

The competitive environment in the assurance industry: a South African case study

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In loving memory of my father, Pieter Marx de Villiers, who has left us to be with the Lord. You are dearly loved and greatly missed by all.

Zephaniah 3:17

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ABSTRACT

The assurance industry is fiercely competitive with intense rivalry among the Big Four assurance firms. Clients also exert extreme pricing pressure on audit fees to further strain profitability. Understanding and analysing the various drivers within the competitive assurance environment help an organisation to better combat the competitive forces and derive a strategy that will enable it to obtain a competitive advantage. This study analyses the competitive South African assurance environment by means of the Porter Five Forces model which identifies the drivers constituting the five competitive forces and determines which forces are the most influential in the industry. From this analysis the most appropriate strategy to compete and obtain a competitive advantage is identified. Porter's renowned model has mostly been applied in manufacturing and product industries and this study tests the theoretical appeal of the model against its practical usefulness for professional services firms, for which minimal empirical research on competitive environment analysis was found in existing literature. Semi-structured interviews with eight partners from Organisation X, the subject of a case study that was executed to answer the research questions, found the dominant force in the industry to be the bargaining power that buyers exert over assurance providers, followed closely by the rivalry among competitors. In addition the biggest concerns, challenges and developments in the industry were found to be in the areas of regulation, globalisation, skills shortages and pricing pressure. Organisation X chose to compete via a strategy of differentiation with a specific market sector focus. A gap identified in Porter's model was its sole focus on the external environment and negligence to aid organisations in developing their chosen competitive strategy; hence the Resource-based approach to strategy formulation is suggested specifically for the African investment case. Consequently, in developing an organisation's strategy to compete, management should utilise the various strategic models available to evaluate both the organisation's internal resources and capabilities and the external environmental forces affecting their organisation.

AFRIKAANSE OPSOMMING

Die ouditindustrie is hoogs mededingend met 'n intense wedywing tussen die Groot Vier ouditfirmas. Kliënte oefen ook uiterse prysdruk op ouditfooie uit wat winsgewendheid verder onderdruk. Die begrip en ontleding van die verskillende drywers binne die mededingende ouditomgewing verleen hulp aan 'n organisasie om die mededingende kragte beter te bestry en om 'n strategie te ontwikkel wat hul in staat sal stel om 'n mededingende voordeel te verkry. Hierdie studie ontleed die mededingende Suid-Afrikaanse ouditomgewing, deur middel van die "Porter Five Forces-model" wat die drywers identifiseer waaruit die vyf kompeterende kragte bestaan, ten einde te bepaal watter krag die invloedrykste in die bedryf is. Vanuit die ontleding word die mees geskikte strategie om mee te ding en 'n mededingende voordeel te bereik, geïdentifiseer. Porter se welbekende model word meestal toegepas in die vervaardigings- en produkindustrieë en hierdie studie toets die teoretiese aantrekkingskrag van die model teen die praktiese nut vir professioneledienste-firmas, vir wie minimale empiriese navorsing oor mededingende omgewingsanalise in die bestaande literatuur te vinde is. Semi-gestruktureerde onderhoude met agt vennote van Organisasie X, die onderwerp van 'n gevallestudie wat uitgevoer is ten einde die navorsingsvrae te beantwoord, het bevind dat die dominante krag in die industrie, die bedingingsmag wat kopers uitoefen op die ouditfirmas is, gevolg deur die wedywing tussen mededingers. Daarbenewens is bevind dat die grootste bekommernisse, uitdagings en ontwikkelings in die industrie, in die areas van regulasie, globalisering, vaardigheidstekorte en prysdruk is. Organisasie X het gekies om mee te ding deur middel van 'n strategie van differensiasie, met 'n spesifieke marksegment-fokus. 'n Gaping in Porter se model is geïdentifiseer as die uitsluitlike fokus op die eksterne omgewing en die nalating om organisasies in die ontwikkeling van hul gekose mededingende strategie van hulp te voorsien. Hieruit word die Hulpbron-gebaseerde benadering tot strategieformulering, spesifiek vir die Afrika-beleggingsaak voorgestel. Gevolglik moet die bestuur van 'n organisasie in die ontwikkeling van 'n strategie om te kompeteer, gebruik maak van die verskillende strategiese modelle beskikbaar om beide die organisasie se interne hulpbronne en vermoëns en die eksterne omgewingskragte wat hul organisasie beïnvloed, te evalueer.

CHAPTER 1: INTRODUCTION

1.1. INTRODUCTION

Searching for the means that will help to attain competitiveness is a great concern for every organisation (Draoui & Liu, 2007:4). In the age of increasingly global competition, coupled with a business environment that is becoming more dynamic, organisations (including assurance organisations) have to recognise suitable areas wherein they will be able to be more competitive and to develop the appropriate strategies that can help them to maintain competitiveness (Draoui & Liu, 2007:4). The most successful companies constantly aim to identify new competitive spaces, in order to serve new customers, while they contemporaneously try to find ways to better serve existing customers (Hoskisson *et al.*, 2004:135).

Draoui and Liu (2004:7) stated that, despite the complexity of competitiveness, it is still an attractive research area to which various researchers are drawn. Multiple studies around competitiveness had been conducted, using different methods and theories (e.g. Bilalis *et al.*, 2006; Burcher & Lee, 2000; Denton, 1999; Meredith *et al.*, 1994; Persson, 1991; Pitelis & Antonakis, 2003). Strategic competitiveness is a result of an organisation's ability to use its competitive advantages to compete in individual product markets to satisfy the needs of groups of customers (Hoskisson *et al.*, 2004:135).

A competitive advantage is defined on a basic level by Grant (2008:205) as one organisation earning a persistently higher rate of profit over another organisation in the same market. Ireland *et al.* (2006) define it as a distinctive competence allowing an organisation to perform an activity that creates value for customers that competitors cannot perform. Pitkethly (2003:233) views it as the range of factors that primarily compromise the industries an organisation competes in. Thus, competitive advantage is the range of organisation-specific factors that enable an organisation to create value to customers that competitors cannot perform, in order to allow it to earn a persistently higher rate of profit compared to other firms within the same market.

In the 2011-2012 global competitiveness report, issued by the World Economic Forum, South Africa was ranked 50th out of 142 countries whose competitiveness was assessed. This position improved from 54th out of 139 countries in 2010-2011. Remarkably, South Africa achieved the number one position in the world for the strength of auditing and reporting standards in the two consecutive reports (World Economic Forum, 2010; World Economic Forum, 2011). The Forum therefore considered South Africa to be the world leader in implementing auditing and reporting standards and practices, and as with all industry leaders, the author of this dissertation anticipated the competition within the South African audit/assurance industry to be fierce. It is therefore submitted that the South African assurance industry is a perfect fit for a competitive environment analysis.

The Porter Five Forces model was deemed ideal for such an analysis, as Porter (2008:78) stated that an awareness of the Five Forces helps organisations to understand their industry structure and stake out a position that is more profitable and less vulnerable to attack, thus enabling them to be competitive. The purpose of the Five Forces model is to obtain a comprehensive understanding of a given industry by analysing the external environment (Porter, 1980). Vining (2011:65) commended the generic nature of the forces to their broad application across different industries and sectors, and it is submitted that the model could therefore also be applied to a competitive environment analysis of the assurance industry.

