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Norman R. Walker

Michael D. Doll

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The Relative Importance of Auditing to the Accounting Profession: Is Auditing a Profit Center?

Norman R. Walker
Michael D. Doll
Price Waterhouse

This paper deals with certain aggregated financial, statistical, and other information relating to the US operations of the Big Eight firms—Arthur Andersen & Co., Arthur Young & Co., Coopers & Lybrand, Deloitte Haskins + Sells, Ernst & Whinney, Peat Marwick Main & Co., Price Waterhouse, and Touche Ross & Co.—primarily their accounting and auditing components. The Big Eight segment of the accounting profession was chosen because of its dominance in auditing publicly-held companies and because information concerning these firms was the most readily available.

Introduction

If you were to read the myriad of articles which have recently appeared in business publications and professional accounting and auditing journals, you might be led to believe that the outlook for the future and profitability of the auditing profession is rather dim. For example:

- The standard audit report is often viewed as a commodity. There are those who believe that there are few means to distinguish between auditing firms except on the basis of price.
- So-called competitive pricing for audit engagements is often punctuated by underbidding, or "low-balling." The perception is that an accounting firm "buys" the audit of a company in an attempt to obtain lucrative tax and management consulting work.
- Merger/acquisition activity has reduced the number of major publicly-traded companies. The recurring audit of these giant companies had been considered by many to be the "bread and butter" of the Big Eight firms.
- Firms in financial services and other commercial activities, often paying higher salaries, increasingly seem to attract the more capable undergraduate and MBA students who might otherwise choose auditing as a career. Many of these students view the work done by staff accountants (at least in their first several years) as repetitive and uninteresting. These prospective auditors do not relish the thought of sitting for a difficult examination after graduation in order to obtain a license as a CPA. At the same time, they perceive the work done in the arenas of finance and investment banking as both challenging and rewarding (mentally and financially).

- The supply of students who do choose accounting and auditing seems to be dwindling. From 1984 to 1986 (the most recent year for which we have information), the supply of accounting graduates from four major universities (which have traditionally been important recruiting sources for our firm and which are widely recognized for having outstanding accounting programs) declined, on average, fourteen percent.
- As shown in Table 1, accounting and auditing (A&A) revenue as a percentage of total revenue has been declining for the past five years for the Big Eight firms. This is a continuation of a trend that has been occurring for at least the past decade. On a percentage basis, average annual revenue growth for the Big Eight firms over the last several years has increased in tax and management consulting services (MCS) at significantly higher rates than in accounting and auditing (Table 2).
- Some observers argue that A&A is no longer the major profit center for the Big Eight (or at least will no longer be in the near future) and that tax and, especially, MCS have become the major profit centers. Others have gone so far as to predict that some of the Big Eight firms will eventually get out of the auditing market altogether, concentrating instead (they claim) on the more profitable tax and management consulting segments of the profession.

Despite the impact of these and other challenging issues, we believe auditing remains a significant, robust segment of the accounting profession. This paper discusses some recent statistics concerning auditing and gives our views on its future.

Problems/Issues Affecting the Relative Importance of Auditing

This section provides background data and additional information on several of the problems/issues affecting the relative importance of auditing to the accounting profession which were raised in the introduction.

Table 1

Average Fee Distribution* for the Big Eight Firms: 1983-1987

Activity	1983 (%)	1984 (%)	1985 (%)	1986 (%)	1987 (%)
Accounting & Auditing	63	62	59	58	56
Tax	22	22	23	23	24
Management Consulting Services	15	16	18	19	20

* Data were derived from Annual Reports to the SEC Practice Section of the AICPA Division for CPA Firms

Table 2

Average Percentage Increase in Revenue for the Big Eight Firms: 1983-1987

(Except for inflation rate, data were derived from the International Accounting Bulletin (IAB) and the Public Accounting Report (PAR)).

