Advisory Services Rise Again at Large Audit Firms

Like a Phoenix, Revenues Reborn amid Renewed Concerns

By R. Mithu Dey, Ashok Robin, and Daniel Tessoni

Nearly one decade ago, most of the large accounting firms divested their advisory services business. The divestitures were motivated not only by business and management reasons, but by regulatory pressures as well. In particular, regulators were concerned that audit quality could suffer if advisory services threatened auditor independence. As a result of the divestitures and the adoption of the Sarbanes-Oxley Act of 2002 (SOX), advisory services revenue represented only a small share of accounting firms' revenues circa 2007. In recent years, however, advisory services revenue has risen again, renewing concerns of its potential effects on audit quality. But auditor independence is no longer viewed as the primary threat to audit quality; instead, concerns revolve around the audit firm's culture and the quality of the resources allocated to advisory versus assurance services. The following is an examination of the rise and fall—and rise again—of advisory services within public accounting firms.

Background

Advisory services revenue grew rapidly at public accounting firms during the late 1990s; yet, by the early 2000s, all but one of the then–Big Five had spun off or sold these business lines. Three factors drove these divestitures: 1) internal management tensions because of the faster revenue growth and perceived higher margins of advisory services as compared to assurance services; 2) the opportunity to unlock higher values and raise capital through sales to publicly traded corporations or via an initial public offering (IPO); and 3) the pressure applied, and regulations adopted, by policymakers aimed at ensuring auditor independence.

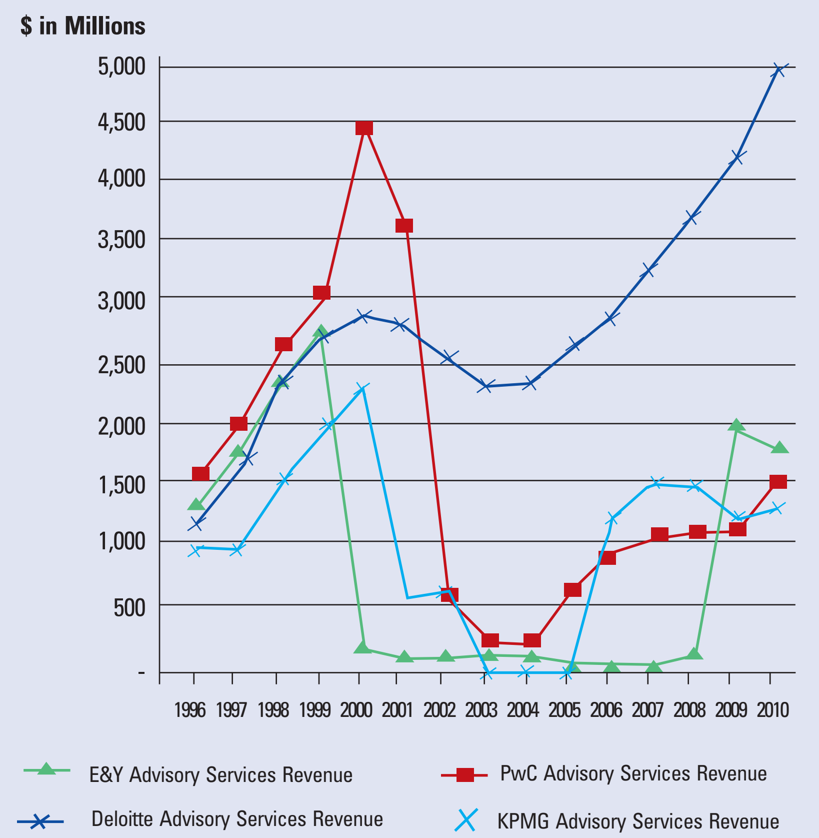
Beginning in the early 2000s, advisory services revenue shrank due to divestitures and the adoption of SOX. At the same time, assurance services revenue soared as SOX fueled rapid increases in the demand for assurance services from clients. As a result, advisory services played a diminished role in accounting firms beginning in the early 2000s to about 2007. Since 2007, however, advisory services have represented a rising share of revenue for accounting firms, triggering renewed concerns.

Over the years, observers have raised management and policy concerns about the role that advisory services play in the accounting industry. Arthur Wyatt, a former FASB and International Accounting Standards Board (IASB) board member and Arthur Andersen senior partner, has discussed concerns about internal conflict in accounting firms that may adversely affect audit quality ("Accounting Professionalism—They Just Don't Get It!" *Accounting Horizons*, March 2004; "Accounting Professionalism: A Fundamental Problem and the Quest for Fundamental Solutions," *The CPA Journal*, March 2004). According to Wyatt, such internal conflict might have a bearing on the allocation of resources and talent, and might result in a shift in client focus from the investing public (audit realm) to company managers (advisory realm). On the policy front, most of the concerns in the late 1990s and early 2000s focused on auditor independence, which was viewed as a contributing factor in the collapse of major corporations such as Enron, WorldCom, and Adelphia. These policy concerns about auditor independence appeared to be largely addressed through SOX, which essentially prohibited the primary auditors from also providing advisory services.

