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by
James S. Turley
Chairman, Ernst and Young LLP
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[Introductory note: James S. Turley is chairman of both Ernst & Young International and Ernst & Young United States. In 1977, he joined the audit staff of Ernst & Young (Houston), specializing in the energy industry, and was admitted to partnership in 1987. From 1987 to 1989, he served as national director of Client Services and Business Development. From 1994 to 1998, he was area managing partner for the Upper Midwest practice of Ernst &Young, and from 1998 to 2000, he was area managing partner for the company's metropolitan New York practice. In July 2000, Mr. Turley was named chairman-elect of the firm, effective July 1, 2001. His clients have included Archer Daniels Midland Company, Target Corporation, SBC Communications, and British Petroleum.

Mr. Turley earned both a bachelor's and a master's degree in accounting from Rice University.

It is a great pleasure to be here at the Emanuel Saxe Distinguished Lecture Series. I have to say it is an equally great pleasure to be here on the ground in New York. It has been about nine months since I was asked to take the chairmanship of our firm. Needless to say, it has been a whirlwind of activity. Ours is very much a relationship business, as I'm sure you know. I have invested a lot of my time during the transition period in making sure that we transition the relationships both externally with our clients, educators, and regulators and internally, to make this a very seamless issue. Over the last nine months I have been to most of our largest operations here in the U.S. I have made trips to Canada and Mexico. I have hit all the usual places in Europe: London, Paris, Berlin, Stockholm, Zurich; and some other interesting places: Tokyo, Moscow, Cape Town, and Marrakech. I just got back last night from a ten-day trip to Sydney and came back through India. So it is a great pleasure to be on the ground and not in an airplane.

Ernst and Young has a long history of supporting Baruch in many different ways. I was talking briefly beforehand with several members of the faculty and I think the college keeps track of more than 100 alumni that are part of our firm. I am quite confident that we have much closer to 200 Baruch alumni working with us today. We have also been very supportive financially of Baruch, as demonstrated by the new Ernst and Young classroom.

My remarks today address the separation of auditing and tax from the management consulting service and the implications for the profession. I thought I would go into that in three separate ways. First, by clarifying and talking about why we sold our IT consulting business; second, talk about our one-year experience since then; and third, pull out the crystal ball a little bit and speculate on the longer-term future.

Why did Ernst and Young sell our consultancy? I think you have to look back to the history of our firm. We have been a firm of first movers time and time again. We started the consolidation of the Big Eight, when old Arthur Young and old Ernst & Whinney came together. We were the first firm to split our tax compliance and our tax consulting business because these two businesses are very different. We were the first firm to make an industry acquisition -- EYKL -- a boutique, real estate shop and great accountants. We were the first firm to build a sales culture through the organization. The first firm to be publicly recognized for building a knowledge-sharing culture. And then we became the first to sell our IT consulting business.

The reasons behind that sale are different from what most people think. We sold the business to Cap Gemini for very solid business reasons, not because of regulatory issues. Many people say this had to be a regulatory play, but it wasn't. Our view of the IT consulting business is that it has to be very global, with end-to-end capabilities on the ground everywhere in the world, to deliver the kind of IT service that the Fortune 500 companies need. Ernst and Young had a great IT practice here in the United States and was rapidly building strong European and Asian resources. The Cap Gemini transaction was really a merger that formed a global IT consulting powerhouse that is second to no one in the industry. So global strength was business issue number one. Issue number two was the fact that access to capital is critical to make the business grow -- capital to fund technical solutions, capital to fund very long-term, large-scale projects. Partnerships can't offer that; public companies like Cap Gemini can.

The third issue was making sure that our consultants could enter into projects without any detriment to auditor independence. In this industry, companies and IT consulting firms need to be able to create joint ventures to fully leverage relationships with vendors and customers. Frankly, these relationships often end up providing independence problems to the audit practice since you can't "own" or participate in any company that you also audit.

Clearly not everyone agrees with our assessment. You have seen KPMG take their business and sell it in an IPO. You have seen PricewaterhouseCoopers announce the sale of their consulting business and then have the deal fall apart because of the value shrinkage. But others are looking at the same set of facts and reaching different conclusions. This is very beneficial for the industry and for the marketplace.

We are absolutely delighted that we wound up selling our business. We sold it at a high value point and it is something that we all take great pride in. But again, this was business-driven, not regulatory-driven.

So what has happened in the twelve months or so since we sold that business? It has been a very, very remarkable time because what we have seen is an unprecedented amount of change, an unprecedented amount of activity in the auditing market. More big companies changed auditors in the last twelve months than anyone can recall in any other twelve-month period in history. And Ernst and Young has been incredibly successful with these changes. We wound up winning far more than our share: Société Générale in France, NEC in Japan, Olivetti in Italy, many companies in the States-Compaq, Hewlett Packard, Verizon, big names. *The Public Accountant Report*, an industry publication that many of you have probably seen, tracks this and reported that in the year 2000 -- the year after we announced the sale of our consulting 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 consulting 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.