In this chapter a background on the assurance industry and Porter's model is given, followed by the motivation for the study, problem statement and research questions, research objectives and research methodology. The chapter concludes with a brief chapter overview and summary.

1.2. ASSURANCE INDUSTRY BACKGROUND

Marx and Dijkman (2009) identified a number of factors that drastically impact the evolving role of the registered assurance profession, including the constant increase in the complexity and number of laws, regulations and standards governing entities and their auditors, globalisation, information technology and the volume of transactions. Following the corporate collapses and major United States (US) bankruptcies of Enron and Worldcom in 2002, landmark legislation known as the

Sarbanes-Oxley Act (Sarbanes-Oxley Act, 2002) or SOX was implemented under the, then governing, George Bush administration (Burrows, 2011:60). The act was aimed at restoring confidence in the markets by requiring corporate executives to certify their financial statements as well as their use of appropriate internal controls. SOX also limited consulting by auditors to ensure that independence was maintained and that their audit opinions could be relied upon (Burrows, 2011:60). The Enron bankruptcy resulted in the demise of Arthur Andersen, one of the, then, Big Five auditing firms (Thomas, 2002). Since then, the “Big Four” audit firms / assurance organisations of the world are: Deloitte, Ernst & Young, KPMG and PwC (Marx & Dijkman, 2009; Dunn *et al.*, 2011; Temkin, 2008).

In a study by Dunn *et al.* (2011), in which the impact of the Big Four audit firms’ consolidation on the audit market share equality was investigated, an increased equality amongst the Big Four audit firms at both the national-industry level and city-industrial level was identified (Dunn *et al.*, 2011:72). Tyranski (2008:11) states that the reputation of the Big Four remains very strong, but many national and regional firms continue to gain market share among public companies. Tyranski (2008) argued that the expectation that an organisation had to use a Big Four auditor was beginning to erode. On the New York Stock Exchange (NYSE), an increase in the number of next-tier national and regional firms performing company audits (like BDO, Grant Thornton and Moore Stephens) was noted. Tyranski (2008) also noted that the percentage of NYSE-operating companies audited by a Big Four firm decreased from 98% a few years earlier to 94%.

Amoils (2008) stated that, of the 339 companies listed on the main board of the Johannesburg Stock Exchange (JSE), 67% of the companies were audited by the Big Four audit firms. According to the 25 May 2011 JSE list of accredited auditors, there were 29 Independent Regulatory Board of Auditors (IRBA) registered audit firms that met the JSE requirements to audit a listed company (JSE, 2011). In spite of this, of the ‘Top 40’ companies listed on the Main Board of the JSE in 2009, only two companies were audited by non-Big Four audit firms (Marx & Dijkman, 2009). Temkin (2008) and Marx and Dijkman (2009) identified the inability to limit one’s liability and the cap and cost involved with professional indemnity insurance as the main reasons for the inequality of large clients audited by other firms.

In a study by Clatworthy *et al.* (2009:162) it was noted that a large number of studies predicted and found, that large auditors demanded a premium for their services; possibly due to superior audit quality, comprehensive financial wealth and resources (deep pockets) and other reputational effects. In the study, the Oaxaca-Blinder decomposition was applied to OLS regression results and it was found that the greater part of the Big Four's premium was attributable to large differences in the characteristics of Big Four and non-Big Four auditees. Using the estimates of linear equations for samples with markedly different characteristics, the Big Four's premium was estimated at 29-31%. Blokdijk *et al.* (2006: 27-28) stated that in a given audit market, considering the expected costs and benefits, clients had a heterogeneous demand for audit quality. Clients that demanded greater quality were served by large firms, and as a result their audits were of a higher expected quality, resulting in a price premium earned by these large firms.

Extremely relevant to the South African environment, is the ongoing process of transforming the social and economic landscape and uplifting the previously disadvantaged groups of people, a term generally referred to as "transformation". The South African government implemented the Employment Equity Act, 1998 and the Broad-based Black Economic Empowerment Act, 2003 that advances people from the so called "previously disadvantaged" groups and aims to promote and achieve equality in the workplace (South Africa, 1998a; South Africa, 2003).

By legal definition, the designated groups include people with disabilities, people from rural areas, white females and all people of colour. Government's employment legislation, however, favours the black-owned companies and reserves 80% of new jobs for black people. The Broad-based Black Economic Empowerment Act is quota-based with specific required outcomes and is implemented through Codes of Good Practice. Each company is required to meet minimum requirements in terms of representation of previously disadvantaged groups, and this is measured through a relatively complex scoring system which allows for some flexibility in the manner in which each company meets its legal commitments. Topics covered in these acts include, amongst others, representation at employee and management level (up to board of director level), equity ownership, procurement from black-owned

businesses and social investment programmes (South Africa, 2003; South Africa, 1998a).

Furthermore the Chartered Accountancy (CA) Charter was implemented in 2011 to help grow the number of black people in the CA profession to better reflect the country's population demographics and to enable and empower black people to meaningfully participate in and sustain the growth of the economy. The Charter aims to hereby advance equal opportunity and equitable income distribution among the country's population (SAICA, 2011).

From the above, it was evident that, although the Big Four were considered to be dominating the market, they also experienced a loss of market share to smaller, next-tier firms. This indicated that some of the market forces might have been underestimated by the Big Four. In addition, the South African environment, with its unique black economic empowerment requirements, puts the industry under a lot of pressure to transform. The author of this dissertation is, therefore, of the opinion that it is advisable for assurance organisations to conduct competitive environment analyses to ensure that all the forces affecting the industry are identified and appropriately addressed. A thorough analysis of the competitive environment could result in a better understanding of the industry, which would allow firms to gain market share and reap the benefits of premiums available to Big Four audit firms.

1.3 PORTER'S FIVE FORCES AND THE GENERIC STRATEGIES

In 1979, *Harvard Business Review (HBR)* published "How Competitive Forces Shape Strategy" by a, then, young economist and associate professor, Michael E. Porter. As his first HBR article, this started a revolution in the strategy field. Porter brought his signature economic rigor to the study of competitive strategy for organisations, regions, nations, and more recently, healthcare and philanthropy. Almost three decades later, the editor's note of Porter's 2008 HBR article "The Five Competitive Forces that shape strategy" emphasised that "Porter's Five Forces" had shaped a generation of academic research and business practice (Porter, 2008:79). Pitkethly (2003:251) claimed Porter's Five Forces model to be one of the most influential and well-known schemes of strategic analysis in the industry environment

to date. The model has been widely used and successfully applied in various manufacturing/product industries, including but not limited to:

- Rubber contractors in the automotive industry (Draoui & Liu, 2007);
- Public agency external analysis using a modified “Five Forces” framework (Vining, 2011);
- Mobile telecom industry in Bangladesh (Moon *et al.*, 2010);
- Publishing industry (Giannelos, 1988); and
- Application to the Nedcor-Stanbic takeover bid (Reddy, 2002).

