Point of view
Benefits of scale

Key messages

• Leading audit firms have grown in response to the needs of the market. As companies have become more global, they have required their auditors to provide consistent quality service across the world.

• This has led firms to achieve the necessary scale in part through mergers and acquisitions and to make substantial investments in new methodologies, technology and people throughout the world. This investment has created a gap between the ‘Big Four’ and other firms which cannot be bridged in the short term.

• To conduct quality audits, firms need experts in many areas such as tax, actuarial valuation, risks and systems – as well as the ability to keep pace with constantly changing regulations, standards and industries. Large multi-disciplinary firms are therefore essential for providing global businesses with high-quality audits.

• However, we believe there are some reforms which could encourage new entrants into the market and allow existing firms to compete and grow. These include: prohibiting contractual clauses that make it compulsory to use a large firm; changing the rules on firm ownership; and effective oversight by audit committees of the audit.
Benefits of scale: The context and the explanation

What is the challenge?
The European Commission (EC) believes that the size of the Big Four and the breadth of services they can provide are a barrier to small and mid-tier firms developing the necessary skills and expertise to undertake the statutory audit of large, global companies. They also believe that there is a systemic risk to the market if one of the Big Four were to fail. They have set out a series of proposals that they suggest will address these issues – including mandatory firm rotation, substantial bans on non-audit services, and, in specific instances, the formation of ‘audit only’ firms.

The evidence suggests that the level of investment in people, skills and expertise, compliance and regulatory requirements and technical and IT infrastructure required to undertake large complex audits is too great for mid-tier and smaller firms. We do not believe that any of the measures proposed by the EC will achieve the objectives to remove barriers to competition or encourage new entrants to the market. In fact, they could have unintended consequences and negative impacts on audit quality and competition.

Why is scale important?
Legislators, regulators and other stakeholders have raised concerns about potential conflicts of interest arising for statutory auditors when they also provide non-audit services to their audit clients. This has been linked to questions about why international accounting and auditing networks like the Big Four need to be so large to carry out high-quality audits and the implications for competition.

Our size is a consequence of:
• the changing needs of large, international clients
• increasing complexity of regulation and standards and
• the investment needed in systems and people to meet these requirements across the globe, whilst ensuring high-quality audits are delivered.

Globally sophisticated companies and in some cases regulators, increasingly require auditors to provide a diverse range of services and expertise in addition to the core statutory audit. The largest networks, with the resources and geographic reach that matches (as far as possible) those of the client, are uniquely qualified to provide those services and serve the best interests of the company and its investors.

Where are we now?
The drivers of change:
Over the past 25 years, the Big Eight firms became the Big Four. The main drivers for this were mergers and the ‘failure’ of one firm (Arthur Andersen in the US) about ten years ago. The mergers happened because firms needed to grow to meet their clients’ needs, but couldn’t do so fast enough without joining forces.

Over the same period, companies became more global, complex and increasingly looked to the accountancy profession to provide high-quality audits across the world. This complexity led to more demanding and international standards for independence, audit performance, financial reporting, accounting and the regulations around corporate governance.

These changes reinforced the need for firms to be more integrated and consistent in their approach, systems and standard of service across their networks. They needed to increase the depth and breadth of their skills around the world, including in emerging markets, so they could carry out high-quality audits according to the new standards in accounting, auditing and controls.

Complexity, capabilities and capacities:
The largest networks can carry out effective and efficient audits because of the scale of what they can take on. All their operational structures are in place and they can invest for the future – and in the talent they need to carry out increasingly complex assignments.
As global companies have grown and become more complex, they have needed deeper technical and industry expertise from their auditors. For today’s audits, firms need experts in many areas beyond core audit skills, including technical accounting, regulatory, actuarial valuation, tax, fraud, mergers & acquisitions, risk and systems and controls. Larger firms can carry out high-quality audits because of a combination of greater in-house expertise – including investments in audit processes, training and in emerging markets – and stronger incentives to stay independent and protect their brand and reputation around the world. In addition, as a further safeguard to independence, the larger firms are not reliant on the fees of any one client. In a world where standards, regulations and industries change at a frenetic pace, keeping expertise up to date is vital for a high-quality audit. Increasingly, global companies expect the firms that audit them to operate like they do and in the same countries. This is so experts are always available, quality is consistent and rules and regulations are followed – wherever those companies are in the world.

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These companies and their shareholders have increasingly tended to choose the larger audit networks, with a strong global brand, because they have common standards and values and enough people with the skills to do the job. They also have methods and tools they can use anywhere in the world to make sure their audits are consistently efficient, effective and of the highest quality. Companies also argue that it represents value for money and is more efficient, enabling them to leverage the knowledge and understanding of their business developed by their auditors, in other areas of ‘assurance’ work.

**Organisational structure:**
The Big Four networks responded by organising themselves to meet these needs. They established structures to make them more coordinated around the world (including in emerging markets) and common ways of working (including reviewing and overseeing quality). And they developed programmes for transferring staff and sharing expert teams, to make sure they could respond to their clients’ needs – wherever in the world they choose to operate.

Improvements in the standards of corporate governance and the fact that audit committees now expect more from their auditors, have made this even more of a priority.

**Investment:**
The larger networks have also made substantial investments in new audit methodologies and related technology. They have done this so they have a consistent, effective approach for auditing the consolidated financial statements of complex, multinational companies. Underpinning this is investment in global training platforms, technical guidance, oversight, risk and quality functions, risk evaluation and management approaches and in staff who are qualified to give expert industry and sector advice.

What makes the larger networks stand out is this ability to make substantial investments to provide technical and industry knowledge, meet the future challenges of further and more complex regulatory requirements and make sure their audits are of a high quality.

This investment has led to a gap between the Big Four and the mid-tier firms in terms of size, geographic coverage, technical knowledge and industry expertise. We believe that now the gap in the number of employees they have and the countries they work in is too big to bridge in the near term (although there are reforms that can be made to encourage new entrants and existing firms to grow in the medium term, see below). The problem with bridging the gap is especially true in emerging markets, where there is a limited supply of talent and access to network-supported IT systems, processes and training which is vital for carrying out high-quality audits.

**What does PwC believe?**
Competition is good for everyone. But we wouldn’t want this to be achieved by artificial means that would limit the choices companies have and unnecessarily restrict the size firms need to be to invest in audit quality and serve the capital markets effectively. As in all efficient markets, a firm’s success should depend on its skill, ingenuity and ability to improve the quality of service. Audit committees shouldn’t have to choose a firm they don’t think suits their needs, or that doesn’t have quality of service as a priority.

We also think that firms need an integrated network made up of many disciplines to carry out quality audits.
As the business environment, companies and accounting principles become more complex and global the need for many different kinds of expertise in the audit process grows. To attract and retain experts in those areas and to make sure those experts stay up to date with their market knowledge and expertise, the firms have to have broad market experience – providing services to both audit and non-audit clients. Their ability to understand the marketplace as a whole informs the audit process and is critical to making quality judgments. The benefits of scale and multi-disciplinary firms to serve the global marketplace, are vital for a high-quality audit.

We support changes which:

• Prohibit contractual clauses that make it compulsory to use a large network firm
• change the rules governing who owns firms so new firms can grow and compete more easily and provide credible alternatives to the Big Four
• provide regulators with additional oversight of firms and audit committees with additional oversight of the audit.

In conclusion
The large firms are a reflection of market need. They have made substantial investments to develop the necessary scale and capabilities to service large, complex, global companies. In this environment, we believe oversight by strong, independent regulators is critical. We also believe that healthy competition is good for the market place. However, this should not be achieved through artificial intervention which is detrimental to audit quality.