Activity	1983 (%)	1984 (%)	1985 (%)	1986 (%)	1987 (%)
Accounting & Auditing	8.8	9.0	8.8	10.6	13.9
Tax	15.2	13.6	13.3	12.3	21.5
Management Consulting Services	12.9	21.2	23.7	19.8	23.9
Total	10.8	12.0	12.5	12.8	17.6
Inflation Rate*	3.8	3.9	3.8	1.1	4.4

* Inflation rate is the Consumer Price Index, All Urban Consumers (Source: US Bureau of Labor Statistics)

Repeal of Ban on Solicitation and Advertising

In the late 1970s, under threat of anti-trust action from the Justice Department and the Federal Trade Commission, the AICPA eliminated, from its Code of Ethics the prohibitions against competitive fee bidding, solicitation of clients, advertising, and promotion of specialities. This effectively deregulated the accounting profession and led to increased competition among all accounting firms (especially the Big Eight).

The competition for audit clients in the US market has increased significantly since the ban was lifted, particularly so in the past five years. The market is now characterized by pervasive use of public relations and advertising. Each of the Big Eight firms has adopted advertising campaigns, many of which feature "tag lines" aimed at capturing the public's attention and increasing awareness of the sponsoring firm, both generally and in specific industries and services. For example, while Arthur Young & Company explains that "We take business personally" and Ernst & Whinney boasts "Ernst & Whinney . . . and results. They go together," our firm, Price Waterhouse, proclaims "Expect more from us." Some of the advertisements are audit-related in a broad sense, but many are aimed at special industries (e.g., health care, insurance, law firms, manufacturing) or special services (e.g., financial planning, budgeting, tax planning). For example, Deloitte Haskins + Sells features the slogan "The Competitive Edge in Health Care" in their advertisements to that industry.

Who is the target of all this marketing effort? Not surprisingly, to a significant degree there is vigorous pursuit of largely the same target markets in which many Big Eight firms see the greatest opportunity for profitable practice growth and development—in addition to those industries previously mentioned, in high technology, smaller businesses in high growth industries, and financial services.

A significant amount of direct solicitation of existing clients now occurs in the form of telephone, direct mail campaigns, free seminars, and call programs. Software products, free consulting time, training aids, lower fees for current services—you name it—all are being offered by various Big Eight firms, sometimes with, but sometimes without, specific knowledge of the company's business operations and its possible needs.

The changes which have occurred in the auditing profession as a result of lifting the AICPA prohibitions against advertising and solicitation have forever altered the way public accounting is practiced in the US. One of the most significant changes—so-called "competitive pricing"—is discussed below.

"Competitive Pricing" of Audit Services

The U.S. market is characterized by deep discounting of fees—particularly for audit services. A recent article in *The Wall Street Journal* [Berton, 1985] contained the following introduction: "Attention, Corporate Treasurers: Think your outside audit is too expensive? Now may be a good time to get a bargain." The article went on to recite numerous examples of companies which had reduced their audit fees through competitive proposals. Discounts to existing clients, "low-balling" fees to gain new clients (in some instances with fees at less than 50% of standard billing rates), fixed fees covering three to five years, free work and the like are examples of the intensity of the competition which currently exists among the Big Eight firms in the US.

Some believe an accounting firm may have many justifications for bidding below standard billing rates to engage a client. An initial low bid may be justified on the grounds that a new client should not be charged for the high start-up costs that occur as the accounting team learns about the new client company and its industry. In addition, the marginal cost of serving a client during the off-season is very low and may justify a lower-than-normal bid. Other reasons for a significantly low bid may be the desire to gain industry experience, to attract a prestigious client that would be a good source of referrals, or to market other services such as tax planning or consulting [Dykes and Hermanson, 1985].

The economic decline experienced by the US economy in the late 1970s and early 1980s forced companies to critically review all discretionary and non-discretionary expenditures in their efforts to sustain financial well-being and ensure cost-effectiveness. Fees for professional services became a target for negotiation. Many companies began requesting multiple bids for their outside audits in an effort to cut costs. Accounting firms hoping to secure new work were increasingly willing to discount their fees; the incumbent firm often found it necessary to lower its fee to remain competitive. Once the "waters were tested," so to speak, and many companies found that fee concessions could be gained, the era of uncontested fees for quality services—if it ever really existed—was gone. The disconcerting element introduced, however, was that even where superior services were rendered at a fair price, companies were aware that services similar in name could most likely be obtained elsewhere at a lower price—the idea of the audit as a commodity.

