New global realities and their impact on the accounting profession;

Edward A. Kangas
It's great to come back here. Back east we don't have a sky like this. You can't see the clouds on the horizon because you can't see the horizon. It's different. I remember so many things about my days at KU, five of the best years of my life. Some of the people here helped me get to where I am, and a lot of faculty members such as John Tollefson, Joe Pichler, John Blocker, Howard Stettler, Arno Knapper, and a bunch of others were very important to me. I learned a lot of things here about business, accounting and finance, but I learned a lot more about things that I have reflected on with my colleagues a number of times: The importance of communication and the ability to write. Leadership is a team sport. Sometimes in life, in business and life, taking the trip is more important than the destination. I learned about the power of consensus. I learned the fact that in many organizations power flows up, not down. I don't know if I would have learned all this any other place, so I have very special feelings about this University. So I thank you for being here.

My purpose is to talk about one of my favorite topics: the accounting profession. I am not going to talk about auditing because there are too many people here that know more about auditing than I do. But I am going to talk about auditing firms, and some things that I call the new global realities that have impacted our firms, our markets, our clients, causing us to rethink the way we are organized, what we do, how we do it, and what we are all about. I've identified fourteen or so, such realities, just by simply reflecting back on what it is that I have watched happen in the last ten years for sure, but maybe for the last three, four, or five as they became more intense. Let me start. I'll go through them quickly.

Individually, I think you're going to find that none of these are earth shattering, and I doubt that I am going to tell you very many things that you don't know. If you take them together, however, and paint the mosaic of what has confronted the profession, and especially the big international, multi-national accounting firms, I think you may get a sense of just how much buffeting, or

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1This paper is an audio transcript of the keynote speech delivered by Ed Kangas at the symposium.

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as John [Tollefson] would say, just how much whitewater, these firms have been through, and what we are still facing over the course of the next four or five years.

First new reality: The world is balanced. In the mid 1800s the sun never set on the British Empire. The world was centered in London. After World War II, the world was clearly centered politically in Washington and financially in New York. We Americans for many years believed that that's what the world was about. In fact, when we talked about auditing or talked about auditing firms, they really were U.S. firms with overseas branches. We never wanted to say it, but that's the way many behaved. Well, things have changed. A new sun is rising in the Asian Pacific. Tokyo and the Japanese are a powerful economical and political force, with growing strength in Korea and Taiwan and all through the Asian Pacific. Europe is gaining strength with its consolidation and its economy in general. So today we have a very, very balanced world, both politically and economically.

Number two: Specialization. We have talked about specialization for years, but it has come home to roost in the auditing firms. It used to be that everyone wanted to be a generalist. Then we went through a phase in most of the big firms that we focused on industry practice. Well, it's gone a step further than that. Today, if you want, for instance, to focus on health care, you don't just focus on health care. You often have to have expertise in managed care, or HMOs, or some subset of health care. Today you don't just specialize in financial institutions or financial industries. You don't even focus simply in securities. You may have to become an expert in the unit investment trust. The degree of specialization that is driving the firms, especially the larger firms, is significant and is going to continue. It has its advantages. The market demands it. Therefore, it is easier to sell services. The services are probably more efficient when done by specialists and people that focus on them. The quality tends to go up and as a result of the efficiency associated with it and the value, that determines higher prices, you are more efficient and make more profits. The drive toward specialization is significant, but it flies somewhat in the face of what the young people joining the profession want to do with their careers.

Number three: Technology. I won't dwell long here; most of you are very familiar with the advancements. The impact of technology at our clients and how they do business and the way the firms go about using technology to audit is still in what I call the embryonic stages. In the next five years we will see a major, major change in the way the major firms use technology in the conduct of their auditing business.

Number four: The world is becoming seamless. We are clearly not there yet, but the signs are there. Just think about Europe 1992. They may not do all they set out to do, but they will make strides. Barriers will come down, as with the U.S.-Canadian trade pact, and in the Eastern European countries. There's constant pressure to remove trade barriers with Japan. The movement of the trend is clear. The world from the business and financial trading perspective will become more seamless as time goes by.

Number five: Globalization of the big multinationals. Ten years ago companies really weren't multinational companies. They were huge. They had
primary headquarters in the U.S. or the U.K., or wherever they were, and they had overseas branches and subsidiaries. Generally, the overseas branches operated as self-contained companies with their own manufacturing, distribution, marketing, accounting, etc. systems. As a result of that, companies could have the same auditor worldwide, or they could have different auditors in different countries. It was up to them. Well, the world has changed in the last three years, maybe four. It's changed primarily because of telecommunications and computers. Today it's possible for the big multinational companies, if they so choose, to operate in truly one global enterprise. They may design their product in Germany, buy raw materials in Brazil, manufacture in Mexico, distribute all around the world, get their debt financing in London and their equity financing in New York. They behave as one intertwined ball of yarn, all driven by on-line computer and telecommunication systems that have in fact allowed them to operate as one entity.

