The Maturity Institute

Auditing the "Big 4" Accounting Firms – Preliminary Report

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'A corrupted financial system with a state aided, global cartel fostering mistrust, exhibiting obsolescence and damaging Total Stakeholder Value – all in plain sight.'

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About Maturity Institute (MI)

MI provides a unique, evidence based approach to organizational health and the creation of Total Stakeholder Value and has created a new, revolutionary approach to organizational health by raising global standards of professionalism in organizational leadership and management practice. Our OM30 diagnostic instrument enables measurement and improvement of Total Stakeholder Value (TSV) created by organizations and provides ratings on OMINDEX: a comparative scale from D to AAA. Our work is multi-disciplinary and uses a whole system perspective, aiming to adopt the same level of evidence-based decision making to be found within the medical profession for human health.

The Maturity Institute **is an independent, not for profit, professional body with a separate operating company limited by guarantee, HR Maturity Limited, to manage its finances, operations and administration.** HR Maturity Limited **is a not-for-**profit company limited by guarantee and is incorporated in the UK (Company number 08478762, VAT registration 159 5300 05).

Executive summary

OMINDEX: Big 4		
	OMR	**Risk Factor**
Deloitte	BB	52.68%
EY	BB-	55.93%
PwC	BB-	56.49%
KPMG	B+	58.86%

1. Each firm has an Organizational Maturity Rating (OMR) at or below "*Junk*" grade reflecting material value loss arising in Total Stakeholder Value terms (see 9 below).

2. The Big 4 all provide evidence of an underlying purpose primarily focused on revenue growth via client service expansion (breadth and depth) creating an inherent conflict with their fundamental purpose of system assurance and compliance.

3. OMINDEX Risk Factor levels range from 52.68% to 58.86%. This means that value loss and risk probability is severe, with high materiality. We expect audit failures to remain at current levels with the possibility of extreme cases arising. In short, all are carrying significant risk as the causal factors inherent within Arthur Andersen at the time of the Enron scandal continue to exist in each firm today.

4. We see little evidence of effective risk management with inadequate understanding and capability to monitor governance, cultural and human capital risk factors. This applies to both external audit services, which are not fit for purpose in this respect, and internal risk control systems within each individual firm.

5. 'Outsourcing social purpose' is defined as employees seeking an outlet for their innate social conscience outside their employer's activities. This is a common and significant CSR narrative found throughout the Big 4's annual reports. Certain activities are tagged as 'social' (e.g. volunteering hours, charitable donations or providing discounted fees for services to social impact businesses). This 'outsourcing' is a clear indication that the core business model itself is neither societal in nature nor reconciled and integrated with its business model.

6. There is little explicit acknowledgement that the primary societal benefit of each firm is audit assurance and only one firm articulated that its client advisory work should create societal value. No firm evidenced any aim of managing towards zero audit failure. Compare and contrast this track record with the airline industry or MI exemplar Toyota; who aim for zero defects for c.10m cars manufactured annually.

7. Value creation within professional services are bound to arise directly from the efforts of their human capital yet none of the Big 4 met MI's global standard for value management systems. In fact, since Deloitte's 2015 abandonment of its existing performance management processes, each firm continues to demonstrate a poor understanding of how to systemically link their people to value outcomes.

8. The Big 4 are more of a fragmented, 'franchise' of individual firms than their branding portrays to external stakeholders. Such fragmentation militates against the highest assurance standards being applied consistently. This requires the development and management of a cohesive, strong, healthy culture to promote trust based compliance. The present arrangements actually undermine any impression of market dominance being justified by a cohesive market.

9. Inadequate human value management systems are coupled with business models that encourage the erosion of Total Stakeholder Value (TSV) – see figure below. For example, much tax advisory is arguably a 'zero sum game', made negative by Big 4 fees, thus reducing Total Stakeholder Value. Our view is that total TSV loss among the Big 4 is in the magnitude of tens of billions ($) on an annual basis.

10. The Big 4 has sought to influence global regulatory bodies such as the UK FRC[1] and the wider system network has become complicit in lowering audit quality standards and placing partner interests above all other stakeholders.