The view that the audit is a commodity was institutionalized with the publication of the Cohen Commission Report in 1978. It stated (in part) that (Commission on Auditors' Responsibilities, 1978, p. 111) "When a product or service offered by different suppliers differs significantly to the user, or appears to differ significantly, it is easier for one of its producers to maintain a higher, noncompetitive price. Public accounting firms go to considerable length to develop superior services for their clients, but there is little effective product differentiation from the viewpoint of the present buyer of the service, that is the management of the corporation." Thus, if a prospective client views professional accounting services—such as an audit opinion—primarily as a commodity, it will generally attempt to obtain the commodity at the lowest possible price.

Many executives view the Big Eight firms as essentially identical. Their view appears to spring from observable similarities among the Big Eight: depth of personnel sufficient for all practical purposes; domestic and foreign offices blanketing the globe; claims of special industry expertise tailored to the company's interests; availability of a full range of services in accounting, tax and management consulting; and auditing approaches said to promote optimum efficiency and effectiveness. All of the firms must comply with auditing standards set by the American Institute of Certified Public Accounts (AICPA), financial reporting standards set by the Financial Accounting Standards Board and regulations of the Securities and Exchange Commission (SEC). As members of the SEC Practice Section of the AICPA Division for CPA firms, each of the Big Eight firms must undergo triennial peer reviews and comply with numerous other requirements designed to promote high-quality practices. Therefore, the argument goes, a "clean" opinion expressed by any of the Big Eight would be acceptable. Using this reasoning, the "best" opinion is the one that costs the least. Many observers within the profession, and among our clientele, note that the basic attest function—the audit—is currently being bought and sold like a commodity, with price being the dominant factor.

Severe price competition has caused the audit function to become less profitable for the Big Eight firms, other things being equal. Bids below cost to attract new business have become fairly common. The audit is seen by some primarily as a "foot in the door" or "loss leader" to sell other services.

Auditor Changes Related to Fees

As reported in the *Public Accounting Report,* one of several publications which keeps track of changes in independent accountants of publicly-traded companies, there were 194 public companies that changed auditors in 1978. Over 700 publicly-traded companies changed auditors in 1987, a nearly 400% increase in the decade. Table 3 presents a summary of publicly-traded companies with auditor changes for each of the five years in the period from 1983 through 1987 and provides the most often cited reasons for the change.[1]

As can be seen from Table 3, the most often cited factor for the increase in auditor changes over the past three years—when nearly two thousand publicly-traded companies changed independent accountants—was fees. The next most often cited factor was service.

[1] The statistics for publicly-traded companies with auditor-changes presented in Table 3 should be viewed with "a grain of salt." Each company changing auditors is presented in Table 3 as an equal unit, no matter what the level of audit fees. Obviously, the loss of a single Fortune 500 client with $500,000-plus audit fee is of much greater concern than the loss of several clients each with an audit fee of $10,000.

Table 3

Number of Publicly-Traded Companies with Auditor Changes: 1983-1987

	Year 1983	1984	1985	1986	1987
Number of publicly-traded companies with auditor changes	480	523	542	737	719
Percentage of companies citing following reasons for change:					
Fees	36%	32%	33%	35%	29%
Service	24%	38%	37%	26%	15%

Note: Source of data is the Public Accounting Report (PAR).

Sharing of Fee Knowledge Among Multiple Parties

Over the last fifteen years or so, the contributions and responsibilities of audit committees have attracted an ever-increasing amount of attention. Audit committees typically are composed of outside directors. One of the committee's responsibilities is the selection of auditors for the company. (The actual selection generally is proposed by management, with the audit committee and the board of directors confirming management's selection. In many instances, the selection is ratified by the shareholders during the proxy process.) Many outside directors serve on multiple boards of directors and audit committees as well as on the board of directors of their own company. Thus, a three- or four-member audit committee may collectively have "fee knowledge" relating to the audits of many other companies. The sharing of this knowledge has frequently increased audit fee pressures on the Big Eight.

Sophistication of the Audit User Base

The audit user base has become much more sophisticated. Due to (i) increased public awareness of the accounting profession through the media, (ii) the large number of alumni of Big Eight firms employed by commercial enterprises, (iii) information obtained through service on audit committees, boards of directors and a variety of other sources, and (iv) the greater use of in-house personnel and internal auditors, the potential users of audit services have become far more sophisticated and discriminating in understanding what audit services are, how they are priced, and how they are performed. Although this can work in favor of the accounting profession, it has nevertheless contributed to opening up the audit market to competitive forces.

