network firms to pursue divergent growth strategies, possibly diminishing the influence of the assurance practice leadership at the local and global network level.
- The lack of global command and control within global networks may undermine firms' ability to innovate, react quickly, and deliver consistent audit quality globally.
- The partnership model rewards long-term loyalty and performance and breeds exceptional loyalty among audit partners, which may promote continuity of service, audit quality and firm stability.

D. Partnership Model and the Threat of Private Litigation

- The partnership model may not effectively incentivize long-term investment in the audit practice.
- Given evolving business models and increasing complexity of auditing, the pyramid structure of firms may no longer be appropriate.
- Firm governance may not be able to address potential compensation and cultural challenges between different lines of practices, which may potentially destabilize the firm or cause significant disruptive changes in the firm's organizational structure, including the departure of one or more lines of practice.
- Firms may use inappropriate compensation metrics that encourage behavior counter to promoting audit quality.
- Partners may focus on their own personal wealth over firm loyalty and financial results, which may negatively impact the stability of the firm.
- Firms may make reduced investments in audit practice due to lack of resources, including inability to raise capital.
- Pressure to keep partner compensation competitive may divert resources from investments in the assurance practice.

E. Quality and Extent of Resources in the Labor Market

- Top performers in the assurance practice or new hires may seek to work in the advisory practice rather than the assurance practice if it is believed there is more opportunity, less risk and higher income in advisory services, resulting in the loss of audit expertise and competence.

- The potential intermingling of advisory and assurance staff may result in assurance personnel acquiring skills that promote and improve audit quality.
- The firm's growing advisory practice may help the firm attract and retain experienced assurance personnel (i.e., a diversification effect).
- Inability to attract or retain experienced individuals may result in personnel assigned to audits who do not have the appropriate level of experience or skills to appropriately respond to audit risks.
- Alternative staffing arrangements such as offshoring may help alleviate pressure on fees for the firms but may have implications on the development of audit skills of local resources and the partner pipeline.
- The use of offshoring, on-shoring and centres of excellence may increase audit quality by allowing for deeper specialization in certain audit processes.
- The specialist role may strengthen retention of quality resources by providing an alternative career path for audit professionals not wishing to pursue partnership.

F. Impact of Emerging Technologies on the Audit

- Increased value of the audit to stakeholders by providing greater insights and foresights into organizations.
- Greater efficiency and effectiveness of the execution of audit procedures through analysis of 100% of a population.
- Increased use of technology will require the audit firms to attract professionals with a different skillset, or internally develop those skills through deeper training; with data analytics growing in importance across many professions, there is a risk that the audit firms may not be able to attract or retain highly skilled professionals who may seek out opportunities in the advisory areas within the firm or in industry.
- The changing expectation of skills for audit professionals may have an impact on universities' curricula and prerequisites for employment.
- The collection, use and sharing of broader data sets that may include data across various organizations may raise concerns around auditor independence, data privacy and data security.
- Due diligence will need to be performed on the technology that firms acquire or develop to collect data and execute analytics to validate the integrity of the data used for audit procedures.
- Standard setters may be too slow to address changing auditing techniques/use of emerging technologies.