Recently, however, advisory services have again become important to accounting firms. These firms have found ways to sell advisory services to clients for which they are not the primary auditor. This rebirth of advisory services has generated renewed policy and management concerns. A Treasury report (*Final Report of the Advisory Committee on the Auditing Profession [ACAP] to the U.S. Department of the Treasury*, October 2008) on the auditing industry raised concerns about the adverse role advisory services might be playing in public accounting firms. Although the ACAP report was silent in its recommendations about the firms' scope of services because the issue was not part of the committee's charge, the co-chairs commented on the scope of services issue in their transmittal letter accompanying the report. Specifically, they expressed concern that as non-audit services grow at a faster rate than audit services, fewer resources will be allocated for audit work. Their concern shifted from the issue of independence (alleviated by SOX) to that of resource allocation in accounting firms and the potential implications for audit quality. Other commentators (Dana R. Hermanson, "How Consulting Services Could Kill Private-Sector Auditing," *The CPA Journal*, January 2009) have expressed concern that talent and resources might be diverted from auditing toward the faster- growing, and apparently more lucrative, advisory side of the business. If advisory services growth continues on its current trajectory, these concerns are likely to become more important in the very near future, potentially leading to some kind of policy or management response. The authors believe that it is in the best interest of the accounting profession to take a proactive approach in addressing that potential policy response.

The fact that the Big Four are delivering value for their advisory services clients is indisputable. The markets clearly recognize their prowess as consultants. In an April 2010 Gartner report of all consulting providers, the Big Four are included in the list of "Top 10 Consulting Service Providers' Revenue, Growth and Market Share, 2008–2009" for North America (http://www.gartner.com/id=1362249). At

EXHIBIT 1
Advisory Services Revenue from All Clients, 1996–2010



issue, however, is not whether the Big Four are doing a good job of consulting, but whether strong consulting businesses inside audit firms pose a threat to audit quality and firm culture. The authors' focus is on whether the return to consulting is harmful to audit quality—an issue of significant concern to investors and regulators.

Prior Round of Divestitures

Around 2000, all of the then–Big Five, with the exception of Deloitte, divested their advisory services practices. The divestitures were driven by one or more of the factors described earlier: management tension, opportunity for unlocking value, and pressure from regulators. Each of the Big Five's experiences is described below.

Arthur Andersen. Management tension caused the breakup at Andersen Worldwide, the parent company of Arthur Andersen (AA), and Andersen Consulting (AC). A formal profit-sharing agreement between AA and AC was struck in 1989, just before the IT boom contributed to the lucrative environment for advisory services during the 1990s. The agreement required that the more profitable firm share profits with the less profitable one; fueled by IT, AC grew much faster and was more profitable than AA. Thus, this agreement caused a great deal of tension between AC and AA management. The conflict, as reported in the press, lasted for about three years, until AC finally split off by paying AA $1 billion and foregoing the rights to the Andersen name (Brown, "Andersen Consulting Wins Independence: Arbitrator Tells Firm to Pay Auditing Arm $1 Billion; Parent's Role Criticized," *Wall Street Journal*, August 8, 2000), with AC becoming Accenture. Subsequent to the split, AA restarted its advisory arm, often competing for the same clients as Accenture.

Ernst & Young. Ernst & Young (E&Y) sold its advisory group for $11.1 billion to French IT firm Capgemini in March 2000, at the very peak of the Nasdaq stock market boom. According to interviews with leading executives at E&Y, the advisory services business was sold for financial, regulatory, and strategic reasons (Malhotra and Pierroutsakos, "An Assessment of Cap Gemini's Cross-Border Merger with Ernst & Young Consulting, *Multinational Business Review*, summer 2005). Financially, the offer of 2.75 times the advisory services unit's annual revenue allowed E&Y partners to monetize the advisory services asset investments of the 1990s. Regulatory pressure brought to bear by the SEC to separate audit from non-audit functions in order to ensure auditor independence also motivated the sale. A final reason given for the divestiture was that it allowed management to focus more closely on its audit practice: E&Y's CEO claimed this was an important reason E&Y outperformed other large audit firms.