Maturing Demand for Audit Services

Another significant factor in the competitive evolution has been an indicated reduction in the client population base itself. The last five years have seen a tremendous upsurge in the number of mergers and acquisitions (M&A) among U.S. companies, many of them occurring in the Fortune 1000 market, considered one of the primary markets for services among the Big Eight and other major accounting firms. This rash of mergers spurred additional audit fee competition as new parent companies dropped the auditor of one of the merged concerns (or decided to seek competitive bids from additional accounting firms). Following the merger of two large concerns (or the acquisition of one by another), the combined audit effort for future examinations is generally significantly less than is required to issue separate reports on the individual pre-merged companies. Accordingly, the fee for the post-merged company is generally much less than the combined pre-merger fees.

M&A activity slowed for a while after the October 1987 stock market crash but seems to be reviving rapidly. Many are predicting a continuation of this trend. The upshot of this activity is that the Big Eight, with basically similar strategic goals of growth and profitability, may be pursuing a shrinking base of potential service users. Hence, the initiation of vigorous efforts to seek and attain competitive advantage.

Is Auditing a Profit Center?

Up to this point, the paper has discussed certain problems and issues affecting the relative importance of auditing to the accounting profession. This section turns to the question of whether or not auditing is a profit center.

Statistics Available for Analysis

The easiest way to determine if auditing is a profit center for the Big Eight firms would be to have access to each of the firms' financial statements by discipline (i.e., accounting and auditing, tax, and management consulting services) for the past five or six years. Obviously, we have the Price Waterhouse financial statements for each of these years and are pleased to report that auditing has been, and remains, a major profit center for us. However, current and historical information on the profitability of the US operations of the remaining firms in the Big Eight (in the aggregate or by discipline) is not readily available.

The following information is either disclosed annually by each of the Big Eight firms or can be derived from other sources: total revenue, total number of partners/principals, total number of professional staff, revenue by discipline (accounting and auditing, tax, management consulting), number of partners/ principals by discipline, and number of professional staff by discipline. This information has been used to prepare Tables 2, 4, 5 and 6.

Tables 4, 5, and 6 present selected average revenue data for the Big Eight firms as a group.[2] As might be expected, there were variances by discipline,

[2] The sources for the 1987 revenue amounts were the *International Accounting Bulletin* (IAB) and the *Public Accounting Report* (PAR). The revenue of Peat Marwick Main & Co. (resulting from the merger of Peat, Marwick, Mitchell & Co. and KMG Main Hurdman) is included in 1987. Revenue for 1983-86 includes only that of Peat, Marwick, Mitchell & Co. The source for 1985 and 1986 revenue amounts was PAR. Revenue data for previous years was taken from the respective Big

sometimes significant, among the various firms. However, the purpose of this paper is not to discuss the relative importance or profitability of auditing to any particular firm of the Big Eight, but to the Big Eight firms as a group.

Use of Revenue per Partner or Revenue per Professional Staff as Estimators of Profitability

For purposes of this paper, we have used "revenue per partner" and "revenue per professional staff" as estimators of profitability to examine the premise of whether or not auditing is a profit center. We acknowledge that these are somewhat inexact predictors of profitability but, in our view, these are reasonable approximations of profitability. We believe it is not unrealistic to use them as estimators of profitability since personnel costs represent the largest cost factor for accounting firms. We have assumed that, in general, personnel costs do not vary significantly by discipline for similar experience levels. (If anything, salary levels for A&A may have been somewhat less than those for tax and MCS thereby resulting in a more conservative estimate of audit profitability.)

Other important factors which impact the level of profitability of the Big Eight firms include billing rate realization, staff utilization, leverage (i.e., effect of the staffing pyramid), expense control, and speed of accounts receivable collection. Intuitively, we believe the effect of these factors varies among the Big Eight firms. This paper does not attempt to quantify the impact of these factors on Big Eight profitability.

Obviously, we have assumed that each of the Big Eight firms has, in fact, been profitable during the past five years. Based upon anecdotal evidence, and our own knowledge, this seems to be a reasonable supposition.

