

FINANCIAL

FINANCIAL INFORMATION

Audit firms, like other types of professional services businesses, are based on people. The firms' principal assets are their people and their revenue is generated from the hours worked by those people. The firms' principal "hard" assets are the receivables due from clients that reflect the work performed by the firms' people. The firms' operations do not involve significant amounts of long-term assets. Moreover, state law restrictions on the structure and ownership of audit firms and state and federal independence standards limit the sources of capital and other financing for audit firms.⁵ These fundamental facts to a large degree dictate the firms' financial structure. The following discussion describes the audit firms' key financial characteristics.

CAPITAL

Charts 1 and 2 reflect selected balance sheet data for all firms on an average basis. These charts show that nearly three-quarters of the firms' long-term capitalization comes from partners' capital, with the remainder supplied by long-term debt. Chart 1 shows that as of the most recent fiscal year end, the average total long-term capitalization per firm was \$1,308 million. Partner capital represents 17.6 percent of the six firms' total revenue.

⁵ As discussed, state laws require audit firms to be owned to a substantial degree by CPAs. Independence standards further limit the sources of financing.

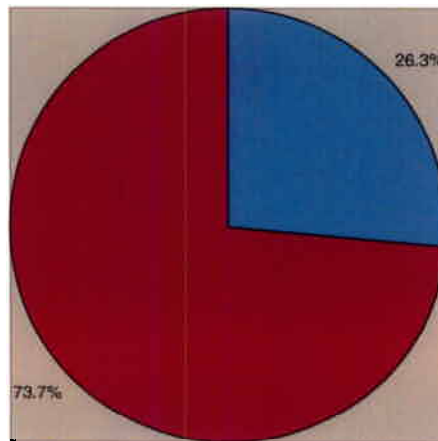
**Chart 1: Balance Sheet – Selected Financial Data for All Firms
Most Recent Fiscal Year End^{1,2}**

(in millions, except per partner data)	Average	
	Amount	%
<u>Long-Term Capitalization</u>		
Total Long-Term Debt (including current portion)	\$ 344	26.3%
<u>Partners' Capital</u>		
Contributed Capital		50.7%
Undistributed Earnings ³		26.6%
Advanced Distributions		-3.6%
Total Partners' Capital	<u>\$ 964</u>	<u>73.7%</u>
Total Long-Term Capitalization	<u>\$ 1,308</u>	<u>100.0%</u>
Total Partners' Capital as Percentage of Annual Revenue		17.6%
Contributed Capital per Partner ⁴	<u>\$ 418,365</u>	
<u>Other Sources of Funding</u>		
Total Unused Revolving Credit Facilities	<u>\$ 386</u>	
<u>Partners' Clearing Accounts - Short-Term demand loans/subordinated debt/drawing accounts</u>		
Total Partners' Clearing Accounts ⁵	<u>\$ 222</u>	
<u>Unfunded Deferred Compensation and Retirement Obligations</u>		
	Total	
Gross Obligation	\$ 19,743	
Funded Portion	<u>\$ (9,309)</u>	
Net Unfunded	<u>\$ 10,434</u>	

Notes:

1. Data are presented as of the most recent fiscal year end for each firm, which is not, in all instances, the same date.
2. The firms may not necessarily use the same method of accounting in presenting the reported financial information.
3. During the year, earnings awaiting distribution to partners are classified temporarily as a component of partners' total capital before the distribution occurs. These amounts fluctuate significantly depending on the point in the firms' fiscal year and earnings distribution cycle at which they are measured. At fiscal year end, some firms reclassify the undistributed annual earnings from total capital to partner clearing accounts.
4. In calculating per partner information, in some cases, the number of partners reported includes principals and/or limited partners.
5. Some firms reported that there were no balances in their partners' clearing accounts.

**Chart 2: Total Long-Term Debt and Total Partners' Capital
as Percentage of Total Long-Term Capitalization for All Firms**



Average ^{1,2}

■ Total Long-Term Debt (including current portion) ■ Total Partners' Capital

Notes:

1. Data are as of the end of each firm's most recent fiscal year, which is not, in all instances, the same date.
2. Average is based on the total long-term debt and total partners' capital for the six firms as a whole.

Given the average capital contribution per partner (as of the most recent fiscal year end) of \$418,365 (defined as total contributed capital for the six firms as a whole divided by the total number of partners for the six firms), a partner's capital investment in the firm is frequently that individual's most significant financial commitment other than his or her home.⁶ This capital is different from an individual's other investments, however, in that it does not appreciate yet it can be lost in its entirety. Indeed, that is what happened to the capital of the individuals who were partners in Arthur Andersen.

In particular, for individuals with less tenure as a partner, the capital contribution to the firm is a very substantial financial obligation that frequently is financed through personal loans provided by third parties, typically a bank. This is particularly true because partners must fund their capital contribution with after-tax income. To the extent that a partner must supply required capital out of current income, he or she is put in the position of paying tax on income that is not "received," but rather is immediately used to fulfill the capital requirement. Many of the alternative career opportunities available to audit firm partners do not carry a similar capital obligation.