The important thing in the last year is not that we have had a pretty good time. The important thing is what the market is saying and what the clients are saying. I have talked to many of them and this is what I hear, because I think it is descriptive of where the profession is going: First, you have to be global or you are dead. One of the things that became clear is that if you don't have the global capabilities to serve these leading companies, you will lose in the marketplace. You will never have the scale we need. You will never develop the specialty services we need that are so important, not just to meet the clients' needs, but to excite the people as well. So, global reach is key.

It is also true that with today's technological environment, small companies can go global like that, simply with a click-not of your fingers, but with a mouse. So global issues are impacting our profession dramatically and it causes a lot of different concerns. The first one, one that everybody seems to talk about most, is structure. Structure is important. And we have a great structure within our firm. More important than structure are mindset, processes, technologies, and approaches.

We must have a firm that has a multi-cultural mindset. It sounds funny to say that here at Baruch, the ultimate multi-cultural college. We have to have a firm that has the same mindset that you have at this college. We have to invest heavily in mobility for our partners and staff. Many people don't want to live and work in the same cities their whole lives. They are looking for more experiences. Not just our own people, but the clients want experienced people who have seen other things. So we are investigating heavily in making sure that our people have the opportunity to experience different cultures, different countries, different ways of life. It is something, in retrospect, I wish I had done early in my career-lived overseas. I think that is a great experience. We have to invest our own time and the time of the people being on the ground. That is why I have been all over the world in the last nine months. It is not easy, but it is something that we have to do. Only by being global, only by really living, do we end up winning.

Let me tell you a quick story that will hopefully make some of this come alive. We heard from Compaq on a Thursday that we had an opportunity to propose on their worldwide audit work. We had our first meeting in Houston, Texas, their home base, the following Wednesday. In that six-day period, we mobilized the firm, we identified the key resources with technology background all around Compaq's key locations. We went to the first meeting in Houston with seventeen partners from all over the globe. The next day, one of our competitors -- I won't say who -- showed up for their first meeting with a handful of local people. They had just as good of a chance, if not better, to win this account. I am convinced that we won that account from day one, when Compaq saw the depth of our resources globally and how we could make it come alive for them.

So, the market is saying to be global. Two, listen to the clients, listen to the market. We need to be a firm in which client service is celebrated over everything as the pinnacle of success. It's a heck of a lot more important than being an overhead guy like me. We have to have fewer overhead guys. And those that we have must be deeply connected with our clients. So we really have to listen to what the clients are saying in a time when the whole world is changing and pushing everybody internally.

Three, the clients are saving, "Understand who you are and focus around a common base of knowledge," if you will. What we are today is a firm, as I said earlier, of audit-related services, tax-related services, corporate finance-related services, and, where it is permissible, legal-related services. If you think about those four service lines, they all revolve around the same knowledge base: financial, transactional, and risk knowledge. All four businesses circle around and use the same knowledge language. Being very together and seamless in serving clients is a very strong proposition. Their needs are not single-dimensional; they are all multi-dimensional. We have to be very focused around knowledge. That means if there is a business that capitalizes on the same financial and transactional knowledge, then we really ought to think about being in that business. If there is a business that uses a whole different knowledge universe, we really ought to ask ourselves why go in that direction? As much as anything, that is why we chose to sell consulting. If you think about the big IT system, development and installation, it is a different knowledge universe than finance and transaction. So, the third issue is knowledge.

Fourth, and most important really, is your people. You'd better win the war for talent because it is truly a war. The demographics are terrible in our industry; you are seeing it as much as we are. We have a need for a lot more educated, qualified people than we have. It seems we are heading into a decline over the next decade before it comes back. So being in a firm that really puts its people first is critical to winning in the long term. It's very interesting when you are talking about culture change, mindset change, where every decision the firm makes factors more into the impact on people collectively than on each person individually. That is a very different mindset from how most of us operated before. Talk to some consultants that study the Big Five and they say, by and large, the culture is first, clients second. What we are really going to change is being a people-first culture.

What does that mean? First, I'll tell you what it doesn't mean. It doesn't mean that everyone's wishes are going to automatically come true tomorrow. It doesn't mean that everybody is going to sit on the beach all day long and still be employed by our firm. What it does mean is we are going to think, as I said earlier, first about the impact on people. I will give you an example. All of the Big Five have processes surrounding client continuance. We think very, very carefully abut whom we are going to do business with when clients want to hire us. What many people don't know is we also think just as seriously about whether we want to continue working with these clients. In the past, that decision was almost automatic. You figure out the risk that this client provides to our firm and if it offsets what they pay us. None of the firms ever thought about the impact of having client-oriented people. Do our people like to work on this account? Are people learning anything from working on this? So we really need to change even the most basic process in terms of factoring in what our people are thinking - managers and senior managers throughout the practice.