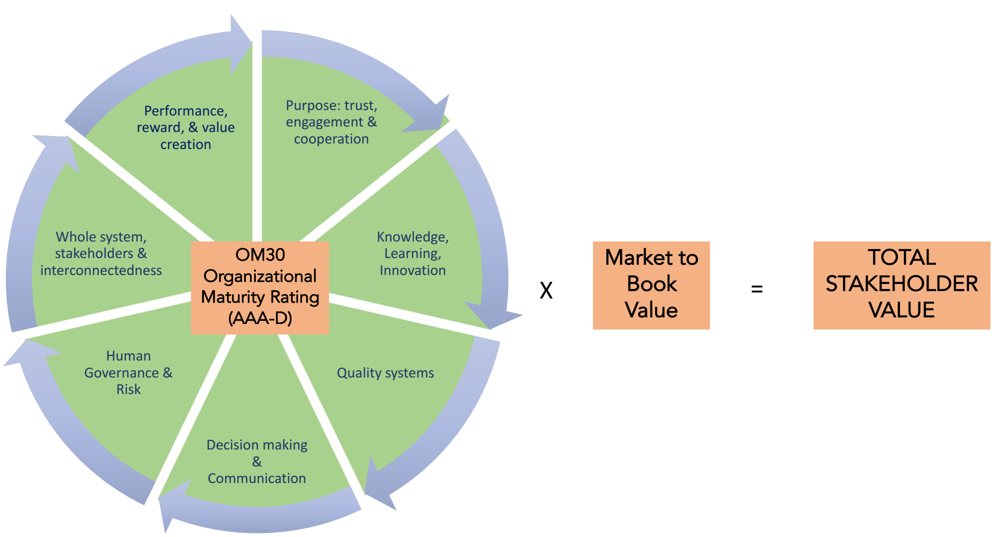

Figure 1. Total Stakeholder Value (TSV) measures the value of the whole system from a societal perspective

[1] https://www.thetimes.co.uk/article/the-financial-reporting-council-a-watchdog-that-doesn-t-bite-ltqrjdh2k

The Big 4 in numbers (all FY2017 except KPMG FY2016)

	Total Revenues $billion	Assurance/audit $billion	Tax $billion	Advisory $billion	Employees
Deloitte	38.80	c.9	c.7	c.22	263,900
EY	31.40	11.63	8.17	11.58	247,570
KPMG	25.42	10.17	5.56	9.74	189,000
PwC	35.26	15.96	9.46	12.25	236,235

MI's Purpose & Method

MI was established in 2012 as the first, global, professional institute to develop a whole system, analytical methodology for ensuring all organizations are enabled to create as much societal value as possible: measured as Total Stakeholder Value (TSV).

The evidence base to produce this score is collected by MI's OMINDEX of organizational maturity. OMINDEX is a global index that provides a picture of how well the capitalist system is working for the benefit of the whole of society. MI is developing a new generation of professionals who are able to analyse maturity levels and offer simple solutions to resolve many of the world's most pressing problems.

MI's whole system, maturity analysis of the global auditing system

The purpose of a global finance system is to provide the world with the finances it needs to run the global economy; providing as much value as possible from the world's resources. The purpose of the auditing system is to assure that the financial system is working effectively. MI's preliminary, first pass, analysis of the Big 4 is captured in their relative OMINDEX ratings.

Deloitte, EY, KPMG and PwC have the lion's share of revenues from the global, financial auditing system. This fact alone would not have earned them the soubriquet, 'Big 4'. It is their size and shared culture that are now widely recognized as representing a force that has become too big to tame. If the Big 4's shared goal was the maximization of TSV then society would have little to fear.

Unfortunately, the overwhelming evidence from MI's preliminary audit paints a picture of a cartel-like group supported by other key actors; such as the clients who pay for their assurance and the regulators who offer tacit approval. There is endemic mistrust of the Big 4's motives and the accounting and audit professions, themselves, openly admit (in the form of the Integrated Reporting Council and bodies such as the Sustainability Accounting Standards Board) that their own conventions and methods have become obsolete in the face of changing societal expectations. So far, no accounting/auditing firm has produced a single integrated report that meets the requirements of the IIRC's own <IR> Framework. The absence of "human capital" reporting is particularly notable by its absence.