Audit firms' capital typically funds current operations of the firm, bridging the time in which work is performed and employees are paid and the revenue generated from that work is collected.

⁶ Partners receive a return on their contributed capital, which is set at different amounts by different audit firms. These amounts are included in the funding costs reported on Chart 3.

As Chart 1 shows, audit firms also obtain short-term funding from partners who lend funds to their firm, for which they receive interest payments. These funds are in excess of partners' capital requirements and may be withdrawn on demand. Finally, firms also have access to revolving credit facilities.

Unfunded Deferred Compensation and Retirement Obligations

Chart 1 also sets forth the unfunded deferred compensation or retirement obligations of the audit firms. The terms of these obligations typically are set forth in a firm's governing documents and applicable plan documents, which have been, and may continue to be, amended over time. Generally, an audit firm's unfunded deferred compensation or retirement expense for a given year is capped at a specified percentage of the audit firm's net income for that year. Historically, no firm has limited deferred compensation payments as a result of the applicable cap, and – based on three-year financial projections – no firm believes it will approach the applicable cap during that period. In the aftermath of Arthur Andersen's indictment and decision to cease providing services, retired Andersen partners did not continue to receive their full pension or deferred compensation payments.

Revenue

Charts 3 and 4 show, on a weighted average basis for all firms, with each firm's data weighted by its revenue as a percentage of the total revenue for the six firms as a whole, the apportionment of costs in relation to \$100 of audit firm revenue. Given the nature of the business, it is not surprising that by far the largest amount, 46.5 percent, is devoted to personnel-related expenses, and that does not include partner compensation. With partner compensation on a pre-tax basis included, the figure would be nearly 70 percent.⁷

⁷ The firm's net earnings are paid to the partners in lieu of a salary; they thus represent the partners' compensation for their work.

**Chart 3: All Firms Apportionment of \$100 of Revenue¹
Recently-Completed Fiscal Year**

	Weighted Average^{2,3}
Expenses:	
Employee compensation and fringe benefits	\$37.2
Pension funding (expense)	5.2
Non-client-related travel	2.1
Education	2.0
Personnel-related expenses	\$46.5
Partner compensation	22.6
Client-related expenses	10.8
Litigation and practice protection-related	6.6
Non-client-related purchased services	3.8
Facility costs and related amortization	3.5
Technology-related	1.9
Funding costs	1.5
Other	2.8
Total	\$100.0

Notes:

1. Revenue may include disbursements that are reimbursed by the client. The firms may not necessarily use the same method of accounting in presenting the reported financial information.
2. Weighted average is based on revenue reported by the six firms for each firm's most recent fiscal year.
3. Numbers may not add due to rounding.

One of the largest costs incurred by audit firms other than compensation-related expense is litigation and practice protection costs,⁸ which comprise 6.6 percent of total revenues – nearly twice the cost of the next largest single item: maintaining numerous offices around the country to house thousands of employees and partners.

The portion of total revenue spent on litigation and practice protection figure significantly understates the litigation burden related to auditing, because, as discussed below, the overwhelming portion of the litigation cost is associated with public company audit work, yet the revenue from that work is only

⁸ Litigation and practice protection costs include all litigation-related costs – costs of outside counsel and other experts, settlements and judgments, internal litigation-related costs, and insurance premiums; less insurance recoveries. Although the “Client-related expenses” category is larger, it reflects specific out-of-pocket costs incurred in serving clients, such as travel and related costs, that generally are reimbursed by clients.

a subset of the total audit firm revenues (which include revenue from tax and other advisory services).⁹

Total litigation and practice protection costs constituted 15.1 percent of the six firms' audit-related revenues. Even if that 15.1 percent is discounted for the relatively small non-audit litigation costs reflected within it, the figure is consistent with the range of audit-related practice protection costs shown as a percentage of audit-related revenue reported in the past by the four largest firms:¹⁰

1999	7.7%
2000	8.3%
2001	11.5%
2002	12.5%
2003	10.7%
2004	14.2%

As these historical percentages reflect, practice protection costs fluctuate with a variety of factors, including the cyclical changes in litigation filings, which are discussed below.

Audit firms' practice protection costs are dramatically greater as a percentage of revenue than those borne by any other type of business. The RIMS Benchmark Survey is widely considered to be the authoritative study of liability costs. The 2006 Survey found average total liability costs across the economy of \$0.31 per \$100 of revenue;¹¹ the figure for audit firms reflected in Chart 3 is twenty times greater. When only the firms' audit revenues are considered, the percentage for the firms is more than forty times greater than the RIMS survey average for the economy.

Even when only professional services firms are considered, the RIMS average liability cost per \$100 of revenue increases by only \$0.08, to \$0.39.¹² Audit firms' costs as set forth in Chart 3 remain many multiples greater. Information reported for the 100 largest U.S. law firms (by gross revenue) indicates that the average profits per partner as a percentage of revenues for these firms – which, like audit

⁹ For example, Chart 17 indicates that payments to resolve audit-related cases were 94.3 percent of all payments greater than \$1 million to resolve cases in 2007. (These payments do not include litigation costs, such as attorney and expert fees.)