On March 26, 2001, Chairman James Turley noted, "The year after we announced the sale of our advisory business, we won three and a half times more revenue than the rest of the Big Five combined! I am not saying that our sale of advisory directly led to that, but I really do believe that the focus that we are now putting on the core businesses played a part in that" (http://newman.baruch.cuny.edu/digital/saxe/saxe_2001/turley_2001.htm). In spite of the proclamation that focusing on core business was a key competitive advantage, E&Y started to build its advisory practice soon after its non-compete agreement with

EXHIBIT 2
Top 100 Accounting Firm Revenues

Top 100	Total Revenues	Assurance (Percentage of Total)		Advisory (Percentage of Total)		Tax (Percentage of Total)	
1996	$21,221.90	$7,910.99	37%	$8,302.14	39%	$5,008.62	24%
1997	25,469.80	8,393.81	33%	10,903.39	43%	6,148.38	24%
1998	31,665.80	9,550.72	30%	14,847.70	47%	7,267.38	23%
1999	36,739.69	10,920.39	30%	17,695.50	48%	8,123.80	22%
2000	34,772.60	12,872.10	37%	12,824.03	37%	9,076.48	26%
2001	35,362.33	13,176.18	37%	11,270.82	32%	10,915.33	31%
2002	28,422.61	11,517.70	41%	7,144.62	25%	9,760.29	34%
2003	30,643.26	13,871.01	45%	5,893.86	19%	10,878.39	36%
2004	33,154.08	15,594.98	47%	6,690.24	20%	10,868.86	33%
2005	38,010.71	19,003.03	50%	7,658.91	20%	11,348.76	30%
2006	41,795.83	22,792.29	55%	8,511.31	20%	10,492.22	25%
2007	40,854.65	21,544.75	53%	8,538.60	21%	10,771.30	26%
2008	44,600.48	22,978.19	52%	9,389.17	21%	12,233.12	27%
2009	42,638.90	19,001.83	45%	11,225.05	26%	12,412.02	29%
2010	42,500.06	18,351.48	43%	12,252.89	29%	11,895.69	28%

All amounts in millions of dollars
Source: 1997 to 2011 *Accounting Today* "Top 100 Firms" published annually

Capgemini expired in 2005. Ironically, the rebuilding of advisory capabilities was performed under Turley, who earlier had argued for an increased focus on assurance services.

KPMG. In 2001, KPMG spun off its advisory practice, which it named Bearing Point, through an IPO. KPMG disclosed its IPO plan in May 2000, two months after the Nasdaq peaked. The IPO was delayed due to the turbulent market conditions. Nevertheless, management pushed ahead in the belief that the IPO would provide the advisory practice greater freedom in partnering with and investing in the equity of clients. Such opportunities are severely limited for advisory units affiliated with an accounting firm because of the potential conflicts of interest concerning audit clients ("IPO Still On For KPMG Consulting," Larry Greenemeier, *InformationWeek*, January 8, 2001). Subsequent to the expiration of its non-compete agreement with Bearing Point in 2006, KPMG began rebuilding its advisory practice.

PricewaterhouseCoopers. A similar story unfolded at PricewaterhouseCoopers (PwC), where the primary reason for the divestiture appeared to be pressure from the SEC. PwC experienced at least two failed attempts in divesting its advisory unit. In 2000, near the peak of the IT bubble, computer giant Hewlett Packard (HP) offered PwC $18 billion in cash and stock for its advisory unit, but HP later dropped the offer because an agreement could not be reached. PwC also attempted an IPO, named "Monday," in the summer of 2002, but the market for new issues had collapsed at that time. Subsequent to these two failed attempts, and with the adoption of SOX, many of PwC's largest clients decided to either cut their advisory relationship with PwC or to reduce it. In 2002, for example, 22 of the 100 largest audit clients did not want to hire PwC for advisory services, and 16 wanted to reduce the amount of advisory services sourced from PwC ("Goodbye Monday," *Economist*, August 1, 2002). Eventually, in October 2002, PwC sold its advisory services to IBM for $3.5 billion in cash and stock, less than one-fifth the amount HP had offered just two years earlier. Like the other firms, once its non-compete agreement expired in 2006, PwC began rebuilding its advisory practice.

Deloitte. The sole member of the Big Five not to "successfully" divest its advisory practice was Deloitte. Deloitte's attempt to divest through a management-led buyout fell through in March 2003. Borrowing costs for the capital needed to finance the buyout skyrocketed in the wake of Andersen's closure, and revenue sank as cautious audit clients canceled non-audit contracts. On March 31, 2003, the firm scrapped its divesture plans; in hindsight, the firm's management viewed this as a blessing in disguise. "In a strange kind of way, we're very fortunate," said Barry Salzberg, CEO of Deloitte & Touche USA. "By serendipity, we ended up with a strategy that is unique" (Nanette Byrnes, "The Comeback of Consulting," *BusinessWeek*, September 3, 2007). In terms of absolute advisory revenue, as well as a percentage of total revenue, Deloitte's advisory services are significantly larger than those of the other large accounting firms.