Why MI is auditing the Accounting/Auditing Sector of OMINDEX

Previous research by MI (reports on Banking Governance & Culture, the pharmaceutical sector and individual companies such as Nestlé) has been building a global picture of organizational maturity where only very few exemplars (e.g. Toyota in manufacturing, Handelsbanken in banking) can be seen to be pursuing a goal of TSV. All the companies we have studied so far have been regularly audited, over many years, in accordance with international recognized standards and conventions; supported by national statutes and regulators. Yet it is self-evident that this 'auditing system' has proved ineffective; not only in preventing the crash of 2008 but in improving corporate governance, conduct and behaviour: as repeated cases of misconduct, including within their own ranks, testify.

Absolute trust is both a necessary and sufficient condition for the auditing/assurance process to function effectively. The reality, however, is that the relevant authorities, across all jurisdictions, do not trust the sector as a whole; and especially the Big 4 players. The policy of 5-yearly 'mandatory rotation' is supposedly designed to prevent a collusive relationship developing between audit partners and their clients but does nothing to address the root causes of the problem; the inherently problematic relationship between auditor and client that is prone to abuse. It is also highly inefficient and fails to grasp all of the societal benefits afforded to mature exemplars (as in the Toyota model) of mutually beneficial, long-term, trusted supplier relationships.

If anything, the rotation policy, ironically, only serves to provide further evidence that the whole system has become corrupted: so the solution has to be redesigning and rebuilding the system anew. Instead, the timidity and inaction on the part of the authorities has sent a clear signal to the Big 4 that they are now too big to fail; thereby reinforcing and sustaining the power of the partners to this global cartel to behave almost as they please. A situation perfectly analogous to banking and an inevitable outcome of the whole financial system becoming infected with a failure of the professional bodies to enforce standards and disintegrating integrity from every quarter.

All of the key factors that led to Enron, and the downfall of Arthur Andersen, are still with us today (poor governance, skewed value motives of partners, avarice, ineffective governmental and regulatory control, obsolete accounting and auditing practice). Bringing the sector back into line requires re-visiting the Andersen option of revoking one of the key player's licence. By rating the sector on the OMINDEX scale, and the client organizations being audited, MI can identify both the worst candidates for the most serious sanction and the best who can become the sector's exemplar of the best behaviour and the highest value. MI's initial, baseline OMRs (shown in the 'OMINDEX BIG 4' table above) identify KPMG as bottom of this cozy, closely-knit pack. This signifies no clear water in performance or culture between them. All should be required to demonstrate their commitment to continuous, whole system, improvement by signing up to the MI professional standard, asking themselves the questions on our OM30 (see appendix) and reporting accordingly; as part of their own journey towards the highest levels of maturity and societal legitimacy.

Conventional, external auditing is a conceptually flawed and dubious practice

Auditing is only necessary because legitimate stakeholders (society, investors, employees, citizens) cannot trust organizations to report transparently on the overall health and value of their enterprise. In the 'dog-eat-dog' version of capitalism, providing such information publicly is seen as both giving away competitive advantage and inviting unwanted scrutiny. That self-imposed tendency to opacity and obfuscation, by organizational leaders wanting to cover their tracks, reinforces all of the traditional, negative connotations around auditing. This spin adds momentum to the vicious circle for auditing, so that it is perceived as a necessary evil rather than a boon to society.

Injecting commercially-driven, as opposed to societally responsible, external auditing partners into this equation exacerbates the problem. If the auditing firm (maturely) declares its purpose as providing the most accurate and truthful picture, of what is going on behind the scenes and the PR gloss, they are unlikely to attract (immature) clients who want to skew or hide the facts. This has become the sector's "Catch-22", where the goal of maximizing a partner's fee income is bound to conflict with audit veracity. The default justification for giving in to the pressure of these opposing forces, especially from the Big 4, is '… if we don't provide a product the client wants someone else will'. MI's solution is to rate both the auditing firm and their client. The vicious circle will only be broken when they both sign up to improving their TSV. Of course, the FRC and similar bodies also have to be trained in maturity analysis if they are to monitor and control their constituencies effectively. The longer the present situation persists the stronger the vicious circle will become; where immature companies (lacking transparency) will only seek out auditing firms who share their anti-societal value focus.