Table 4 illustrates the average revenue per partner for the Big Eight firms for each of the five years in the period from 1983 through 1987, in total and by discipline. The increase in average A&A revenue per A&A partner was very impressive over the five-year period—an increase of $253,000 per partner, or 38%. While not as great as the $337,000 (or 44%) increase in average MCS revenue per MCS partner over the same period, it did exceed the $241,000 (or 37%) growth in average tax revenue per tax partner.

Table 5 illustrates the average revenue per professional staff for the Big Eight firms for each of the five years in the period from 1983 through 1987, in total and by discipline. The comparative growth statistics for average revenue

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Eight firms' Dingell Subcommittee submissions when so disclosed, or prior estimates published by PAR as an alternative. (We have found the IAB/PAR revenue "estimates" to be uncannily accurate, for Price Waterhouse at least, leading us to believe that sources from inside the Big Eight firms supply the information to IAB/PAR.) Revenue by discipline was (1) obtained from Dingell Subcommittee filings or (2) derived by applying revenue composition percentages— reported in annual information summaries filed with the AICPA—to the total revenue amounts. The sources for the total professional staff counts, including partners, were (1) each Big Eight firm's annual information filing with the AICPA and (2) an informal staff count data base maintained on each of the other Big Eight firms by Price Waterhouse. The AICPA controls provided the control totals; personnel statistics by discipline for all years were calculated using relative staff composition percentages resident in the Price Waterhouse data base. We acknowledge that the data produced by this process is somewhat "soft" since our data base information is probably not completely accurate; however, we have no reason to believe that the information is biased in any particular way.

Table 4

Average Revenue Per Partner for the Big Eight Firms: 1983-1987
(Dollars in Thousands)

Activity	Year 1983	1984	1985	1986	1987
Accounting & Auditing	$663	$702	$750	$ 842	$ 916
Tax	648	711	763	821	889
Management Consulting Services	768	867	980	1009	1105
Total	670	722	781	863	942

Note: Sources of the data are the *International Accounting Bulletin* (IAB) and the *Public Accounting Report* (PAR).

Table 5

Average Revenue Per Professional Staff for the Big Eight Firms: 1983-1987
(Dollars in Thousands)

Activity	Year 1983	1984	1985	1986	1987
Accounting & Auditing	$74	$78	$80	$ 86	$ 91
Tax	88	93	92	94	103
Management Consulting Services	83	90	96	101	105
Total	78	82	84	90	97

Note: Sources of the data are the *International Accounting Bulletin* (IAB) and the *Public Accounting Report* (PAR).

per professional staff are very similar to those for average revenue per partner. Average A&A revenue per A&A professional staff increased by $17,000 (or 23%) over the five-year period. It exceeded the $15,000 (or 17%) increase in average tax revenue per tax professional staff but was less than the $22,000 (or 27%) increase in average MCS revenue per MCS professional staff.

Although average A&A revenue per A&A partner and average A&A revenue per A&A professional staff are both below average total revenue per partner and average total revenue per professional staff in each of the five years, neither is significantly so (less than 4% for average A&A revenue per A&A partner and less than 7% for average A&A revenue per A&A professional staff in any of the years shown). This indicates that while, on average, auditing may not be the *most* profitable service offered by the Big Eight firms, it does generate significant revenue per partner and per professional staff. The charge that the audit is a loss leader, while possibly true in isolated instances, is clearly not true in the aggregate.

Increases in Audit Revenue

As noted earlier in this paper, the annual percentage growth for A&A revenue has been less than the percentage growth for tax, MCS, and total revenue for the Big Eight firms. It should be noted, however, that aggregate A&A revenue for the Big Eight firms has posted annual increases in absolute dollars and, as shown in Table 2, in percentage increases which are significantly greater than the corresponding rates of inflation.

Table 6 shows the average dollar increase in revenue for the Big Eight firms for each of the five years in the period from 1983 through 1987, in total and by discipline. We acknowledge that the dollar and percentage increases outside A&A have been impressive, particularly for MCS. But we also believe it is important to point out that A&A has posted significantly higher dollar increases in each of the five years than has either tax or MCS. Percentage increases for tax and MCS are more impressive partly because they are developed from a smaller revenue base than A&A. Further, there was a $25 million "spread" between the 1987 audit and MCS revenue increases. In the preceding four years, the average spread was $14 million. There was also a $24 million spread between audit and tax revenue increases. In the preceding four years, the average spread was $17 million.