Number six: Global financial markets are driving global financial reporting standards and the globalization of these big multi-nationals is driving global audits. More and more companies in fact cannot have audits done by one auditor in one country and even refer to another. In fact, the audits have to be conducted more and more as one global audit led by one globalized engagement partner as one engagement on a consolidated basis.

Number seven: The U.S. today is a tax haven. Our tax rates are incredibly low compared to the rest of the world. The dollar is relatively low in relationship to the value of other currencies. Our assets and operating businesses are bargains. What's more, this is a politically stable country.

Number eight: The world has been, for the past eight or nine years and probably well into the future, awash with money. There is more money chasing fewer deals than probably any time in the last fifty years.

Number nine: Direct foreign investment is significant and it will continue. I predict that domestic takeover activity, while at a bit of a lull now with the demise of junk bonds as a preferred source of financing, will come back. Not like it was in its heyday, but it is already strengthening and we've seen it in the last 60 to 90 days. And direct foreign investment has continued, not quite at the same pace, but the amount of money coming from Japan, from the Asian Pacific, from the UK, from the Netherlands and France, is significant and it will continue. In many ways we've had the largest change in equity ownership in American business than at any time since the Great Depression. That probably will continue.

Number ten: The firms, as they look at where growth is going to come from, are finding the greatest opportunities for audit growth do not exist in the U.S. They exist in Europe, they exist in Japan, and the Asian Pacific. Take all the major Fortune 1,000 or equivalent companies from various parts of the world, 95 percent of them will be audited by the Big Six firms here in the U.S. In Europe the number is only 70 percent and in the Asian Pacific, it's only running 65 percent. The opportunities for new and merging multi-nationals and the opportunities for growth are in Europe and the Asian Pacific more than they are in the United States.

Number eleven: Auditing is becoming more important, not less important at this stage in time. There was a period of time during the late 70s when I
was, when probably a lot of us were, a little distraught, because I believed
that auditing was in fact declining in its importance, somewhat driven by the
competitive behavior of the profession, and it was becoming too much of a
commodity. That has reversed. The last two, three, or four years auditing has
become more important for a whole variety of reasons.

Number twelve: The Big Six accounting firms, and many others, today
in fact are consulting firms. At Deloitte & Touche we have revenues of ap-
proximately two billion dollars a year in the United States. Our recurring audit
and recurring tax business, out of that two billion dollars, is only eight hun-
dred million dollars. That doesn't mean it's all management consulting. In
fact, there is four hundred million dollars of special auditing type consulting
work that goes on within the auditing division. There is three hundred mil-
lion dollars of tax consulting going on out of the tax division, and then there
is five hundred million dollars of management, actuarial and other types of
consulting going on out of the various consulting divisions. What that says
is that as a firm, it's eight hundred million dollars of base, recurring work,
four hundred million of audit consulting, three hundred of tax consulting and
five hundred of management and related consulting. The realities are that
we are a consulting firm with less than half of our volume today coming from
recurring business.

What is all that consulting? Lots of debate swirl around what it is. I'm going
to give you a list from our firm, which is not too different from most of the
other firms. What is common about these businesses? Think as I run through
these and I will tell you my conclusions at the end, which also might say some-
thing about why there is so much demand for these services.

We do merger and acquisitions, LBOs, capital market service related
consulting. A lot of due diligence type of activity, a lot of tax structuring, a lot
of takeover defense work. Litigation support, forensic accounting, special in-
vestigations, bankruptcy consulting and auditing, restructuring. There's a lot
of business in companies like Texaco and LTV and Storage Technology,
Eastern Airlines and Continental, etc.. Liquidation work. Actuarial and ben-
efits consulting. Valuation and appraisal type work. Hard assets, soft assets,
valuing businesses or assets for tax reasons, borrowing reasons, or in cer-
tain cases, buy and sell reasons. Restructuring, financial restructuring, big
companies using accountants for significant work. Places like Kroger and Kraft
and Mason's that we have been involved with. Legislative assistance in Wash-
ington, especially on the tax side. Government contract consulting and re-
lated cost accounting services. Utility rate consultations, business interruption
type consulting. A couple of examples: Exxon has their refinery destroyed
in St. Croix by the hurricane, the Stouffer's Hotel was destroyed by the hur-
ricane in St. Thomas. There is accounting related business, interruption
claim consulting to be done. Information technology and computer consult-
ing. Advanced manufacturing systems. Strategy work, in our firm through a
division we call Braxton.