Partnerships as entities and determinants of organizational culture and behaviour

While bankers have been the butt of harsh criticism and ridicule since 2008; as with all publicly quoted companies they are, nevertheless, subject to a level of scrutiny that partnerships manage to avoid – from external shareholders. This moderating influence, even when it is barely functioning as it should, provides a necessary check (particularly on executive remuneration) in the capitalist system that is not imposed on partnerships. Equally, publicly quoted companies have their market value on show every day. The Big 4 do have the capability for putting a similar, albeit nominal, value on themselves which, along with their book value and OMINDEX rating, can be used to calculate their TSV. Instead, the Big 4 trumpet their revenue growth as though that, in itself, is a measure of its worth to society rather than just an indicator of a business model that focuses solely on revenue.

The PR writers of the Big 4's annual reports, as one would expect, would have us believe that all is well with their corporate governance. They are designed to look like a traditional structure, with chairpersons and supervisory boards. The 'king of the jungle' can be granted joint roles as both Chair and Senior Partner but such a policy is frowned on by MI as wrong in principle and pernicious in practice. There is the additional concern in partnerships that this combined role should not be regarded as equivalent to a CEO.

A CEO is expected to drive strategy while setting the tone and shaping the culture of the organization. The role of 'top partner' is not the same as an executive or senior manager. Their remits may look similar but in a partnership the whole edifice is geared more towards personal gain because they are the only 'shareholders'. Indeed, the status and personal gain from achieving partner status is held out as a lure to young trainees. Moreover, fee income is more directly associated with individuals in an LLP than in a listed company, which demands a whole system, less individualistic, collective effort.

The 'professional' standing of partners is more closely associated with their technical expertise than their abilities for managing large numbers of people. In the accounting and auditing professions, which still only measure people as a cost, human capital management is not even understood on a different conceptual level, never mind translated into effective management practice.

The Big 4 all operate a range of 'service lines' that require a range of disciplines but they all *look and feel* like accountants. This is why they have failed to rise to the challenge of producing integrated reports. None of their annual reports (or "transparency" reports) are integrated and human capital evidence is particularly simplistic (still measuring training hours). Also, partners are generally allowed more autonomy in their own areas and this can breed inconsistent values and behaviours that go unchecked. So, when a Big 4 partner commits an act, for which the firm becomes liable to pay a fine, not only is a "severe reprimand" (PwC) deemed sufficient punishment; there is a temptation to regard it as an isolated incident with less of an imperative to consider the wider implications of what is, after all, a failure by the whole organizational system, not just one or two people within it.

We see no evidence that the FRC or SEC understand or know how to respond to this peculiar dynamic encountered in partnerships. Moreover, if a partnership is predicated on serving its own financial interests, above every other consideration, and regulators are unable to control and mitigate these motives (for whatever reason), then the only solution is to challenge the Big 4 to demonstrate how they reconcile their own interests with those of the society their PR purports to serve.

Tax advisory: lucrative revenue for partners, a zero-sum game for society

Of course, the personal motivation patterns of the partners (how they define value) dictates the quality of governance and the culture of the whole firm: that is, the drivers of its practices and behaviours. Probably the best test of the Big 4's commitment to providing societal value comes not from their auditing practices but their tax advisors. Tax advising is a significant percentage of total revenues (PwC 25% $9.462Bn: KPMG 22%, $5.56Bn, Deloitte 18% c.$7Bn, EY 26% $8.17Bn) and the ordinary citizen has a legitimate question to ask – 'whose side is the tax advisor on?'

Tax advisory is, at face value, a zero-sum game: every $ of tax saving for the client is a lost $ of tax for society. When the costs of the tax advisors' fees are factored in, Total Stakeholder Value always falls. This is why the recommendations of this report include asking the Big 4 to justify their tax practices in terms of the benefit to the society and the FRC to investigate the extent of potentially illegal tax planning. If neither of these conditions are met then societal legitimacy is lost and can only be restored through legislation and/or regulations with a clear purpose of increasing TSV.

Low professional standards from outmoded professional bodies

The MI (chair) has signed up to the Banking & Finance Oath, an Australian development to restore trust in banks, and all signatories must put societal value at the top of their priorities. Compare this to the ACCA code of ethics, which places no responsibility on accountants to put society first. So clients will get what they want, not what society needs. Why should auditors not have to follow the same Hippocratic oath as the medical profession – to do no harm? MI models itself on the same professional standards, purpose and quality of evidence as the medical profession and is developing a new group of professionals accordingly.