One of the most significant aspects of the importance of auditing to the accounting profession that cannot be measured in terms of dollars and cents is that it allows Big Eight partners and managers direct access to the most important executives in corporate America. Proper execution of a difficult assignment provides the opportunity to impress those persons who ultimately make the decisions concerning the appointment of consultants for a multitude of other engagements. Notwithstanding arguments to the contrary, the fact

Table 6

Average Dollar Increase in Revenue for the Big Eight Firms: 1983-1987
(Dollars in Millions)

Activity	Year 1983	1984	1985	1986	1987
Accounting & Auditing	$29	$33	$35	$46	$ 66
Tax	18	18	20	21	42
Management Consulting Services	11	21	27	29	41
Total	58	72	82	96	149

Note: Sources of the data are the *International Accounting Bulletin* (IAB) and the *Public Accounting Report* (PAR).

that a Big Eight firm has performed in a quality manner on an audit engagement is often the most important reason the same Big Eight firm has been engaged to perform tax work and management consulting services. The cross-selling of additional services to existing clients is a primary source of new work for the Big Eight firms. The audit of a company can almost always be used as a "foot in the door," but we believe that foot-in-the-door tactics alone simply will not work over the long pull. Promises must be followed by delivery of constructive services—services perceived as solid values for the price paid.

The Audit as a Commodity—a Rebuttal

Some executives seem to regard auditing services as a commodity because the end result—the audit report—is tangible and straightforward. We believe this is akin to viewing the outcome of a jury trial—that is, a guilty or not-guilty verdict—in a similar fashion. From our perspective, neither the report of independent accountants nor the verdict of a jury is a commodity. Both are products of processes that are dependent upon *people.*

In response to the Cohen Report [1978, p. 111] claim that there is "little effective product differentiation from the viewpoint of . . . management of the corporation," we believe that it is the men and women representing the various Big Eight firms that provide audit product differentiation. The primary resources of the Big Eight are its people. Once the buyer of a service has made a selection, the spotlight shifts away from a firm with its litany of credentials to a handful of individuals with the levels of expertise and experience needed to get the job done in accordance with the promised specifications. It is individuals who deliver services, and whose actions either preserve and improve upon a firm's reputation, or damage it.

For example, one of the first and most critical success factors to an audit engagement is understanding the business and its related inherent risks. This understanding is the basis for all subsequent audit work. Obtaining this understanding is not a mechanical exercise. It is highly dependent upon people—not only the audit staff assigned to the engagement, but the client personnel as well. It is through discussions and interaction with client personnel, from the CEO on down, that the audit team gains the necessary understanding. The effectiveness and efficiency of this process, both from the auditor's and client's perspective, is dependent on the quality and expertise of the audit team members.

Is There A Shrinking Audit Market for the Big Eight?

We previously noted that merger and acquisition activity has reduced the number of *major* publicly-traded companies. In direct contrast, the large number of initial public offerings (IPOs) in recent years has provided major audit practice growth opportunities for the Big Eight firms. Weissburg, editor of *Going Public: IPO Reporter,* has reported (in a private communication) that the number of IPOs[3] (firm commitments) has ranged from a low of 354 in 1984 to a high of 719 in 1986.

[3] This information needs to be viewed in the same light as that contained in Table 3. Each initial public offering, no matter how large or small, is viewed as an equal unit. Obviously, a larger initial public offering implies a larger company and larger recurring audit fees.

The Securities Act of 1933 requires that registration statements (including those for initial public offerings) contain audited financial statements. Many filings under the Securities Exchange Act of 1934 (e.g., annual reports on Form 10-K) must also include audited financial statements. The importance of these requirements to the Big Eight firms cannot be over-emphasized. Public accountants have a monopoly on this work; the Acts specify that the financial statements be "certified by independent public accountants," without mention of the size of the auditing firm to do the work. However, it has been our experience that many underwriting firms encourage (often insist) that their clients engage one of the Big Eight firms to examine the financial statements included in registration statements even though the company going public may have had a satisfactory relationship with a non-Big Eight accounting firm until that time. The capital markets of the world rely on financial statements which have been certified by independent accountants. These markets also recognize the integrity and independence of the Big Eight firms.