Porter’s model is an approach for organisations to undertake in determining what they have to do to survive and prosper in a rapidly changing environment. An analysis of the Five Forces allows an organisation to assess its organisation-environment fit, monitor the degree of environmental change and gives it the ability of self-modification and adaption to the changing environment (Giannelos, 1988:36). Porter (1980; 2008) identified the following Five Forces in his model:

- The threat of new market entrants
- Bargaining power of suppliers
- Bargaining power of buyers
- The threat of substitute products or services
- Rivalry among existing competitors

Best (2008:224) rooted Porters’ development of the Generic Strategies to his impact analysis of the five competitive forces on an organisation’s profits. To deliver superior shareholder value, strategies developed have to combat the forces better than those of a rival. Porter identified three Generic Strategies organisations can use to deal with these forces:

- Overall cost leadership
- Differentiation
- Focus

Management has to dedicate themselves to just one of the three strategies to avoid diluting their competitive advantage. This is seen as the only way organisations can

outperform rivals while still delivering high or satisfactory returns to shareholders (Best, 2008:225).

1.4. MOTIVATION

With homogenous audit services provided to a fiercely competitive market with a heterogeneous demand for audit quality, assurance organisations have to distinguish themselves from rivals by having a different strategic approach. In the current study, the theoretical appeal of Porter's models being an excellent tool in evaluating an external environment and deriving strategies could be tested against its practical application and usefulness to a professional services firm (PSF) by means of a case study on one of the globally renowned Big Four firms, referred to as "Organisation X" to protect its identity.

As the world leader in the strength of auditing and reporting standards, the unique South African industry is a perfect fit for conducting a competitive assurance environment analysis. Porter (2008:80) mentioned that understanding the competitive forces and their underlying causes reveals the roots of an industry's current profitability while providing a framework for anticipating and influencing competition and profitability over time. Within the assurance industry, forces are not necessarily well defined and a Five Forces analysis could assist in identifying the strength, importance and characteristics of each force which ultimately determines and affects profitability. Ou and Chai (2007:477) mentioned that strategic researchers had paid little attention to PSF's, which include firms providing assurance services, and coupled with the fact that limited research has been conducted on the assurance industry as a whole, the study aimed to contribute to the literature by revealing some of the underlying roots of competitiveness and profitability within the assurance industry.

1.5. PROBLEM STATEMENT AND RESEARCH QUESTIONS

The Big Four demonstrate the ability to earn a price premium on assurance services provided, but without a thorough understanding of all the external forces, it is proposed that they will be unable to develop optimal strategies to maximise earnings on these available premiums.

A thorough understanding of the rapidly changing assurance industry is essential as it enables organisations to effectively develop current strategies and anticipate future industry developments in order to remain competitive. It was therefore crucial in this study that a Five Forces and Generic Strategy analysis be conducted in the assurance environment.

The above raises the following questions with reference to Organisation X, the subject of the study:

- i. What are the concerns, challenges and developments faced in the South African assurance industry and how do they affect the industry and Organisation X specifically?*
- ii. Which external market forces affect Organisation X and the South African assurance industry, and how are they assessed and categorised within the Porter Five Forces model?*
- iii. What is the correct strategic response to obtain a competitive advantage, based on the industry analysis and Porter's suggested Generic Strategies and does the current strategy, developed by Organisation X, respond appropriately?*

1.6. RESEARCH OBJECTIVES

To answer the research questions formulated in Section 1.5 the following research objectives were addressed in the study:

- I. To formulate an assurance industry analysis incorporating the concerns, challenges and developments as perceived by experienced industry participants:**

To address this objective, semi-structured interviews were conducted with the participants, aimed at gaining an understanding of the industry concerns, challenges, developments and profitability factors from the perspective of experienced industry participants employed by Organisation X. Their combined responses provided a current industry analysis to address the first

research question in Section 1.5. The methodology is more clearly explained in Section 1.7.

II. To perform a literature review of Porter's Five Forces model and an external environmental assessment of these forces as interpreted by experienced industry participants:

To address the second research question in Section 1.5, this part of the study aimed to identify the individual aspects within the Five Forces model that an organisation has to consider; followed by an analysis of how experienced industry participants from Organisation X understood and interpreted these aspects. The Five Forces model was applied to the South African assurance industry by conducting semi-structured interviews with selected participants from Organisation X, in which they assessed the forces in terms of strength and importance, as well as identified the individual characteristics of the forces relevant to the assurance industry.

III. To perform a literature review of the different strategies an organisation may employ to obtain a competitive advantage and to apply these strategies to the assurance industry:

An organisation's response to the competitive environment based on one of the three Generic Strategies was evaluated in an attempt to answer the third research question (refer Section 1.5). It was then attempted to gauge how practical a response based on the three Generic Strategies was (given the specific environment in which Organisation X operated); and how this compared to the current strategy of the organisation to obtain a competitive advantage.

IV. To reach conclusions and make recommendations on all of the above, with Porter's theory in mind.

1.7. RESEARCH METHODOLOGY

1.7.1. RESEARCH DESIGN

This study consisted firstly, of a literature study and secondly, of an empirical study. The literature study focused on the competitive environment in which Organisation X operated and the purpose was to identify and highlight the important variables based on previous research. Information on Porter's Five Forces model and the three Generic Strategies were gathered from textbooks and scientific journals, the internet and other relevant publications.

Secondly, the empirical study analysed the external competitive environment of Organisation X by way of a case study. Guided by the literature study a Five Force analysis was performed on the assurance industry and available strategies to compete was examined. The study included observations, semi-structured interviews and inspection of policies and other strategic documentation at Organisation X to gather the necessary information.

1.7.2. RESEARCH PARTICIPANTS

The empirical research was conducted on the Johannesburg office of Organisation X; one of the Big Four assurance firms. This was the largest office of Organisation X within South Africa. The research was specifically focused on the assurance service line within the organisation and consisted of guided semi-structured interviews (refer to Appendix 1) with eight partners of the firm (referred to as 'the participants') across different assurance sectors. The participants (discussed in detail in Section 3.2.5) were responsible for either, or both service delivery and strategy development and implementation in the assurance industry. Policies and other strategic documentation were also obtained from responsible personnel within Organisation X and considered, together with the interview responses and observations made, to obtain a complete view of the position at Organisation X in support of the case study methodology followed.

1.8. CHAPTER OVERVIEW

1.8.1 CHAPTER 1: INTRODUCTION

This chapter provides a background to the assurance industry and Porter's Five Forces model and the Generic Strategies applied in the study. This is followed by the motivation, problem statement, research questions and objectives of the study. Finally, the research methodology is briefly explained and participants to the study identified.

1.8.2 CHAPTER 2: PORTER'S FIVE FORCES AND THE GENERIC STRATEGIES

This chapter reviews the existant literature on the research topic. Porter's Five Forces analysis is discussed to highlight some of the most important factors an organisation has to consider to ensure competitiveness in its industry. Literature on the Generic Strategy analysis is also examined to highlight the three successful strategies to deal with these forces. Criticisms against the Porter model are reviewed and other popular strategic models are also explored.

1.8.3 CHAPTER 3: COMPETITIVE ENVIRONMENT ASSESSMENT IN PRACTICE: AN EMPIRICAL STUDY

This chapter sets out a detailed explanation of the research method, objectives, data collection procedures and participants of the study. Based on the interview results, the major industry concerns, challenges and developments are formulated and methods Organisation X uses to assess its external environment are discussed. An assurance Five Forces model with a chosen Generic Strategy is presented as a further result of the interviews, observations and inspection of documentation in the case study.