What is in common about those businesses? Many people worry about
the far flung consulting activities of the accounting firms. I don't see it that
way. The businesses that have prospered when the demand is there – and it
has almost been pulled out of our firm – have four characteristics. They
have, as a root, a requirement for objectivity, which is akin to independence. They are fact or data driven. They are opinion related in terms of offering consultation or advice. And four, they require highly educated, specialized professionals, which says typically these things are not business services, they are professional services.

In fact, these businesses very naturally and normally fit under the umbrella of what the profession has traditionally done in its base service of auditing. The place where the Big Six firms have prospered, and I believe the profession will continue, is when services are required by businesses or by government that fall back on those fundamental principles of objectivity, fact driven, data driven, advice or opinion or consulting related, and they require highly specialized professionals. When all four are present, there is value added to those services coming out of the Big Six firms. Those consulting businesses will grow, and not so much because the firms decided to do it. Frankly, accounting firms are not that well managed and not great marketers. The market has demanded and wrung these services out of these firms naturally and progressively.

Number thirteen: More and more is being expected of accountants and auditors. There are natural expectations in what we do. Sometimes misunderstandings occur, but expectations of the smart, bright lay person are there. The courts add to that their findings and what they hold the accountants responsible for. Politicians get in the act, regulators get in the act, and, interestingly, the constant examination of competence in these consultive arenas, in fact, builds confidence in what these firms can do and it adds even more to what the expectations are of the firm in its auditing role.

Number fourteen: The firms and the services they deliver are more and more collaborative. More of the work that is provided is done by people out of the different functions. You don’t see as many pure tax projects, or audit projects, or management consulting projects, or actuarial consulting projects. What we’re finding more and more of is a collection of specialists out of various divisions being applied to projects. One of the big requirements of doing that well is that those specialists have an appreciation and understanding of the other disciplines that they are working with.

You might say, “There are fourteen new realities; so what?” I am going to boil them down to three broad categories. For once and for real, globalization of the big companies. Not only specialization, but sub-specialization is being demanded by the market. And a growing expectation from the profession in terms of what it must do.

Those three things have caused two big things to happen to management as they wrestle with any firm. One is, it has changed our definition of critical mass. Critical mass is a notion that says an office has to be of a certain size, a department has to be of a certain size, for the human resource dynamics, recruiting, development, training, the capacity to build presence, the impact of marketing, and building a reputation – you have to be so big. When we were a general practice there was a definition of critical mass. But as we started to subdivide in specialized and sub-specialized areas, the critical mass factor for those became almost as large as what we thought of as our general practice. As a result, in order to build that specialization and have enough busi-
ness in that specialization, the practices had to be bigger and hence the definition of critical mass grows.

Secondly, the issue of globalization. Specialization expectations have driven us to raise what we viewed to be the standard of adequate capability to serve in many countries throughout the world. We could get away until maybe two or three years ago with having weakness in Brazil or Taiwan or Malaysia or France or Sweden or pick your country. We had to have presence, but frankly, because we tended to do referred audits, we could sort of send someone there to double check it. Or if you needed to, frankly, you could have another Big Six firm or local firm do your work in a given country. As these enterprises have become truly global enterprises, that is no longer adequate because you have to audit them worldwide as one entity, which raised the requirement to have consistent quality every place in the world. And in many of the middle size and smaller countries, there were not eight or nine or ten high quality accounting firms.

It's pretty obvious what that did. It drove mergers, especially among some of the smaller of the Big Eight firms, to the place where today we have a whole new order in the profession in terms of the size and critical mass. I believe these trends will continue and would, in fact, draw more mergers, except for the Justice Department isn't going to allow it. Jim Rill, the head of the Antitrust Department, and I flew together recently between New York and Washington. I had some controversial and testy debates with Jim prior to our current merger being approved. On this trip, we had a very friendly chat, and he said as long as the Bush administration is here there won't be any more mergers among the Big Six, and may not be any mergers from the second tier into the Big Six. He also said, if Bush gets thrown out by the Democrats, I think they'll like big business even less than the Republicans. So, I would guess that the order of the major firms is going to be where it is at least probably for the next ten years.

Let me talk about one last new reality, which, frankly, you probably understand better than I do. That is that young people have changed. I look at the people we have hired today and they are different. They are different from what I was. I still think of myself as a little kid. It just isn't true. They, as a general rule, are smarter, they have broader experience than most of the people we were hiring twenty or thirty years ago, they've traveled more, they've had more experiences. They have grown up in an economy that has allowed most of them to be able to afford to do things many of us were not able to do. They generally have a broader education, not necessarily in terms of the classroom, but in terms of what they seem to have experienced at the time they join one of the firms.