Because of potential liability under the 1933 Act, audit examinations performed in connection with an initial public offering are generally considered to be more than a low level of risk. Accordingly, this type of work is normally performed at standard billing rates; these engagements tend to be very profitable for the Big Eight firms. Also, certain accounting and auditing fees associated with an IPO are generally considered part of the cost of issuance and distribution of the securities (along with legal fees and expenses, printing, etc.) and are deducted from the proceeds of the offering. Because of this factor, this type of work tends not to be as fee sensitive as a recurring audit.

An aspect of M&A activity which has not yet been discussed in this paper is that mergers, acquisitions, restructurings and leveraged buy-outs (LBOs) very often spawn additional accounting and auditing work for the Big Eight firms. As business units are spun-off or sold to partially repay debt incurred as a result of the merger/acquisition/restructuring/LBO, Big Eight firms are often engaged to assist in "carve out" work, opine on historical financial statements of former divisions or subsidiaries, etc. Following the transaction, many of these spun-off or sold units retain the Big Eight firm to perform their annual financial statement examination.

Although no empirical data are currently available to us, we believe the combination of the effects of the IPO market and the positive impact of M&A activity have provided significant A&A fees for the Big Eight firms during the 1983-1987 period. The significant dollar increases in average A&A revenue per A&A partner and average dollar increase in A&A revenue for this period would also seem to dispel the notion that there is a shrinking A&A market for the Big Eight firms.

Improving the Attractiveness of Auditing as a Career

In part because of the concerns of current and potential auditing students which were noted earlier in this paper, Price Waterhouse made a commitment last year to improve the attractiveness of auditing as a career path, both in fact and in perception. We made this commitment to enable us to better compete in the broad marketplace for the best college graduates. The obvious first step—and, by comparison, the simplest one—was increasing the compensation for all professional staff, current and prospective, to a level comparable to other leading professional service firms and organizations seeking accounting and finance-trained graduates.

Raising compensation levels was a giant step for Price Waterhouse (as it would be for any of the other Big Eight firms). However, it was merely "catch up" when we compared ourselves to other alternatives open to graduates and as we realized how public accounting had not kept pace with contemporary pay scales. We believe it represented a fundamental first step in the right direction. It was costly, but the alternative—being non-competitive for quality people—was, in our view, not an option.

The task of defining and executing the next steps to raise the attractiveness of auditing as a career pursuit requires redoubling efforts in several areas. Some specific ones include:

- Providing information to high school guidance counselors about the nature and attractiveness of the accounting profession. As a practical matter, the profession does not have a vehicle such as *LA Law* or *St. Elsewhere* to provide the image of accountants and auditors as positive role models;
- Re-emphasizing to college administrators the importance of having talented A&A instructors at the university level to college administrators. In our view, academicians need to do a better job of attracting quality students to their A&A programs. The strong emphasis on research at some universities seems to have reduced the emphasis on teaching. We believe it is important that experienced instructors who are dynamic in the classroom teach at least some sections of "Principles of Accounting" as well as upper division electives;
- Fostering professional independence sooner in one's career;
- Providing early recognition to the best performers; and
- Loosening the lock step advancement policies evident in the Big Eight firms.

In addition, client expectations and today's business environment call for professionals who can be more than strict specialists or deep technical experts. Superior accounting and auditing skills alone are clearly insufficient. The situation calls for those who can acquire and apply a broader view of the world around them. These individuals must possess the ability to adapt, to grow, and to develop new skills over the span of their careers.

These are lofty goals which are somewhat long-term in nature. Three areas which we believe will improve the attractiveness of auditing as a career path over the short-term are (1) an emphasis on a risk-driven audit approach, which emphasizes understanding the business, risk assessment, and selection of responsive audit procedures; (2) the positive impact of technology on the audit process, and (3) increased use of audit professional assistants (i.e., paraprofessionals).

As previously stated, the first and most critical success factor to an audit engagement is understanding the business and its related risks. This represents a judgment-based approach proceeding "top-down" which directs the audit effort to the most challenging and risky areas. This is in contrast to the more traditional and mechanical "bottom-up" detailed approach. We believe the top-down approach is far more attractive to young professionals.