1.8.4 CHAPTER 4: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

Chapter 4 starts with participants' perceived future developments in the assurance industry. The information gathered from the literature study is evaluated in conjunction with the results from the empirical study to propose possible actions Organisation X could take to shape the competitive forces into the organisation's (and perhaps other industry participants') favour. Furthermore the research is

summarised, upon which the final conclusions and recommendations are presented, followed by the limitations on the study and the scope for further research.

1.8.5 CHAPTER 5: THIS TIME FOR AFRICA

From the results and insights gained into the assurance industry and its competitive environment, the forces at work in the industry and the optimal strategies that enable organisations to obtain a competitive advantage, the researcher identifies a gap in the Porter theory and aims to bridge this gap by formulating a strategy specifically for the African environment. This concluded the study and made a contribution to the literature by suggesting a strategy to be followed by assurance organisations to promote the case for investment in the African continent.

1.9. SUMMARY

Assurance organisations compete fiercely to maintain their market share as a result of the increased competition with the advance of globalisation (Barringer & Ireland, 2006:77) joined by increased equality among rival firms (Dunn *et al.*, 2011:72). An industry analysis is essential for organisations within the industry to explore their potential competitive advantage at both the organisational level and the product/service level. The nature, intensity and extent of industry competition are determined by its basic underlying economic structure – defined as the five basic competitive forces (Giannelos, 1988:36; Best, 2008:222).

De Kock (2008:27) accentuated the external environmental evaluation as an essential exercise in both risk and profitability analysis, and conducting a strategic industry analysis ensures that an organisation's resources are focussed on the forces that mainly contribute to profitability (Hoskisson *et al.*, 2004:90). In the assurance industry it is submitted that profitability is mainly a function of rivalry between competitors, and it could be of value to determine how the other underlying factors/forces ultimately affect the profitability of organisations in the assurance industry. This research conducted, uncovered the strength and importance of each of the forces in the assurance industry, which will assist strategists in assigning appropriate resources to shape the forces into an assurance organisation's favour.

This chapter provided some background on the assurance profession, Porter's Five Forces model and the Generic Strategies which was followed by the motivation, problem statement and objectives of the study, together with a brief explanation of the research method and participants of the study. In Chapter 2, the themes highlighted in Chapter 1 will be further explored by way of a detailed literature review, to set the scene for the empirical study documented in Chapter 3.

CHAPTER 2: PORTER'S FIVE FORCES AND THE GENERIC STRATEGIES

2.1. INTRODUCTION

The generic characteristics of a service (which includes assurance services) as something that is perishable, subjective, intangible, immediate and inherently variable, were criticised by Chen and Hsieh (2008:40-41) as too generic and not applicable to all services. For services to be effective, Chen and Hsieh (2008:41-43) identified the management of service delivery, service production as a performance rather than an objective, service standardisation as a means of producing service quality and the management of employee emotions to achieve successful service production and delivery, as essential.

Professional service firms have different objectives that vary from longevity and survival to quality of life for partners and collegiality within the firms, economic performance and a lasting impact on public life or improved social welfare. These objectives are only worthwhile when the PSF partners agree to pursue them (Nanda, 2004:1). Nanda (2004) conducted a study on the drivers on which PSF leaders had to focus on, if they sought to achieve superior economic returns (which is probably the most common objective of the ones listed above). In a professional partnership, profit earned per partner was the measurement used for economic return. The study concluded that profitability was driven by leverage, margins and productivity, of which increased productivity had the strongest effect on increasing profitability. The drivers were interrelated as Nanda (2004) found a negative relation between margins and leverage; leverage and productivity weakly related, and productivity and margins strongly and positively related. Because of the latter's strong positive relation, simply cutting margins is unlikely to yield improved productivity or, consequently, profitability (Nanda, 2004:13). As productivity (which essentially increases profitability) was identified as an important driver, it appears that increasing profitability in the assurance industry is as simple as increasing service productivity and effectiveness.

Porter conversely gave a different perspective on determining the profitability of an industry through his summary of the theoretical foundation of the Five Forces model as: "Industry structure, as manifested in the strength of the five competitive forces,

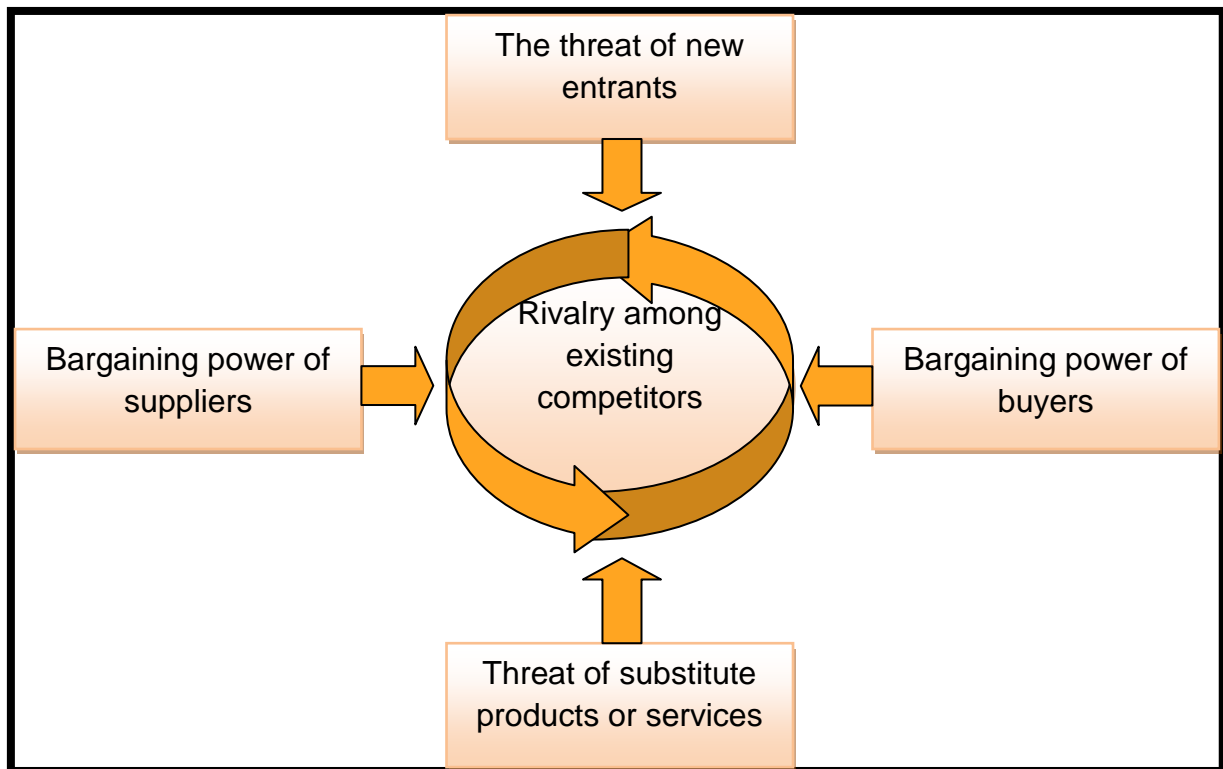
determines the industry's long-run profit potential because it determines how the economic value created by the industry is divided – how much is retained by organisations in the industry versus bargained away by customers and suppliers, limited by substitutes, or constrained by potential new entrants” (Porter, 2008:86). He explained that by considering all five forces, a strategist keeps overall structure in mind, instead of leaning into any one element and the strategist's attention remains focused on structural conditions rather than on fleeting factors. In this study the assurance industry was analysed to determine the roots of profitability – which foster either Nanda's proposed factors of leverage, margins and productivity, or the industry structure as suggested by Porter.