The Big Four accounting firms have reentered the advisory services market by targeting non-audit clients. In addition, they

EXHIBIT 3
Ernst & Young: Breakdown of Total Revenues

E&Y	Total Revenues	Assurance (Percentage of Total)		Advisory (Percentage of Total)		Tax (Percentage of Total)	
1996	$3,570.00	$1,392.30	39%	$1,392.30	39%	$785.40	24%
1997	4,416.00	1,589.76	36%	1,810.56	41%	1,015.68	23%
1998	5,545.00	1,885.30	34%	2,384.35	43%	1,275.35	23%
1999	6,375.00	2,231.25	35%	2,805.00	44%	1,338.75	21%
2000	4,270.00	2,433.90	57%	213.50	5%	1,622.60	38%
2001	4,485.00	2,601.30	58%	134.55	3%	1,749.15	39%
2002	4,515.00	2,663.85	59%	135.45	3%	1,715.70	38%
2003	5,260.00	3,261.20	62%	157.80	3%	1,841.00	35%
2004	5,511.36	3,692.61	67%	165.34	3%	1,653.41	30%
2005	6,330.64	4,558.06	72%	63.31	1%	1,709.27	27%
2006	6,890.00	4,960.80	72%	68.90	1%	1,860.30	27%
2007	7,561.00	5,292.70	70%	75.61	1%	2,192.69	29%
2008	8,232.10	5,597.83	68%	164.64	2%	2,469.63	30%
2009	7,620.00	3,124.20	41%	1,981.20	26%	2,514.60	33%
2010	7,100.00	2,982.00	42%	1,846.00	26%	2,272.00	32%

All amounts in millions of dollars
Source: 1997 to 2011 *Accounting Today* "Top 100 Firms" published annually

are able to offer nonprohibited advisory services to audit clients with advanced audit committee approval under SOX section 201(a). The current barrier to entry now appears to be lower for accounting firms. The significant brand recognition and recruiting strength of the Big Four provide them access to large clients and qualified advisory services candidates. As the growth in advisory services accelerates, will regulatory pressure force the public accounting firms to replay the divestitures of the early 2000s?

At the present time, the advisory business is thriving among the Big Four, with revenues exceeding $1 billion at each firm. The rebirth of advisory services appears to have been a fairly easy undertaking, inhibited only by non-compete agreements in certain cases. Of course, audit firms are also delivering advisory services that are highly valued by their clients. With audit revenues flat or declining, due to greater standardization since SOX, advisory services are beginning to play an increasingly important role in driving accounting firm revenue and profit growth.

The Increasing Role of Advisory Services in Recent Years: Understanding the Trend

The authors' analysis shows that advisory services revenue has grown since 2007, both in absolute terms and also as a share of total revenue for public accounting firms. The data are compiled from surveys published by *Accounting Today* in its annual "Top 100 Accounting Firms" from 1996 to 2010. The survey instrument requests firms to provide data on their net U.S. revenues and their fee split as a percentage of total revenue. Total revenues (U.S. public and private clients) are disaggregated into three components: assurance, tax, and the remainder as advisory. Starting with the 2002 "Top 100 Accounting Firms," a fourth revenue component, "other," was added, including elements such as financial planning, litigation support and valuation work, payroll, and benefit plan administration. To provide consistency over time, advisory services are defined as "other" and "management advisory services."

Exhibit 1 shows the changes in advisory services revenue for the Big Four from 1996 to 2010. During the late 1990s and early 2000s, advisory services revenue increased rapidly for all of these firms. Advisory services revenue then dropped significantly for three of the Big Four, due to the aforementioned divestitures. And even in the case of Deloitte, which did not divest, revenue declined beginning in 2001. From 2005 onwards, advisory services revenue began to increase again for most of these firms. In 2010, advisory services revenue, as a percentage of total revenue, accounted for a significant share of Big Four revenues: 19% for PwC, 26% for E&Y, 28% for KPMG, and 45% for Deloitte. If the Big Four (Five) are eliminated from the Top 100 accounting firms, one finds that revenue from advisory services was close to 30% from 2000 to 2005 and has been near 20% since 2006. This may indicate that the Big Four are taking advisory services business away from non–Big Four firms.

In the early 2000s, the assurance business took center stage while the advisory business declined. As discussed earlier, most of the Big Four divested their advisory businesses and SOX increased demand for audit services. From 2003 to 2005, in spite

EXHIBIT 4
KPMG: Breakdown of Total Revenues

KPMG	Total Revenues	Assurance (Percentage of Total)		Advisory (Percentage of Total)		Tax (Percentage of Total)	
1996	$2,530.00	$1,012.00	40%	$1,037.30	41%	$480.70	19%
1997	3,000.00	1,230.00	41%	1,020.00	34%	750.00	25%
1998	3,800.00	1,368.00	36%	1,520.00	40%	912.00	24%
1999	4,656.00	1,629.60	35%	2,002.08	43%	1,024.32	22%
2000	5,400.00	1,890.00	35%	2,322.00	43%	1,188.00	22%
2001	3,400.00	1,496.00	44%	612.00	18%	1,292.00	38%
2002	3,400.00	1,496.00	44%	680.00	20%	1,224.00	36%
2003*	3,793.00	2,541.31	67%	–*	0%	1,251.69	33%
2004*	4,115.00	2,962.80	72%	–*	0%	1,152.20	28%
2005*	4,715.00	3,630.55	77%	–*	0%	1,084.45	23%
2006	4,801.00	2,448.51	51%	1,296.27	27%	1,056.22	22%
2007	5,357.00	2,571.36	48%	1,553.53	29%	1,232.11	23%
2008	5,679.00	2,725.92	48%	1,533.33	27%	1,419.75	25%
2009	5,076.00	2,436.48	48%	1,269.00	25%	1,370.52	27%
2010	4,889.00	2,248.94	46%	1,368.92	28%	1,271.14	26%