The effects of technology on the audit process should increase its attractiveness as a career pursuit. The effects are multiple and varied—just to name a few:

(1) microcomputers play an increasingly important part in the Big Eight audit practice. They have the ability to replace many manual and tedious computations;
(2) expert systems are being developed that will help to audit smarter and faster. Expert systems will also result in greater emphasis being placed on the auditor's analytical skills—the profession will need people who can interpret, analyze and intelligently question the output from such systems; and
(3) micro-mainframe links have the potential to significantly enhance audit efficiency in retrieving and analyzing client data. Again, auditors will be able to spend more time putting their analytical skills to work.

Professional assistants (PAs) perform various low-risk audit tasks as well as certain administrative functions. The audit tasks performed by PAs are those which require minimal or no knowledge of accounting and auditing theory and practice, and do not require the exercise of audit judgment. The tasks are objective in nature, requiring the PA to perform specific procedures which have specific results. Of course, to the extent PAs assist in the conduct of an audit, their use and work must comply with generally accepted auditing standards. The tasks typically performed by PAs have been performed by staff accountants in the past and were among those tasks viewed by prospective auditors as the most repetitive and uninteresting. Assignment of such tasks to PAs frees staff accountants for more challenging work.

The Effects of Competitive Pricing on the Big Eight

Recent articles in the accounting and auditing journals infer that severe price competition, characterized by "low-balling," may be coming to an end. We certainly hope so, but retain our professional skepticism.

To a great extent, we view competition as a healthy development—a challenge to be met. It wakes us up and strips away any aura of complacency that inhibits progress. Competition forces us to examine critically the market for our services and to ensure that services offered are fully in tune with market needs. Responding to real-world needs is what professional services are all about. In terms of delivery of services, we believe the most important aspect—and, unfortunately, the most difficult to manage and guarantee—is providing the highest quality people for each and every engagement.

Whether the audit is perceived as a commodity, or is identified as a highly differentiated service, will depend on the skill of the Big Eight firm in making explicit the benefits derived by the client from the engagement. While attention to style of work, commitments to the task, and similar qualities can, of course, differentiate an otherwise standard service, the breakthrough in perception requires something more.

What is required is establishing clearly how the audit contributes to the discipline of the total financial information system of the client. The proposals contained in our 1985 white paper, *Challenge and Opportunity for the Accounting Profession: Strengthening the Public's Confidence,* suggest the need to broaden the focus of the audit. For example, it is suggested that the auditor accept the responsibility to search for management fraud that might be material to the financial statements. In meeting this objective, expanding auditing standards are identified, including:

> Review and evaluate the system of management controls, including conducting an audit process to more adequately address the company's financial condition as well as its financial position. Such review and evaluation would be made without regard to the question of whether or not the auditor intends to rely on the system in developing audit tests. [Price Waterhouse, 1985, p. 19]

The point of this example is not to make a judgment about the proposal, but merely to illustrate a recommendation that is identifying a more sharply defined contribution that an audit might make to a client's overall effectiveness.

The integrity of the financial information system in any large organization is of critical importance to those who make company policy. No wise chief executive fails to appreciate what external auditors can contribute to the company. A wise chief executive officer is not going to opt for the cheapest, and possibly abbreviated, audit. Too much is at stake [Oliverio, 1986].

Peter Scanlon, chairman of Coopers & Lybrand, summed it up this way: "CPA firms that do audit work for low fees cannot sustain quality work. If a company only wants to pay peanuts, it may get monkeys looking at its business instead of thoughtful professionals." [Berton, 1985, p. 33]

Conclusion

The auditing segment of the Big Eight firms faces many challenges in the future, especially from the effects of competitive pricing. Despite these challenges, we believe that auditing continues to be a viable, desirable, and necessary business activity. Audits of publicly-held companies (and of those about to go public) are one of the keys to the confidence that investors place in the capital markets, both here in the US and internationally. Audits are a primary means of deterring fraudulent financial reporting. Auditing may or may not be the most profitable segment for the Big Eight firms but certainly generates significant revenue per partner and per professional staff. The A&A research and development work being done by the Big Eight firms (in areas such as microcomputers and audit methodologies) indicates that they believe auditing is a vibrant activity with a profitable future. Such investments would not be made in a declining business or "cash cow." We believe auditing remains a rewarding and challenging career path for those individuals choosing to pursue it.

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