In Chapter 1, the importance of the assurance industry and the Porter model was briefly explained. In this chapter the literature behind Porter's Five Forces analysis is discussed together with the Generic Strategies an organisation may employ to compete with other organisations. This chapter also highlights some of the criticisms against the Porter model and reviews other relevant strategic models available to professional services firms.

2.2. PORTER'S FIVE FORCES ANALYSIS

Porter (2008:79) highlighted the understanding and dealing with competition as the fundamental job of a strategist. He, however, noted that managers frequently define competition too narrowly, as if it only occurred among the current direct competitors, while competition for profit actually goes beyond established industry rivals to also include four other competitive forces, namely: customers, suppliers, potential entrants and substitute products. The extended rivalry resulting from all five these forces (referred to as the Porter Five Forces, illustrated in figure 1) defines an industry structure, while also shaping the nature of competitive interaction within the industry (Porter, 2008:79).

Figure 1: Porter's Five Forces



(Source: Porter, 2008:80)

Porter (2008:80) noted that a healthy industry structure should be as much a competitive concern to strategists as their organisations' own position – as understanding the industry structure is essential to effective strategic positioning. Understanding these competitive forces and their underlying causes reveal the core of an industry's current profitability, while providing a framework for foreseeing and affecting both competition and profitability over time (Porter, 2008:80). Crucial to any organisation's strategy, is defending against the competitive forces and shaping them into the organisation's favour (Porter, 2008:80; Pitkethly, 2003:251).

Porter (2008:80) added that the configuration of the Five Forces differs between the various industries, with an industry's profitability determined by the strongest competitive force which ultimately becomes the most important to strategy formulation. The strongest force is conversely not always that apparent (Porter, 2008:80), and the author of this dissertation submits this fact to be true in the assurance industry as well. The strength of each competitive force is determined by the industry structure, which grows in turn out of a set of economic and technical

characteristics or “drivers”. These “drivers” are examined in detail through the literature study on the Porter Five Forces and are discussed in the following sections:

- The threat of new market entrants (2.2.1)
- Bargaining power of suppliers (2.2.2)
- Bargaining power of buyers (2.2.3)
- The threat of substitute products or services (2.2.4)
- Rivalry among existing competitors (2.2.5)

2.2.1 THE THREAT OF NEW MARKET ENTRANTS

Draoui and Liu (2007:9) stated that a highly profitable industry becomes a magnet to various new entrants. The new capacity, desire to gain market share and financial resources put pressure on prices, profitability, costs and the rate of investment necessary to compete in the industry (Porter, 2008:80; Ehmke *et al.*, 2004:7; Draoui & Liu, 2004:9; Hoskisson *et al.*, 2004:83; McCray, 1985:33; Giannelos, 1988:40). Porter stated that it is the threat of entry – not whether entry actually occurs – that will hold profitability down (Porter, 2008:81).

The magnitude of the threat is determined by the height of entry barriers and the reaction expected from incumbents. The probability of reaction is high in markets where firms have a history of retaliation, excess cash is committed to the industry or the industry shows slow growth (Porter, 2008:81; Ehmke *et al.*, 2004:7). Entry barriers are unique for each industry and situation and can change over time, and most barriers relate to an irreversible resource commitment that has to be made in order to enter a market. Because of the significant costs involved in setting up a production facility, the barriers to entry are usually higher in manufacturing organisations compared to service organisations (Ehmke *et al.*, 2004:7). Porter (2008:82) concluded that an analysis of barriers to entry and expected retaliation are crucial for any company contemplating entry into a new industry. He argued that the challenge is to find ways to surmount the entry barriers without nullifying, through heavy investment, the profitability of participating in the industry. The barriers to entry, faced by new entrants, together with results from previous empirical studies are discussed under 2.2.1.1 – 2.2.1.7 below:

2.2.1.1 Economies of scale

Economies of scale refer to the decline in unit cost of a product as the absolute volume per period increases. Economies of scale deter entry by forcing entrants to come in at large scale and risk rigorous reaction from existing firms or come in at a small scale and accept significant cost disadvantages, both seen as undesirable options (Draoui & Liu, 2007:10; Giannelos, 1988:40; McCray, 1985:36; Reddy, 2002:6).

2.2.1.2 Product differentiation

Product differentiation indicates that established firms possess advantages of brand recognition and customer loyalties which stem from past advertising, customer service, product differences or simply being first in the industry. To build their own brand name and reputation in the market, new entrants are forced to spend heavily on product development, advertising and customer service to establish their brand and overcome existing customer loyalties (McCray, 1985:37; Draoui & Liu, 2007:10).

2.2.1.3 Capital requirements

Entering a new industry requires the investment of large financial resources in fixed facilities, extending customer credit, building inventories, funding of start-up losses and securing distribution channels (Porter, 2008:81; Draoui & Liu, 2007:10). This large scale of investment may deter new entrants – the barrier being particularly great when capital is required for risky or unrecoverable up-front costs like advertising and research and development (Porter, 2008:81; Draoui & Liu, 2007:10; McCray, 1985:40).

2.2.1.4 Switching costs

Switching costs are the one-time costs buyers of existing products are required to incur to switch from one supplier's product to another's (McCray, 1985:42; Giannelos, 1988:41; Reddy, 2002:6). Reddy (2002:6) mentioned that when these costs are high, new entrants have to offer a major improvement in cost or performance to encourage the buyer to switch from an established organisation.

2.2.1.5 Cost disadvantages

Established organisations might have cost advantages not replicable by new entrants irrespective of their size and attained economies of scale. The most critical advantages are proprietary product technology, favourable access to scarce sources of supply, favourable locations, government subsidies, product and design experience and learning or experience curve effects (Draoui & Liu, 2007:10; Giannelos, 1988:41; McCray, 1985:45; Reddy, 2002:6).

2.2.1.6 Government policy

Government can either limit/foreclose entry into industries through limits on access to sources of supply, legislation and licensing requirements (McCray, 1985:46; Giannelos, 1988:41; Reddy, 2002:7), or stimulate entry through subsidies or aiding research and development (Porter, 2008:81).

2.2.1.7 Previous empirical results

In analysing the barriers to entry for new competitors in the educational publishing industry, Giannelos (1988:168) summarised the barriers to entry in table 1 as follow:

Table 1: Profile of barriers to entry in the educational publishing industry

Barriers to entry	Strength		
	Low	Medium	High
Economies of scale	x		
Product differentiation			x
Capital requirements			x
Switching costs	x		
Cost disadvantages		x	
Distribution channels		x	
Government policy	x		

Giannelos (1988:169) concluded that the publishing industry in general (which includes access to distribution channels as a relevant barrier) presented relatively high barriers to entry for new entrants, and highlighted the belief of one of the marketing and publishing directors interviewed that the barriers in the industry are

not expected to change significantly to make it any easier for new firms to enter the market in the future.