All amounts in millions of dollars
Source: 1997 to 2011 *Accounting Today* "Top 100 Firms" published annually

* For 2003, 2004, and 2005, KPMG's advisory revenues are included in assurance revenue.

of the drop in advisory services revenue, increases in assurance services revenue more than made up the difference, resulting in overall revenue increases for all of the firms. Assurance services revenue increases were driven by increases in liability risks for auditors and clients alike, as well as increases in engagement hours. With the passage of SOX and the implementation of SOX section 404, assurance revenues soared. Due to SOX section 404 compliance, audit fees nearly doubled from 2003 to 2004, and remained high in 2005, according to several studies (e.g., a Financial Executives Institute member survey report, March 2006). The Public Company Accounting Oversight Board's (PCAOB) Auditing Standard (AS) 2 also caused an increase in audit hours. In addition, top executives of publicly traded corporations are now required to take more personal responsibility for their financial statements, leading to greater reliance on auditors for assistance.

From 2006 to 2007, several factors—including a backlash from clients over high engagement fees—impacted assurance revenues of the Big Four (Freeman, "Who's Going to Fund the Next Steve Jobs?" *Wall Street Journal*, July 18, 2008). Auditors reduced their hours and audit revenues dropped (Reilly, "Audit Fees Rise, But at a Modest Pace," *Wall Street Journal*. March 27, 2006). A primary catalyst for this was AS 5, which allowed auditors to take a more risk-based approach in the audit and place more reliance on the work of others, such as internal auditors. In addition, by this time auditors and clients had progressed along the learning curve of SOX section 404, thereby reducing audit hours and audit fees. Furthermore, the financial crisis and recession of 2007 likely contributed to a reduction in aggregate audit revenue. The recession may have also led clients to negotiate more forcefully with auditors to reduce prices. Companies were likely capturing a greater share of the savings generated by the regulatory shift to AS 5 and the learning curve cost reductions resulting from SOX section 404. Other competitive pricing pressure came from second-tier auditors who had become more serious competitors to the Big Four; this competition, of course, was limited to certain sectors of the markets in which the second tier was most capable of auditing. Because of these developments, there was increased economic pressure on the Big Four to seek additional nonassurance revenues (Byrnes 2007).

During this same 2006–2007 period, most of the non-compete agreements on advisory services expired. Thus, as assurance revenues started to stagnate or decline, audit firms had a strong motivation to make up those revenues through other business lines; thus, managers recultivated advisory services. Deloitte's success in maintaining and growing its advisory services, even with the strong regulatory constraints in place, provided a blueprint for the other firms to resuscitate their advisory services. The years following 2007 clearly indicate that advisory services are on the rise.

Since 2008, advisory services revenues have continued to grow for the Big Four, while assurance services revenues have stagnated. Based on this rapid growth, it seems clear that firms are focusing their growth strategy on advisory services. For example, advisory services revenue for PwC grew as a share of total revenue from 14% to 19% between 2008 and 2010, and Deloitte's advisory services grew from 34% to 45%.

The 1996–2010 timeframe can be divided into four periods. The first period, in the late 1990s, was one of rapid growth in advisory services. The second period, 2000–2005, was characterized by divestitures in advisory services coupled with a post-SOX boom in auditing services. The third period, 2006–2007, saw stagnation in audit revenues and an opportunity to reconsider advisory services. The final period, since 2007, has seen a full-blown rebirth of advisory services.

Exhibit 2 takes a big picture look at revenue components of the Big Four. The three primary components of revenues for audit firms are assurance, advisory, and tax, and each has taken a different path over the 1996–2010 timeframe. Assurance services revenues were $7.9 billion in 1996, accounting for 37% of overall revenues. Its share of revenue peaked at 55% in 2006, but has declined to just 43% by 2010 as assurance revenues stagnated over that period. Advisory services revenues, on the other hand, were $8.3 billion in 1996, slightly higher than assurance services revenues and accounting for 39% of overall revenue. Advisory services revenues peaked in 1999 at $17.7 billion and 48% of overall revenues, before declining to a mere $5.9 billion, or 19% of revenues, in 2003. Since 2003, advisory services revenues have been increasing—first slowly and, more recently, rapidly—to account for 29% of overall revenues. Tax services revenues more than doubled between 1996 and 2001 to $10.9 billion, growing its share of overall revenues from 24% to 31%. Since 2001, tax revenues have been relatively flat, fluctuating in a narrow range between $9.8 billion and $12.4 billion. Tax revenues accounted for 28% of overall revenues in 2010.