We found no evidence in the ACCA's code of ethics to suggest that they recognize such taxation practices as immoral or unethical. No accountants have been struck off when partners are fined. Instead a "severe reprimand" is typically the order of the day.

Other professional services offered

The narrative above paints a picture of a sector nominally under strict regulation and control and yet the reality is laxity and incentivized collusion. This has bred a weak and manipulative culture on all sides; thereby undermining the assurance system and significantly increasing the risk of corporate and regulatory failure. So, if these are the types of behaviours and practices that are witnessed in the *regulated* part of the Big 4's business, what chance is there of any integrity and professionalism in the unregulated services they offer?

One area, in which all of the Big 4 have offerings, comes under the generic heading of 'people and organization' (this includes human resources and human capital). In particular, there is a market for 'HR analytics', and other associated metrics, actively supported by the two relevant, international, professional bodies – SHRM and CIPD. PwC Saratoga, for example, produces many meaningless metrics and even includes them in its own annual report. The others compete with their variations on a theme (KPMG BIO, Deloitte Bersin, EY's People Advisory). None of their methodologies are adequately evidence based (i.e. connected to value outcomes) and none have produced an <IR> report that effectively measures human capital in value and risk terms.

Maturity rating measures all consulting activities against a single, common definition of value; where the standard is encapsulated by the constant and persistent question – 'does this activity add value in terms of a combination of its cost, relative to the company's output, revenue, <u>and</u> quality of its products/services?'

Obsolescence and the IIRC framework[2]

Auditing conventions and processes always present a narrow, partial and limited view of an organization. Until whole system, integrated reporting becomes the norm we will not be able to place sufficient trust in organizations, their own accountants and auditors. IIRC's new framework is still from a traditional accounting perspective, looking to just add columns for extra capitals rather than seeing them all as a holistic picture. The conceptual basis for <IR> is flawed, the theory questionable and the practice non-existent. It has yet to produce a single example of a report that effectively integrates all of its 6 Capitals: with human capital value notably absent from all reports to date.

Maturity Institute's initial recommendations and solutions

1. Capitalism has managed to create its own vicious circle. Short-term profitability targets and shareholder primacy have left society out in the cold. The system is rigged by the failure of accountants to account for TSV and auditors to guarantee the assurance of societal value. MI is seeking acknowledgement of this very obvious observation and a commitment by the Big 4 to start turning this into a virtuous circle that benefits everyone.

2. Each of the Big 4 firms needs to fundamentally refocus their purpose towards serving and contributing to society. MI measures purpose against our standard of providing "the best quality product or service at the best possible cost (having factored in measurement of external harm e.g. environmental impact)". We recommend the Big 4 adopt this standard with immediate effect and integrate it into their own value management systems.

3. The Big 4 firms need to embed an objective of maximising Total Stakeholder Value (TSV), thereby ensuring that long-term, sustained value is achievable, including partner return (rather than delivering on this narrow value outcome at the expense of others).

4. Each firm needs to understand the power of healthy culture to drive quality, value and more effective internal risk management. They need to effectively measure and monitor governance and culture across their network firms using an instrument such as OM30. As a minimum, OM30 questions should be integrated with all existing, standard corporate reporting mechanisms to produce a complete and fully

[2] https://integratedreporting.org/the-iirc-2/

integrated report combining financial and human systems. These questions can be answered by the client companies themselves and then checked and verified using maturity analysis alongside conventional reporting processes. Only by assessing and analysing their own organizational whole systems will effective change arise to generate TSV.

5. All accounting and auditing firms should move to a solution, not product, mentality. They should signal this in their own annual reports by providing evidence of the value of their own 'people' practices, both internally and offered to external clients.

6. MI is offering its methodology (OM30), on an open source basis, to regulators, accounting firms and their clients so that immature (corrupted) firms do not continue to undermine the whole system. In addition, there should be a high-profile campaign to find the most mature auditing firm to act as exemplar to encourage the rest of the sector. The regulators will then have a benchmark by which to judge and control the entire sector.

7. MI invites all relevant professional bodies; from accounting and human resources institutes to industry specific bodies such as banking, to embark on a project for developing a whole, integrated system of professional management. We invite any business school that wishes to offer multi-disciplinary, whole system management education. With better evidence, legislators and regulators will also be able to re-frame existing and future regulation around an ultimate, capitalist purpose of Total Stakeholder Value and use OMINDEX to reinforce and support the best of organizational and corporate behaviour.