Draoui and Liu (2007:41) concluded that from the empirical results in the case of rubber subcontractors in the automotive industry a significant challenge was that the threats for new entrants were quite high and therefore had a major influence on the competitiveness of the case company. The company and the other existing subcontractors were constantly unable to prevent the entry of the new players, mainly because some of the barrier to entry factors were not critically high enough to discourage new entrants.

2.2.2 BARGAINING POWER OF SUPPLIERS

Suppliers can exert bargaining power through influencing the terms and conditions of transactions in their favour and capturing more value for themselves. This may be achieved through threatening to raise prices, limiting or reducing the quality of purchased goods and services or shifting costs to industry participants. Powerful suppliers can thereby squeeze profitability out of an industry unable to recover cost increases in its own prices (McCray, 1985:75; Giannelos, 1988:46; Reddy, 2002:10; Porter, 2008:82; Ehmke *et al.*, 2004:2).

Ireland *et al.* (2006:56) added that when a supplier has the ability to either increase the price of its product, or reduce the quality while selling it at the same price, the effect on established organisations' profitability will be negative. If suppliers are weak, this gives buyers the opportunity to force down prices and demand higher quality (Reddy, 2002:10). In 2.2.2.1 – 2.2.2.6, a number of factors that can boost the supplier power in an industry are discussed, followed by highlights from prior research in 2.2.2.7.

2.2.2.1 Suppliers' concentration

Porter (2008:82) considered a supplier group to be powerful when it is more concentrated than the industry it sells to. Suppliers either selling critical products to buyers or a few suppliers selling to numerous fragmented buyers will usually be able to exert considerable influence in the negotiation of prices, quality and terms (McCray, 1985:78; Giannelos, 1988:46; Reddy, 2002:10; Draoui & Liu, 2004:13).

2.2.2.2 Switching costs

Switching costs are the fixed costs that industry participants encounter when switching or changing from one supplier to another (Barringer & Ireland, 2006:82; Porter, 2008:82). The higher the switching costs, the less likely a buyer will be to switch between suppliers (Barringer & Ireland, 2006:82). Draoui and Liu (2004:13) added that buyers will be less likely to switch when a strong relationship has been built with a supplier by investing time, money and vigour.

2.2.2.3 Threat of forward integration

Forward integration is the credible strategic opportunity for a supplier to enter and compete in the industry of its current buyers. The supplier therefore no longer sells to its buyers, but rather sells its products directly into the buyers' industry (i.e. to the buyers' customers). The appearance of such an opportunity enhances supplier power and poses a serious threat to the buyers (Barringer & Ireland, 2006:82; Porter, 2008:83; Draoui & Liu, 2004:13). Porter (2008:83) explained that suppliers will be induced to enter the market whenever industry participants (buyers) are making too much money relative to their suppliers.

2.2.2.4 The industry is not a key customer for the suppliers

Porter (2008:82) stated that suppliers serving many industries will not hesitate to extract maximum profits from each industry. When supplier sales in a particular industry do not represent a significant fraction of overall sales, suppliers are much more prone to exert power (Draoui & Liu, 2004:13; McCray, 1985:80). When a particular industry or an important customer accounts for a large portion of a supplier's volume or profit, the supplier's fortune will be closely tied to the industry or customer and it will want to protect this market through reasonable pricing, and assistance in activities like research and development and lobbying (Porter, 2008:82; McCray, 1985:80).

2.2.2.5 Product importance

Supplier power increases when their products are an important input to the success of the buyer's manufacturing process or product quality. This is particularly true

where the input is not storable, thus preventing the buyers from building up stocks of inventory (McCray, 1985:81; Reddy, 2002:10; Draoui & Liu, 2004:13).

2.2.2.6 Additional considerations

The power of even larger, powerful suppliers may be hampered if they compete with substitutes, therefore supplier power increases when suppliers are not obliged to contend with other substitute products sold in the industry (Reddy, 2002:10; McCray, 1985:78; Porter, 2008:82). Selling differentiated products disables buyers from playing suppliers off against one another, thereby further increasing supplier power (Reddy, 2002:10; Porter, 2008:82).

Porter (1980:27), Reddy (2002:10) and Giannelos (1985:47) added that labour also has to be recognised as a supplier that possesses great power in many industries. Labour power depends on the degree of organisation and the available labour pool. Labour power increases in highly organised and unionised industries where the available labour pool is limited. Scarce, highly skilled employees, tightly unionised labour and skills shortages could bargain away a significant fraction of potential profits in an industry.

2.2.2.7 Previous empirical results

The bargaining power of suppliers in the publishing industry was usefully captured by Giannelos (1988:202) in table 2. The double minus reflects very low bargaining power and the double plus very high bargaining power.

Table 2: The bargaining power of suppliers in the educational publishing industry

Condition	Power			
	--	-	+	++
Suppliers concentration			x	
Switching costs	x			
Forward integration	x			
Industry importance	x			
Product importance			x	

Due to the pattern of crosses the bargaining power of suppliers were considered weak and was not considered as a threat to the profitability of the school textbook publishing industry.

Draoui and Liu (2007:41-42) found that many powerful suppliers enjoyed superior bargaining power over their case company and its rivals even though they were the main buying industry from these suppliers. In addition, the case company, unlike its suppliers was significantly dependent on them with high switching costs. The company consistently feared that one of its suppliers could integrate forward to become part of its rivals in the future. They found that the suppliers might indirectly and negatively affect the relationship of the case company with its customers (i.e. carmakers) if they delivered their products late or of an inferior quality. All the above facts were seen to generate difficulties for the case company to maintain its competitiveness in the marketplace.

2.2.3 BARGAINING POWER OF BUYERS

Powerful buyers can suppress the profitability of the industries from which they purchase by forcing prices down, demanding increased quality and service or playing off industry participants against each other – all at the expense of industry profitability (Porter, 2008:83; Draoui & Liu, 2004:13; Barringer & Ireland, 2006:82; McCray, 1985:60). Hoskisson *et al.* (2004:87) and Porter (2008:83) identified powerful buyers, as buyers who have negotiating leverage relative to industry participants, especially if they are price-sensitive, using their clout primarily to pressure price reductions. On the contrary suppliers can raise their prices and increase their profitability when buyers are weak (Reddy, 2002:11). The power of each of the industry's important buyer groups depends on the characteristics of its market situation and on the relative importance of its purchases from the industry compared with its overall business (McCray, 1985:60).

The factors that affect a buyer's ability to put pressure on suppliers and to restrain the profitability of the industry within which they purchase are discussed in 2.2.3.1 – 2.2.3.6, while 2.2.3.7 will once again highlight previous empirical results.

2.2.3.1 Buyers' group concentration

According to Barringer and Ireland (2006:82), a few large buyers buying from a large number of suppliers can pressure suppliers to lower costs, thus affecting the profitability of the suppliers from which they buy. Draoui and Liu (2004:14) concurred and added that buyers requiring basic products will maintain high bargaining power over suppliers and still have the ability to switch to any supplier at any time without eventual loss, increasing the importance of the buyers towards the suppliers' business processes.