A Closer Look at Each of the Big Four

Ernst & Young. E&Y sold its advisory services to Capgemini in 2000 and was excluded from the advisory market for five years due to a non-compete agreement (Commission of the European Communities, "Regulation [EEC] No. 4064/89 Merger Procedure," May 17, 2000). As shown in *Exhibit 3*, total revenue for the firm peaked at $6.4 billion in 1999 before the sale, and decreased to $4.3 billion in 2000; however, total revenue has steadily increased since then, to $7.1 billion in 2010. The steady increase in total revenue from 2000 to 2010 was only partially due to increases in advisory revenues. Advisory revenues stood at $2.8 billion in 1999, dropped after the Capgemini sale to marginal levels, and remained there until 2009 when it increased to $2.0 billion in 2009. The increase in total revenues from 2000 to 2008 came from steady increases in both assurance and tax services revenues. In the case of assurance services, revenues increased each year after the Capgemini sale, to peak at $5.6 billion in 2008. And tax services revenues increased steadily each year,

EXHIBIT 5
PricewaterhouseCoopers: Breakdown of Total Revenues

PwC	Total Revenues	Assurance (Percentage of Total)		Advisory (Percentage of Total)		Tax (Percentage of Total)	
1996*	$4,135.00	$1,656.85	37%	$1,569.40	40%	$908.75	23%
1997*	4,844.50	1,819.16	36%	2,009.65	42%	1,015.70	22%
1998	5,862.00	1,055.16	18%	4,103.40	70%	703.44	12%
1999	6,750.00	2,362.50	35%	3,037.50	45%	1,350.00	20%
2000	8,878.00	2,903.11	33%	4,439.00	50%	1,535.89	17%
2001	8,057.00	2,819.95	35%	3,625.65	45%	1,611.40	20%
2002	5,174.00	3,000.92	58%	620.88	12%	1,552.20	30%
2003	4,850.00	3,007.00	62%	242.50	5%	1,600.50	33%
2004	5,189.50	3,373.18	65%	259.48	5%	1,556.85	30%
2005	6,167.00	3,885.21	63%	678.37	11%	1,603.42	26%
2006	6,922.38	4,153.43	60%	969.13	14%	1,799.82	26%
2007	7,463.77	4,403.62	59%	1,044.93	14%	2,015.22	27%
2008	7,578.30	4,243.85	56%	1,060.96	14%	2,273.49	30%
2009	7,369.44	3,979.50	54%	1,105.42	15%	2,284.53	31%
2010	8,034.00	4,097.34	51%	1,526.46	19%	2,410.20	30%

All amounts in millions of dollars
Source: 1997 to 2011 *Accounting Today* "Top 100 Firms" published annually

* For 1996 and 1997, data for Price Waterhouse and Coopers & Lybrand are merged to be consistent with the following years' data.

from $1.6 billion in 2000 to a peak of $2.5 billion in 2009. As E&Y CEO Turley noted, the firm was able to focus on its core business after the sale of its advisory services. In 2009, advisory services revenues grew by more than an order of magnitude, to $2.0 billion or 26% of overall revenues, up from a mere 2% in 2008.

KPMG. As previously mentioned, KPMG spun off its advisory arm, named Bearing Point, in an IPO in 2001. Its noncompete agreement expired in 2006. *Exhibit 4* shows that total revenues peaked at $5.4 billion in 2000, before the spin-off, and decreased to $3.4 billion in 2001, immediately after. Since then, total revenues have steadily increased to a new peak of $5.7 in 2008. The increase in total revenue from 2002 to 2005 was entirely due to increases in assurance services. Advisory services were reintroduced in 2006 and promptly accounted for 27% of revenue. Tax revenues have remained relatively unchanged at nearly $1.2 billion during the entire decade. Accounting for more than one quarter of its revenues, advisory services have been a critical source of business for KPMG for the past five years.

PricewaterhouseCoopers. PwC's advisory business accounted for 40% of its revenues in 1996. PwC sold its advisory arm to IBM in October 2002, shortly after the passage of SOX. *Exhibit 5* shows that before the sale in 2001, total revenue was $8.1 billion but dropped to $4.9 billion in 2003. It has steadily increased back to the pre-sale level of $8.0 billion in 2010. All three business segments—assurance, advisory, and tax—have contributed to the increase in total revenues. Assurance services revenues increased from $2.8 in 2001 to a peak of $4.4 billion in 2007, and they now stand at $4.0 billion. Tax services revenues have grown steadily from $1.6 billion in 2002 to $2.4 billion in 2010. Advisory services revenues grew from a low of $242 million to a peak of $1.5 billion in 2010, accounting for nearly one-fifth of total revenues.

