

# The Big 4's move into law

Tony Williams

**The Big 4 accounting firms are developing their legal services capability at a time when their core audit business is facing increased scrutiny and challenge. This article considers what is happening in relation to audit, the impact or otherwise on their legal offering, why the Big 4 are expanding into law, what their legal offering is and their chances of success.**

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## **What is happening in audit?**

In December 2018 the UK Competition and Markets Authority (CMA) published its initial report on the audit sector. It found issues with the way auditors were appointed, that the choice was limited effectively to the Big 4 which undertake 97% of audits of the biggest companies and that the auditor's focus on quality appears to be diluted by the fact that at least 75% of the revenues of the Big 4 comes from other services such as consulting.

It proposed a number of measures. First, a split of the audit and non-audit businesses into separate operating entities. This would involve separate management, accounts and remuneration so that auditors are only rewarded for the audit work that they do. Second, greater scrutiny of audit appointment and management. Third, that the largest company audits (FTSE 350) be carried out by at least two firms, of which at least one should be outside the Big 4. These proposals are out for consultation and the final CMA report will be published in 2019.

On the same day a report was published by a Government-appointed committee chaired by John Kingman which found that the existing accounting standards body, the Financial Reporting Council (FRC), was not fit for purpose and should be replaced by a new body (the Audit Report and Governance Authority (ARGA)) with greater powers and be funded by a compulsory levy on auditors.

As if this was not enough, also in December a report commissioned by Labour's Shadow Chancellor of the Exchequer, John McDonnell, chaired by Professor Prem Sikka, recommended that the leading accountants should be broken up by separating audit from other services. It also proposed a state-backed body to audit the accounts of banks and other financial institutions and an independent body to appoint and remunerate auditors for large groups outside the financial sector. It also recommended that partners responsible for audit should become

personally liable for any failures related to their work and that it should become a criminal offence for auditors of large companies to offer consulting services of any kind to audit clients. Finally, it also recommended a compulsory change of auditors every five years. This report has not yet been adopted as Labour Party policy.

In its submission to the CMA, KPMG, which had been singled out by the FRC for the "unacceptable" quality of its audits, said that it would stop doing non-audit work for its FTSE 350 audit clients.

## **What this means for the Big 4's legal offering**

Although the CMA fell short of recommending a complete divorce of the audit and non-audit businesses, mainly due to the complexity of doing this in such global businesses, it is now clear that there will be much greater scrutiny and restrictions on the legal services that can be provided to Big 4 audit clients. This potentially closes off one important cross-selling opportunity. However, in various countries, including the United States and the Netherlands, there are already restrictions on the non-audit services that can be provided so although this may be unwelcome it is not fatal to the development of legal services. The Big 4 are already much more than auditors. Their other revenues, especially consulting, have been growing rapidly over the last decade and are now a major proportion of their revenues as shown in Table 1 on the next page.

Accordingly, if audit is, effectively, to be ring-fenced within the Big 4 it becomes increasingly urgent to grow other business lines including legal. These other business lines will focus on non-audit clients and will therefore be free of any restrictions. In due course it is not inconceivable that some or all of the Big 4 will effectively entirely separate their audit and non-audit businesses (although it will be an extremely complex process) thereby making the non-audit business free to act for any clients it wants.

**Table 1: Global revenues of the Big 4 in 2017/18**

Firm	Financial advisory (\$billion)	Risk advisory (\$billion)	Tax and legal (\$billion)	Audit and assurance (\$billion)	Consulting (\$billion)	Total (\$billion)
KPMG	–	11.47 (+12.7%)	6.34 (+8.7%)	11.15 (+7.3%)	–	28.96
EY	3.622 (+13.9%)	9.621 (+13.0%)	8.995 (+7.8%)	12.534 (+5.0%)	–	34.772
Deloitte	3.6 (+8.0%)	5.0 (+12.0%)	7.9 (+8.7%)	10.2 (+7.7%)	16.5 (+15.7%)	43.2
PwC	–	13.8 (+10%)	10.4 (+8%)	17.1 (+4%)	–	41.3

### Why law?

The legal sector is attractive to the Big 4 for numerous reasons. Many aspects of legal services are adjacent to their existing services such as tax, HR and risk consulting and could be incorporated in these offerings to provide comprehensive products and services. The legal sector is a large market which at a global level has been estimated at US\$750 billion. Despite its size it is a fragmented market with even the world's largest law firms accounting for less than 0.5% of the total whereas in audit and consulting a relatively small number of firms have a significant market share. Despite its relatively low leverage model, law is very profitable and the Big 4 like the profit margins. The Big 4 see lawyers as very conservative and reactive and lacking business acumen and believe that with their approach to client relationship management, the proactive development and selling of 'products' or 'solutions' to clients and their advanced use of IT they can achieve good margins not only on high-value work but also on more routine or process-orientated work.

Although the Big 4 may not be able to utilise auditors to cross-sell legal services, they tend to have multiple touch points and relationships across a client organisation including with the CEO, CFO, COO, Director of HR, Director of IT etc. They also have board room credibility and acceptability. It also needs to be appreciated that they have truly global scale. Indeed, the three largest of the Big 4 have global reviews that exceed the aggregate revenues of the top 100 global law firms.