2.2.3.2 Significant buyer costs

When the products that buyers purchase from the industry represent an integral part of their total costs or purchases, buyers will be more sensitive to price, shop around for a favourable price and purchase selectively (Reddy, 2002:11; McCray, 1985:66; Draoui and Liu, 2004:14). When the products sold in the industry constitute a small fraction of buyers' costs, they are usually much less price sensitive (McCray, 1985:66).

2.2.3.3 Degree of standardisation of suppliers' products

A buyer's bargaining power is affected by the degree to which a supplier's product differs from its competitors (Barringer & Ireland, 2006:82). A standardised or undifferentiated product offered by suppliers will increase the bargaining power buyers have over suppliers. When buyers believe they can always find an equivalent product, they will play off one supplier against another to obtain the best offer in terms of price, quality and service (Draoui & Liu, 2004:14; Porter, 2008:83; McCray, 1985:67).

2.2.3.4 Switching costs

Switching costs, defined in 2.2.1.4 and 2.2.2.2, lock buyers to particular sellers. Conversely, the buyer's power is enhanced if the seller faces switching costs (McCray, 1985:68). Switching costs can make the suppliers highly dependent on particular buyers as the high switching costs already built up by buyers will enhance their bargaining power over suppliers (Draoui & Liu, 2004:14).

2.2.3.5 Threat of backward integration

Draoui and Liu (2004:14) emphasised that profitability of suppliers may face significant threats from buyers if a lucrative opportunity in the marketplace appears for buyers to enter and thus become a rival within the supplier's industry (backward integration). Porter (2008:84) added that buyers will threaten to integrate backwards and produce the industry product themselves when suppliers are too profitable.

2.2.3.6 Additional considerations

Additional considerations, according to Draoui and Liu (2004:14) are the importance of suppliers' products to buyers, the profitability of buyers within the industry (determines the sensitivity to prices) and the ability of buyers to exercise information control over suppliers (information regarding the actual demand for suppliers' products/services and their various costs incurred increases the buyer's ability to negotiate the most competitive prices).

Ehmke *et al.* (2004:5) highlighted the fact that bargaining power of buyers can be reduced by increasing their loyalty to the supplier. Partnerships, loyalty programs, selling directly to consumers and establishing a brand to increase the perceived value of a product or service are means by which buyer loyalty can be increased. Reddy (2002:12) and Treacy and Wierseman (1993) argued that the idea of organisations succeeding by "selling value" was not new. What is new, is how buyers determine value in many markets. In the past, buyers judged the value of a product or service on the basis of some combination of quality and price. At present buyers have an expanded concept of value that includes convenience of purchase, after-sales service and dependability, amongst others. In order to meet the bargaining power of buyers, these authors suggested that organisations focus on one of the three value disciplines:

- operational excellence;
- customer intimacy; or
- product leadership.

2.2.3.7 Previous empirical results

The conditions of bargaining power of buyers in the publishing industry were summarised by Giannelos (1988:202) in table 3. The double minus, once again, reflects very low bargaining power and the double plus, very high bargaining power.

Table 3: The bargaining power of buyers in the educational publishing industry

Condition	Power			
	--	-	+	++
Buyers' group concentration				x
Significant buyer cost		x		
Degree of standardisation		x		
Switching cost			x	
Backward integration	x			

Even though the scatter of crosses in the above table might seem to indicate to the casual observer that bargaining power in the publishing industry was approximately equal between buyers and suppliers, such a conclusion is incorrect, as the diagram does not reflect the fact that there was only one buyer in the study by Giannelos. Buying power was concentrated in the hands of government, although represented by different departments, and gave tremendous leverage and bargaining power to the buyer, while it posed a threat to publishers (Giannelos, 1988:195).

Draoui and Liu (2007:42) discovered that there were many subcontractors besides their case company that could serve the carmakers with the same/similar products, and the case company was experiencing high switching cost and low bargaining power with its buyers. They found that the buyers were both efficient in analysing the various suppliers in their industry and sensitive to the prices and quality of the company's products. This greatly facilitated buyers to possess a high bargaining power position over the case company, although the products of the company were critical in their manufacturing process. They concluded that, all in all, the influence of the buyers was significantly challenging the competitiveness of the case company.

2.2.4 THE THREAT OF SUBSTITUTE PRODUCTS OR SERVICES

Porter (2008:84) and Ehmke *et al.* (2004:10) defined a substitute as a product using a different means to perform the same or a similar function or satisfy a similar need as an industry product. Organisations are typically competing with others, offering the same or similar products within an industry and substitute products from other industries (Draoui & Liu, 2004:11). Pitkethly (2003:253) explained that when an alternative product or service with obvious advantages arises in competition with existing ones, it will affect the industry's attractiveness. Giannelos (1988:44) stated that it is the degree to which suitable or acceptable substitute products are available or might become available that determines the pressure from substitutes on organisations.

Substitutes limit the potential returns of an industry by placing a ceiling on prices, established organisations can profitably charge (Porter, 1980:23; Porter, 2008:84; Reddy, 2002:7). This is due to buyers' trade off between price and performance – the greater the differential, the more attractive the substitute and the firmer the lid on industry profits (Porter, 1980:23; Giannelos, 1988:44). Substitute products requiring the most attention are:

- those which reveal trends of improving their price-performance trade-off relative to the industry's product (McCray, 1985:73; Reddy, 2002:7; Giannelos, 1988:44; Porter 2008:84); or
- products of high profit industries where product performance improvements or price reductions occur because of competitive developments (McCray, 1985:73; Reddy, 2002:7; Giannelos, 1988:44).

Buyers are typically made price sensitive as they continually compare different products with their available substitutes in order to find the best deal, with the price they are willing to pay partially depending on the availability of substitute products (Draoui & Liu, 2004:11; Barringer & Ireland, 2006:78). Porter (2008:84) highlighted that substitutes are always present, but are easily overlooked as they might appear to be very different from the industry's product. A better relative value of a substitute product will place a cap on industry profit potential. Hence an industry should distance itself from substitutes through product performance, marketing or other

means (Porter, 2008:84). Barringer and Ireland (2006:78-79) concurred that the ability of a substitute product to suppress the profitability of an industry depends on the propensity for buyers to substitute alternatives; hence organisations in an industry will often offer amenities to customers to reduce the likelihood of their switching to a substitute product. Substitutes do not only limit profits in normal times, but also reduce the benefits an industry can reap in good times (Porter, 2008:84).

Draoui and Liu (2004:11) emphasised the willingness of some buyers to mainly buy products available at the lowest prices. A substitute product offered at a reasonable and attractive price will therefore trigger an automatic switch to this product, thereby threatening an entire industry's profitability. New developments will consequently impact industry development and prosperity negatively. Reddy (2002:7) mentioned that when an organisation's products have few close substitutes then, other factors being equal, it has the opportunity to raise prices and earn more profits. Therefore, its strategies ought to be designed to take advantage of this fact.

In a constantly changing environment it is necessary for organisations to continuously monitor their own and adjacent industries for changes that might make them attractive substitutes when they may not have been before (Giannelos, 1988:44-45; Porter, 2008:85). Consequently, technological changes or competitive discontinuities in seemingly unrelated businesses could have a major impact on industry profitability. Furthermore substitution is often seen as the threat that one product will displace another, while it should actually be envisaged more broadly, as the threat that new business models will displace old ones.