Deloitte. Deloitte is the outlier among the Big Four because it never divested its advisory services business. Its overall revenue increased more than threefold, from $2.9 billion in 1996 to $10.9 billion in 2010, as shown in *Exhibit 6*. Assurance services revenues grew at a slightly slower rate, from $1.2 billion to $3.7 billion, during that span. But like the other firms, Deloitte's assurance services got a big boost from SOX, peaking at $4.8 billion in 2008 and accounting for 44% of total revenue. Compared to the other Big Four, its advisory services are a larger source of revenue. Advisory services revenue was $1.2 billion (41% of revenue) in 1996 and increased to $4.9 billion (45% of revenue) in 2010. The share of revenue contribution from each of the business lines has changed little since SOX. And in absolute terms, Deloitte's advisory services revenue is larger than the other Big Four combined.

Policy and Management Concerns: Framing the Debate

Policymakers were especially concerned about the outsized role advisory services were playing at the large accounting firms during the late 1990s and early 2000s. In particular, they questioned whether auditors could be independent if a large share of a firm's revenue—and an even larger share of its profits—came from its non-assurance work. Could a client use the leverage of advisory business to impair the objectivity of the audit and threaten auditor independence? Policymakers promulgated increasingly stringent regulations, culminating in SOX, which prohibited primary auditors from performing a wide range of non-assurance services.

Title II of SOX says in very clear language that "it shall be unlawful for a registered public accounting firm (and any associated person of that firm, to the extent determined appropriate by the Commission) that performs for any issuer any audit required by this title … to provide to that issuer, contemporaneously with the audit, any non-audit service," including nine prohibited advisory services activities. The justification for limiting advisory work performed by the primary auditor was to ensure that auditors were both independent in fact and in appearance with respect to their audit clients. According to an analysis of fees paid to primary auditors in the Audit Analytics database, auditors served as both auditor and consultant to 90% of their public clients before the passage of SOX. For clients who received both auditing and advisory services, advisory services accounted for 65% of total revenue. As a result of SOX, at least until 2006, audit firms appeared to refocus their efforts on assurance services and deemphasized their advisory services. In recent years, advisory services accounted for only 10% of total revenue from clients where the auditor provides both audit and advisory services. Thus, as expected from SOX compliance, advisory revenue from audit clients is relatively low.

The criticism that was leveled at auditors regarding independence softened after SOX was implemented. SOX was successful at enforcing audit independence at the primary auditor level, but now a new issue—audit quality—has risen. Auditors are not constrained from providing advisory services to non-audit clients, and the large firms have increased these services. The Big Four rank among the top 10 consulting firms, reflecting their ability to successfully deliver those services (Gartner Dataquest Research Note G00200370, April 2010).

As noted above, concerns about the growth in non-audit services have been expressed by others recently (Wyatt 2004, ACAP 2008, Hermanson 2009). The cochairs of the ACAP committee expressed the following concern in their statement in the beginning of the report:

> The rate of growth for non-audit services, especially advisory services offered to non-audit clients, now exceeds the rate of growth for audit services. We realize that the allocation of investment dollars and professional talent is in many cases interchangeable, and that some auditing firms are working a delicate balance in allocating resources amongst their various practices. As Co-Chairs of this Committee, we strongly believe that the audit practice should always be the highest priority.

Hermanson, who served on the American Accounting Association committee that commented on ACAP's recommendations, expressed concern that this issue was not part of ACAP's agenda and

EXHIBIT 6
Deloitte: Breakdown of Total Revenues

Deloitte	Total Revenues	Assurance (Percentage of Total)		Advisory (Percentage of Total)		Tax (Percentage of Total)	
1996	$2,925.00	$1,170.00	40%	$1,199.25	41%	$555.75	19%
1997	3,600.00	1,260.00	35%	1,620.00	45%	720.00	20%
1998	4,700.00	1,457.00	31%	2,350.00	50%	893.00	19%
1999	6,750.00	2,362.50	35%	3,037.50	45%	1,350.00	20%
2000	5,838.00	1,809.78	31%	2,919.00	50%	1,109.22	19%
2001	6,130.00	2,022.90	33%	2,819.80	46%	1,287.30	21%
2002	5,933.00	2,135.88	36%	2,551.19	43%	1,245.93	21%
2003	6,511.00	2,539.29	39%	2,343.96	36%	1,627.75	25%
2004	6,876.00	2,750.40	40%	2,337.84	34%	1,787.76	26%
2005	7,814.00	3,438.16	44%	2,656.76	34%	1,719.08	22%
2006	8,769.00	3,946.05	45%	2,893.77	33%	1,929.18	22%
2007	9,850.00	4,334.00	44%	3,349.00	34%	2,167.00	22%
2008*	10,980.00	4,831.20	44%	3,733.20	34%	2,415.60	22%
2009	10,722.00	3,967.14	37%	4,181.58	39%	2,573.28	24%
2010	10,938.00	3,718.92	34%	4,922.10	45%	2,296.98	21%

All amounts in millions of dollars
Source: 1997 to 2011 *Accounting Today* "Top 100 Firms" published annually

* 2008 total revenue is an *Accounting Today* estimate.

that future waves of audit failures could lead to government-run audits.