### What is their legal offering?

The legal offering of the Big 4 is currently evolving. It is apparent that, wherever possible, they want legal to be an integrated part of their offering rather than a stand-alone legal practice. This is for three reasons. First, they believe that their integrated products and

solutions offerings are compelling. Second, they will not be directly competing with established law firms for this work. Third, by accessing this work through various contacts in the client it may reduce their reliance on the general counsel, who may be resistant to lawyers linked to the Big 4.

England and Wales permit alternative business structures (ABS) so lawyers can work in the same entity as their other colleagues. In other countries where non-lawyer ownership of law firms is prohibited, they may need to operate in separate but associated businesses. This may cause some extra complexity to their arrangements but is unlikely, ultimately, to impede their ability to provide integrated solutions.

It appears that currently the legal practice is primarily focused on mid-market activity including immigration, corporate transactions, corporate restructuring, due diligence and regulatory advice and compliance issues. In relation to integrated products, these include tax structuring and related reorganisations and documentation, regulatory risk compliance, training and investigations and employee mobility (immigration, employment terms, share incentives, pensions and relocation packages). In relation to the immigration area in June 2018, Deloitte acquired eight non-US offices of US immigration firm Berry, Appleman and Leiden and entered into an alliance with the US firm and in October 2018 PwC entered into an alliance with the global immigration firm Fragomen.

So far, the Big 4 have been focusing on adding lawyers on a lateral or small team basis and have been particularly active in the Asia Pacific, the United Kingdom and to a lesser extent in Continental Europe where their legal practice is already more developed. It will be interesting to see if they seek to add firms by merger. It should be remembered that in 2001 Andersen Legal was the ninth largest law firm by

revenue and included leading firms such as Garrigues (Spain), Rajah & Tann (Singapore), Zico (Malaysia) and Dundas & Wilson (Scotland).

It would be naïve to assume that they will be content with being mid-market players. The development of their integrated products and their extensive use of legal IT (EY in August 2018 purchased alternative legal services provider Riverview Law) and the increasing depth and breadth of their legal offering will produce opportunities to do more high-value and strategic work. This is not to suggest that they will immediately become leading legal services providers in their markets, but they do have the size and resources to keep pushing the glass ceiling higher.

### Will they succeed?

For the reasons mentioned above, the legal sector is attractive to the Big 4. The ring-fencing and potential separation of audit not only makes other growth opportunities important but also, if full separation does occur, potentially frees them of any audit-related restrictions on their business. They will need to be focused and patient. Developing a legal business is not just a matter of recruiting plenty of lawyers. To profitably grow they will need lawyers of the right calibre with the right business acumen and client relationship skills.

Some of the challenges include:

- *Culture*: lawyers are by nature individualists and rather anarchistic. They rail against anything they consider to be bureaucracy or micro-management. The Big 4 conversely are big, global and managed businesses usually driven by a range of financial metrics. They have multiple layers of management. How well lawyers, especially leading lawyers, will adjust to such an environment and effectively interact with their other colleagues remains to be seen.
- *Conflicts*: generally, lawyers are subject to much stricter conflict-of-interest rules compared to other professionals. This may limit their ability to act for certain clients.
- *Regulation*: the prohibition of non-lawyer ownership of law firms is common around the world. This will make the structuring of law practices more complex but will probably not present an inseparable obstacle to development. US restrictions on the practice of law may be an impediment. However, the further development of technology is likely to blur the distinction with the practice of law over time.

- *Audit*: as mentioned above, it is likely to be increasingly difficult to provide legal services to major audit clients of the firm. This potentially places a large number of potential clients off-limits. Perversely, the full spin-off of audit would avoid such restrictions.
- *Remuneration*: law is generally a very profitable business. In leading firms, it is not unusual for partners to earn over £2 million per annum. The Big 4 are also profitable but not generally in the same league so they may be challenged to recruit leading market participants. Currently this may not be an issue as they may feel that some stars are just too high maintenance and unlikely to integrate well into their organisation (see also culture, above). However, as they seek to move their legal offering up-market this could be an impediment to their growth.
- *General counsel*: there are mixed messages from general counsel. Some have included the Big 4 law firms on their legal panels. Others would prefer to use traditional law firms and be their primary relationship point within their organisation. In relation to integrated products this may not be an issue but for major legal roles it is likely to be a challenge.
- *Litigation*: although all of the Big 4 are active in tax litigation and in advisory services linked to litigation (eg, forensic accounting), it is likely that for conflict reasons general commercial litigation will not be an area of focus. PwC does claim to conduct litigation, but it is apparently the exception.

### Conclusions

The last foray of the then Big 5 may have ended in tears with the collapse of Arthur Andersen, the dissolution of Andersen Legal and the passing of the Sarbanes Oxley legislation in the United States which led the Big 4 to scale back their legal offering. But they are now back with renewed vigour and focus. They already each have about 2,000 or more lawyers spread around the world. They are placing legal IT and integrated products at the core of their business. They have the scale and contacts to have a major impact. Whether they have the stamina and sensitivity to recruit, retain and motivate the lawyers required to sustain this progress remains to be seen. While many may be sceptical it would be a brave person to bet against them.

*Tony Williams is the principal of Jomati Consultants, a global strategic adviser focused on the legal sector. He was previously global managing partner of Clifford Chance and then of Andersen Legal.*

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