Appendix: The OM30© Instrument

OM30 is our comparative measure of organizational health that integrates governance, culture and human capital factors causally linked to material value and risk. Our ratings are carried out in two ways; either using external, publicly available information or with the active participation of a company (typically, on an initial, confidential basis). This therefore makes it applicable for use by multiple stakeholders. Use of the OM30© is taught as part of the MI Orientation programme and our latest version of OM30 is shown below. The OM30 Instrument [Question Set] is shown below. We can provide the full OM30 Instrument upon request:

1. Authenticity The size of the gap between the organization's statements and external communications relative to the reality found in the evidence.
2. Corporate Purpose Does the company have a clearly stated purpose?
3. Societal purpose Does the purpose of societal value have clear primacy in this organization?
4. Embedded societal purpose If yes to 3. does societal purpose cohere with operating plans?
5. **Market &Intrinsic value** What is the primary (not sole) determinant of the company's ability to sustain its present value today?
6. Coherence between market & human values To what extent does the organization see its future as being sustainable only if it reconciles its market value to societal values?
7. **Governance** Does anyone on the board hold specific responsibility for human governance?
8. **Trust** To what extent are the leadership and management team trusted by customers, employees, and other key stakeholders?
9. **Values** Can you identify 3 core values that are lived by the organization?
10. **Principles** Name up to 3 of the most important principles espoused and adhered to by the organization.
11. **Value potential** To what extent does the organization seek to maximise the value it generates from all its human capital (staff/suppliers/society)?
12. Vision How far into the future does this organization see and mentally plan?
13. **Mission** Identify the top priority that must be achieved within 3 years.

14. **Integration of human capital & business strategy** What evidence is there that the organization adheres to a policy of - "If we are to maximize the value of the business we have to make the best use of the total talent pool available and maximize the full value of our human capital; requiring our suppliers to do the same."
15. **Accountability** What are the Board and CEO accountable for?
16. **Strategic cohesion** To what extent do leadership, management and staff understand and work cooperatively towards a coherent set of strategic goals?
17. **Culture** What evidence is there that the Board recognises that constantly monitoring culture is material?
18. **System** To what extent does your organization operate as a coherent and cohesive whole system?
19. **Business planning** To what extent are improvements in the organization's capability in human capital management specifically factored into its current business plan?
20. **Evidence-based management (EBM)** Is evidence-based, management decision making a key principle of the organization and to what extent is it practised?
21. **Never-ending, continuous improvement** To what extent is the philosophy and practice of never-ending improvement embedded throughout the whole organization?
22. **Quality system** Does the organization have a quality system and, if so, to what extent is it applied?
23. **Innovation System** Does the organization have a system to measure the rate of innovation of the entire workforce (including suppliers) and, if so, to what extent is it applied?
24. **Performance management system** Is there a performance management system and, if so, to what extent is it applied?
25. **Learning & knowledge** To what extent Is this a learning organization that continuously and expeditiously aims to acquire and apply knowledge, expertise and experience to continuously create more value and reduce risk?
26. **Identifying the specific value impact expected from human capital** To what extent are business improvements based on linking human capital to the 4 value variables OCRQ?
27. **Return on human capital** Has the organization adopted a discipline of linking human capital directly to financial returns by completing an ROI calculation?

28. **Cooperation** To what extent is the organization characterised by willing, active and enthusiastic cooperation all the way from leaders and managers to the most junior job roles and suppliers?
29. **People risk** To what extent does the organization have a comprehensive system for measuring and assessing the current level of human capital management risk within the organization?
30. **Remuneration & Reward** Does the organization adopt and adhere to a clear set of key principles to underpin its remuneration and reward policy and link it directly to long term value creation?
31. **Communication system** How much importance does the organization attach to communication and is there a system in place to ensure it is working?
32. **Organizational agility, adaptability and flexibility** How well does the organization adapt to changing market conditions with a minimum of risk, cost and business disruption?
33. **Stakeholders** Whose interests, among all of the organization's specific stakeholder/s, are given primacy?
34. **Decision making environment** To what extent would you describe high level decision making in your organization as collegiate?