Audit quality has clearly become the central focus of the debate. Building on Wyatt's discussion of advisory services and audit firm culture (2004), Hermanson (2009) described five negative effects of advisory services on audit firm culture. First, the culture of the firm might no longer be consistent with accounting professionalism. Second, the reason for the firm's existence—audit—might become diluted by advisory work. Third, the "identity of the client" might shift from the investing public (audit realm) to company managers (advisory realm). Fourth, as evidenced in the pre-divestiture environment by Andersen and others, internal management tensions might arise. Auditors and consultants might expend considerable effort arriving at an agreement about compensation and profit sharing, based on the perception that advisory services are often a higher margin business. Such internal squabbles might take energy away from providing high-quality auditing services. Auditors might feel pressure to cut costs on their audits in order to make their margins and profits more comparable to those of the consultants. Finally, the reward system within the firm might focus too much on revenue and profit generation, and not enough on technical ability and accounting professionalism.

The authors are concerned that audit quality might be impaired as firms refocus on advisory services. Specifically, how will this affect the focus of CPA firm employees and clients—for example, when it comes to resource allocation, will audit or advisory services garner the larger share of the most qualified talent in the firm? As advisory services expand, it's very likely that the competition for high-quality performers will increase. There are several reasons for believing that top accounting graduates might choose advisory over the assurance arm, including higher compensation, better opportunities for advancement, more potential clients, declining revenues in the assurance segment, and a broader range of work experience to place on a resume. Of course, even if the Big Four were not actively providing advisory services, top students might choose to work for an advisory-only firm. Finally, high-quality candidates might be more likely to shy away from auditing, given the riskier audit environment and their greater individual liability exposure.

The route to a partnership and what follows differs for an advisory partner, versus an assurance partner; the legal and financial risks from SOX and the PCAOB are greater in the assurance field. Some audit firms also extract financial penalties from audit partners for errors in judgment. This could contribute to assurance personnel constantly second-guessing their work and looking over their shoulder, creating an uncomfortable work environment.

In addition, the authors question how auditors will view prospective clients: as a potential audit client, or an advisory client? If advisory services are more profitable, will auditors only become the client's primary auditor when the probability of doing advisory work is low? Reviewing ads in the popular press, the authors note that marketing ads appear to focus on the overall firm, or individually on tax and advisory services, but rarely on assurance services. It would appear that the large firms are leading with their non-assurance services in targeting potential clients. The constraints placed by the PCAOB have increased the risk profile of audit engagements and of auditors, whereas such burdens and oversight are not apparent in the advisory arena.

A Public Discussion

Advisory services have once again become a significant share of the Big Four's overall revenues. Observers of the auditing profession have expressed renewed concerns about the adverse effects this may have on audit quality. While auditor independence does not appear to be threatened, other concerns have been raised about firms' allocation of key resources, especially talent. The data show very clearly that advisory services have been growing, and given that assurance revenues have remained relatively flat, the profession ought to begin a public discussion on the role of advisory services and its possible impact on audit quality. Paraphrasing E&Y CEO James Turley, jettisoning its advisory services helped E&Y improve its assurance and tax offerings; bringing advisory services back on a large scale may now cause assurance and tax services to suffer.

The lucrative nature of advisory services has been, and likely will continue to be, a major draw for accounting firms. In the early 2000s, when the role of advisory services was last debated within the profession, prominent observers predicted that it would play a significant role at audit firms. Robert K. Elliott, AICPA chairman and KPMG partner, predicted that, in the long run, "all the public accounting firms will be in advisory," ("After Andersen War, Accountants Think Hard About Consulting," by Reed Abelson, *New York Times*, August 9, 2000).

Wyatt (2004) discussed the cultural changes that have occurred within the large accounting firms—which might still dominate the firm culture—since the last round of advisory services growth. Since the 1960s, firms' culture started to change from an emphasis on professionals with technical skills, experience, and knowledge about diverse accounting issues to an emphasis on growing revenues, profitability, and hiring staff without accounting degrees. Success in generating high-margin advisory fees offered consultants an increasing voice in firm management that slowly started to change the culture of the firms. Specifically, Wyatt stated that pleasing the client and doing what was necessary to retain the client reached a prominence unseen prior to the rise of the successful advisory services arms. A cultural shift was occurring within the accounting firms, and the recent return of firms to advisory services may indicate that SOX did not reverse the behaviors and culture that once existed.

A change is observable in the structure of the large accounting firms' revenue streams. Clearly, advisory services are becoming a more important source of revenue for the Big Four. The authors believe that this raises legitimate concerns about the possible impact on the quality of audits performed by these firms. These concerns are unlikely to go away. It would thus be beneficial for the accounting profession to publicly recognize these concerns—and to develop a framework for addressing them. ❑

R. Mithu Dey, PhD, CPA, *is an assistant professor of accounting,* ***Ashok Robin, PhD,*** *is a professor of finance, and* ***Daniel Tessoni, PhD, CPA,*** *is an assistant professor of accounting, all at the Saunders College of Business at the Rochester Institute of Technology, Rochester, N.Y.*