I might digress here and give you a comment or two. That is, all of you are wrestling with the 150-hour program and what that will mean on your individual campus. You know the Big Six firms are generally supportive of that. We have put money and people behind it in terms of the AAA (American Accounting Association) and the AECC (Accounting Education Change Commission) and the projects that are going on there. I would tell you, and I guess you would hear this from other leaders of the big firms, two things. Don't just give them more accounting. Remember the comment I made about the
fact that we now have more collaborative teams – actuaries, auditors, accountants, systems people, tax people, working on teams. One of the biggest problems we have is that we have too few people who understand enough about the other disciplines that they are required to team up with. It’s absolutely critical. If the 150-hour program results in simply more accounting and auditing, and students who are better prepared to take the CPA exam, we will have failed. In fact, I will tell you that I believe there will be a crisis point in the late 90s when the number of students declines. We know that’s going to happen – they’ve all been born. The numbers will decline, and I believe we will have trouble attracting them to accounting programs. I believe when they trade off a five year education and the cost and time of that versus other four year programs, we might double it on the downwards side.

If the accounting profession finds the 150-hour education to be truly valuable, you will find the profession will hang tough. If the leaders of the major firms and others finds the 150-hour program is not doing anything for them, I believe you will find such a huge problem on the part of the profession to hire enough people, they will reverse fields on you. And, you will have big problems; you will have a curriculum in place that the profession will not support. It would be a shame if that happens. This issue around accounting education is very, very serious. The firms will put more money behind it, but it is going to be a partnership that the profession and the faculty are going to have to work on and take very, very seriously. For those people who are inclined to say let’s take what we’ve got without changing it much and add another year of the same, you’re playing with fire. Don’t do it.

I’ll switch back to young people. They are smarter, more broadly experienced, better educated. Those thoughts are probably not so earthshattering. The things that are really different is that they are more independent. They are recalcitrant at times. They value freedom intensely. They are more egalitarian than I remember being. They are less class-oriented. They are very impatient. They are less impressed with things. It used to be you’d take a young person entering business and say “He or she is a partner” and they would go “Wow!” Now they say, “Yeah, they’re getting kind of old, aren’t they?” They are not that impressed with things. They are less inclined to accept the notion of apprenticeship. They absolutely want, have a burning desire, to contribute to the organization they join from the day they walk in the door off campus. They do not want to sit on the bench. They want to get on the playing field from the day they sign up. They hate and reject control as a legitimate approach to managing.

We as accountants are not very well suited to this new reality. Most of us went to school and learned about double entry bookkeeping, and that debits had to equal credits. Many of you took a course in something like controllership. We then learned about auditing and the standards of auditing. We got out of school, we studied, we passed the CPA Exam. We got burned by a few clients that didn’t have the kind of integrity we would want. We learned to doubt. We learned to be skeptical. We learned to double check. We got our first management job somewhere five, six, seven years into our careers, and what was our natural tendency, especially in tough times, to do? Control things.
My partners say you can't let the staff vote. I say they vote differently. They don't vote with their hands; they vote with their feet and walk right out the door. The turnover rates in the profession in the last four or five years have gone sky high. It's a very big new reality that impacts how we will do business, how we will organize ourselves, and how we manage. I have the sense that all the big firms will compete reasonably effectively in the market place for clients, with technology, industry, practice, technical excellence, etc. I think that perhaps the firms that are able to deal with these young renaissance people most effectively and, in fact, modify or eliminate the natural desire to use control as a legitimate management approach, may find the real secret to gaining and sustaining a competitive advantage.

Let me wrap up. New realities: Balanced world; globalization of our clients; sub-specializations of specializations; demand for consulting services; foreign investment; merger and acquisitions; LBOs; increasing expectations; a re-definition of critical mass primarily driven by the need to specialize; a requirement, a demand for consistent worldwide service capability; a restructuring of the profession through mergers and other factors, and a group of renaissance young people. These things are causing us as big firms to readdress who we are, what we do, how we are organized, how we lead, and how we manage. The last three or four years have been fascinating. The next five years will be like having the opportunity of a lifetime to try to figure out how to do something better than anyone else in a time when, in fact, management and organization and what we do and how we do it are critical to success, and, perhaps, building a sustained competitive advantage. It is a very, very vibrant time.

I sit back at times and look at our business and the big firms, which is my perspective. We are very fortunate to live in a free enterprise, capitalistic society. The public accounting profession and its role in facilitating and lubricating financial markets is very, very important. It's exciting and challenging. I am personally having a ball. I enjoyed sharing some of these perspectives. They certainly weren't very technical, but I hope they have some value to you as you wrestle with some of these issues as we go on with the symposium. Deloitte and Touche is delighted to be associated with this program. It has emerged and is continuing to emerge as one of the finest auditing symposiums of this type in the country. We're delighted to make a long-term commitment to be part of it. I thank you for inviting me back here. Thank you.