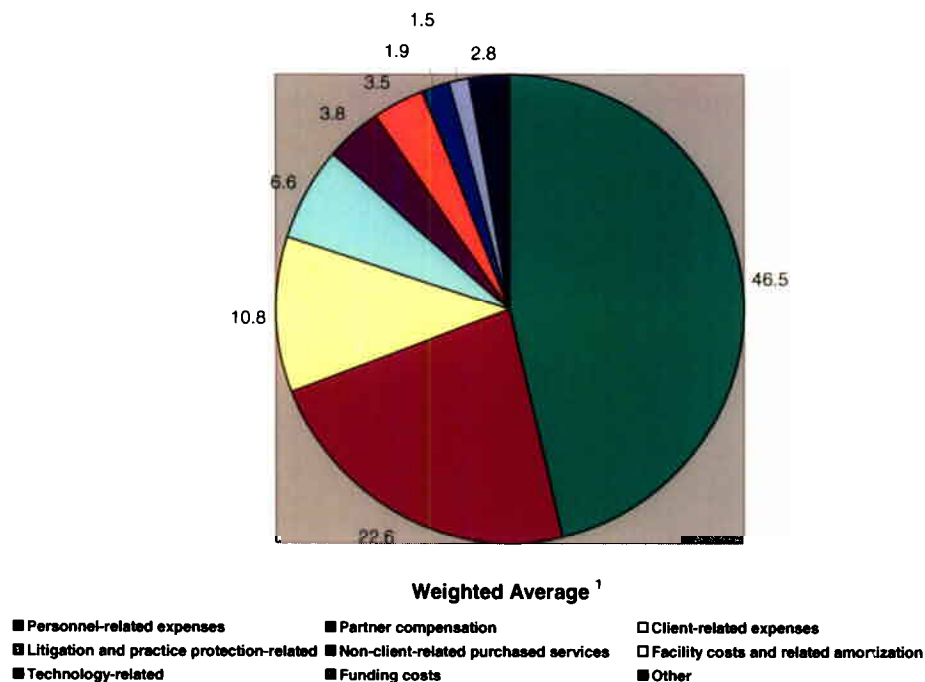
¹⁰ London Economics, *Study on the Economic Impact of Auditors' Liability Regimes: Final Report To EC-DG Internal Market and Services* 84 (September 2006), available at http://ec.europa.eu/internal_market/auditing/docs/liability-/auditors-final-report_en.pdf. Because of time constraints, the firms were unable to collect the data needed to determine audit-related practice protection costs for 2007.

¹¹ 2006 RIMS Benchmark Survey at 10.

¹² *Id.* at 66.

firms, are partnerships – was 38.1 percent in 2007, more than one and one-half times the 22.6 percent partner compensation figure set forth in Chart 3 for the audit firms.¹³

Chart 4: Apportionment of \$100 of Revenue for All Firms



Note:

1. Weighted average is based on revenue reported by the six firms for each firm's most recent fiscal year, which may not, in all instances, be the same date.

Pre-Tax Per-Partner Compensation

Weighted average pre-tax per-partner compensation can be derived from the data contained in Chart 3. Applying the partner compensation percentage in Chart 3 (22.6 percent) to \$32,851.9 million (the aggregate revenue figure for the six firms for each firm's most recent fiscal year), and dividing that sum by the firms' aggregate number of partners (including in some instances principals and limited equity partners and including partners working in all service lines), 9,518, produces an average of

¹³ Calculated from data in the AmLaw 100 Database, see "The AmLaw 100 2007 – Behind the Numbers," *The American Lawyer* (May 2007), by dividing net operating income for the 100 firms by gross revenue for the 100 firms.

\$780,051. Using data provided by the six firms, the estimated median per-partner compensation is \$701,846.¹⁴

Executive Compensation Advisors analyzed the compensation levels in several alternative career paths that could be pursued by auditors. It found that several alternatives – consulting firms, law firms, and some corporate financial roles – lead to significantly greater compensation, ranging from 30 to 50 percent more than audit partners. See Appendix B at 7. Moreover, each of those career paths carries much less risk in terms of litigation exposure than serving as an audit partner.¹⁵

¹⁴ From the data provided by the six firms, average compensation per partner at each firm was calculated. Each firm provided its ratio of median partner compensation to average partner compensation. For each firm, this ratio was multiplied times the firm's average compensation per partner to estimate each firm's median compensation per partner. Each firm's median compensation per partner was weighted by its number of partners as a percentage of the six firms' total number of partners to estimate the median partner compensation for the six firms.

¹⁵ An audit partner's capital is at risk in litigation and, in addition, the partner's personal assets may be vulnerable in lawsuits arising out of audit work in which he or she personally participated.