What they are saying is that putting people first is number one in keeping the high-performance culture that is so central to our firm and to our industry. Also, building a culture where your ideas count, your opinions are sought out and making that come alive in a very real, hands-on way. The other thing, and it is very clear, is that it isn't going to happen from the center. This is something, like any cultural change, that has to happen on the ground and everywhere we do business. So I think it is really critical that you will see firms like ours taking a lead in that, winning the war for talent, everywhere that we do business. These are the four key factors. The market is saying very clearly: be global, listen to them, focus around knowledge, and win the war with people. Those are this year's themes, if you will.

Where are we going from here? First, let me talk about a couple of things I don't think will change. There has been some speculation that firms like ours that sold consulting will lose their war because we sold the "sexy" part of the business. I have to tell you that our tax-related businesses and the other service lines are growing just as quickly, if not faster, than the IT consulting business. Second, the reason we haven't seen any difficulty in recruiting is that the knowledge basis and skills of the IT people that we used to hire are very different from those of the accounting and finance and transaction people we're looking at today. The second thing that won't happen is that the quality of offers will not go down. We were very careful to keep every specialty skill that we need to effectively conduct business. That is IT risk, IT security, privacy, a whole bunch of e-commerce orientation -- all of the things that you can think of. We sold big systems installation, but we kept the IT resources we need in the firm to effectively do our audit work.

So what *will* change? I think one thing that will change is the focus. You will see a whole lot more focus around the specialty areas. That means they are going to be innovated greatly, they will all be enabled to look for efficient plays on services that are very cost-driven. That could mean lumping processing centers, perhaps even offshore. There are going to be any number of changes as they relate to the core. You are going to see the core service lines really enhanced. The second thing you will see is more focus around the total client account. You will see firms look at each account as a market, because everything we do is focused around the same knowledge. It is much, much easier to integrate at the account level now because we are all speaking the same language.

I think, over time, independence issues will continue to evolve. Right now we have a lot of openings at the SEC. We don't have a chairman, so we have to get the new SEC in place. The way I see the independence issue, client management will make these decisions as much as the rules will. So, the practice will evolve and determine what is really going to happen as it relates to independence and what service firms like ours will deliver. I do think that in general there is a slow trend toward the audit channel constricting slightly. I don't see it constricting dramatically. I think you will see ourselves and other firms looking hard at building account-based relationships that will, for lack of a better term, be "channel two" accounts. I think that, in my lifetime, the legal services business might be a big business for our firm worldwide. We have a real conflict today. The multi-disciplinary rules and the SEC's independence rules tend to be restrictive, but the clients are saying there is great power and value in having these services in the same shop.

There is always discussion at times like this and in sessions like this about consolidation in the industry. Will we see further mergers? Will we move from the Big Five to the Big Four or the Big Three? While an argument could be made that it could be good, I think the regulatory environment today is very negative on that - particularly in Europe. I think the prospects of further consolidation of the Big Five are slim in the near term.

I think, finally, the firm that can dedicate itself to being in the business of building skills and resumes and careers for the people is going to win. The one that can do that the fastest-across cultures and across generations-is going to be the big winner. With that, let us get into questions. What is on your mind?

Q & A

Q. You said something about audit channels constricting channel two clients. Was there a suggestion that auditing services will no longer be the primary service to be offered by your firm and other firms?

A. Let me elaborate on that. If you look at a firm like ours today, let's say theoretically that 75 percent of our revenue comes from companies we audit. Now, this is not all audit revenue; we do audit work for them, we do tax work for them, we do some other work for them periodically. Let's say 75 percent of our firm's revenue comes from audit clients, and 25 percent from clients that someone else audits. I think over time you will see the percentage of revenue from the audit channel, channel one, going down, because the non-audit channel-our firm and firms like us selling tax services, corporate finance services, internal audit services, due diligence corporate finance services to other firms' audit clients-is going to grow very rapidly.

Q. Could you sell internal audit services or seek to sell them to a client where you are the external auditor?

A. Well, the answer before the new rule came out was certainly yes. Because we've had some very large relationships that were joint internal/external audits, where we did both the internal and external. The new rule limits to 40 percent the internal audit effort, the amount that an external auditor can provide. If we are the external auditor for Company X and they have internal auditing activities, we can only support them with 40 percent of their internal auditing activities. There was a lot of discussion with the Commission about whether this should be banned or whether it should be encouraged. The reason for the compromise was because there are a lot of skills in IT auditing, IT risk profiling, business process risk issues, and business process control issues that Corporate America can't keep internally because there is not enough demand to have it on staff full time. So the 40 percent was a negotiated solution that wound up giving companies the ability to selectively team with their auditor but not fully outsource to their auditor.