On the contrary, the substitution threat could shift in favour of an industry and can add to its future profitability and growth potential (Porter, 2008:85). Ehmke *et al.* (2004:10) reassured organisations that customers might be reluctant to switch to another product even if it offers advantages to them. When accustomed to either using a certain product in a certain way or the way certain services are rendered, customers might consider it inconvenient or even risky to switch to a substitute.

In the case of rubber contractors in the automotive industry, Draoui and Liu (2007:26) found that their case company believed that the existence of a powerful substitute product would represent a big threat to the competitiveness of the

company. At the time of their study there was no such kind of a substitute to the products of the case company in the marketplace that served the automotive industry. However, the use of the rubber in car production would disappear over the long term as the sealing products (future substitute product) were going to replace it. At the time of their study the sealing products were still expensive, but as they become cheaper they would represent a big threat to the case company. It was anticipated to be difficult to get rid of the strong competition, and it would threaten the profitability of the case company and its industry, leading to a decline in the company's competitiveness (Draoui & Liu, 2007:26). Until these sealing products became cheaper, the threats of the substitute products over the case company were still very low with no challenging influence on its competitiveness (Draoui & Liu, 2007:41). The case company's response to this was that the only option they had was to add these substitute products to their service line (Draoui & Liu, 2007:26). Draoui and Liu (2007:41) concluded that even though there was no substitute product to the case company's products that could serve carmakers, these carmakers were still possessing superior bargaining power over the case company.

2.2.5 RIVALRY AMONG EXISTING COMPETITORS

Rivalry among existing competitors take the familiar form of jockeying for position, where organisations use tactics like advertising battles, price competition, product introductions and increased customer service or warranties to rival each other (McCray, 1985:47; Reddy, 2002:8; Porter, 2008:85; Draoui & Liu, 2004:11; Porter, 1980). McCray (1985:47) stated that rivalry occurs because one or more competitors either feel the pressure or see the opportunity to improve their position. Price cuts are quickly and easily matched by rivals, and unless the industry price elasticity of demand is high enough, they lower revenues for all organisations. Advertising battles, on the other hand, might well enhance the level of product differentiation or expand demand in the industry for the benefit of all organisations (Porter, 1980; Reddy, 2002:8).

The degree of competition intensity among established companies is the major determinant of industry profitability in most industries (Draoui & Liu, 2004:11; Grant, 2008:76; Barringer & Ireland, 2006:80). The profitability of an industry will be limited by high rivalry, and the degree by which profitability is driven down depends firstly on

the intensity with which organisations compete, and secondly on the basis on which they compete (Porter, 2008:85). Rivalry among competitors is often also the strongest of the five competitive forces (Ehmke *et al.*, 2004:12), in some industries even to such a degree that prices are pushed below costs (Barringer & Ireland, 2006:80).

Draoui and Liu (2004:11) stated that most rivals focus on price competition strategy even though this is not a sustainable way of maintaining competitiveness over the long term. The nature and intensity of competition among existing rivals are determined by the factors discussed in 2.2.5.1 – 2.2.5.7 below, while 2.2.5.8 highlights previous case study's results.

2.2.5.1 Numerous or equally balanced competitors

Grant (2008:76) defined seller concentration as the number and size distribution of organisations competing within a market. The likelihood of competitors attempting to fight each other off and acquire further market shares by cutting product prices increases with the number of competitors of equal size and power in the industry (Draoui & Liu, 2004:11; Barringer & Ireland, 2006:81; Porter, 2008:85; Grant, 2008:76).

The absence of a clear market leader stimulates price war among competitors as there is no price leadership in the market to restrain such a price war, which could be unbalanced and destructive to the industry (Draoui & Liu, 2004:12; Barringer & Ireland, 2006:81). Draoui and Liu (2004:12) added that foreign competitors exporting directly into the local market or participating indirectly through foreign investment could have a significant impact on the industry competition.

2.2.5.2 Capacity increases in large increments

Where economies of scale dictate capacity to be added in large increments, capacity additions can be chronically disruptive to the supply/demand balance, especially where a risk of bunching capacity additions exists. This may cause recurring periods of overcapacity and price-cutting in the industry (McCray, 1985:54; Reddy, 2002:9; Porter, 2008:85). Grant (2008:77) identified cost structure as the key factor in determining how low prices will go when excess capacity causes price competition,

and added that economies of scale may encourage organisations to compete aggressively on price in order to gain the cost benefits associated with greater volume.

Draoui and Liu (2004:12) highlighted that one of the most significant reasons that could cause industry profitability to fall is the occurrence of unbalanced circumstances between demand and the capacity provided. Unused capacity will result from overinvestment in production or a decline in market demand. Thus organisations will be forced to lower their prices and attempt to attract sufficient customers in order to get rid of the unused capacity.

2.2.5.3 High fixed or storage costs

The intensity of competition in an industry is highly influenced by the level of fixed costs required (Draoui & Liu, 2004:12). Unlike organisations with low fixed costs, those with high fixed costs are forced to achieve higher turnover in order to reach their break-even point (Draoui & Liu, 2004:12; Barringer & Ireland, 2006:81). High fixed costs create strong pressures for all organisations to fill capacity which often lead to rapidly escalating price cutting when excess capacity is present (McCray, 1985:52; Reddy, 2002:8). Organisations are also tempted to cut prices to ensure sufficient sales are made when their products are costly to store (Reddy, 2002:8).

Grant (2008:77) added that when fixed costs are high, relative to variable costs, organisations will take on marginal business at any price as long as it covers variable costs. Porter (2008:85) confirmed that rivalry increases when fixed costs are high and marginal costs are low. Intense pressure is created for competitors to cut prices below their average costs, even close to their marginal costs, to obtain incremental customers while still making some contribution to covering fixed costs.

2.2.5.4 Lack of differentiation or switching costs

Where buyers perceive a product or service as a “commodity” or “near commodity” their choice is largely based on price and service (Reddy, 2002:8; McCray, 1985:53), resulting in intense price and service competition pressure (Reddy, 2002:8). Investopedia (2012) defined a commodity as a basic good, used in commerce (e.g. oil, grain, gas, beef) which meets a specified minimum standard and is

interchangeable with other commodities of the same type. The basic idea is that although the quality of a given commodity may differ slightly, it will be essentially uniform across all producers with little differentiation between a commodity coming from one producer and the same commodity from another producer. Draoui and Liu (2004:12) and Barringer and Ireland (2006:81) verified that the intensity of competition within a particular industry is, in fact, highly influenced by the level of differentiation among the products offered by the diverse organisations within the industry.

Grant (2008:77) and Draoui and Liu (2004:12) emphasised that rivals offering homogenous products and services will stimulate extreme fighting among rivals and affect buyers' willingness to substitute products, which will increase the incentive for organisations to cut prices to maintain or increase their sales. Product differentiation creates layers of insulation against rivalry as buyers have preferences and loyalties to particular organisations (Reddy, 2002:8). Because of the lower switching costs associated with "commodities", the rivalry is higher in respect of these products (Reddy, 2002:8), and Draoui and Liu (2004:12) added that buyers will apparently opt to switch to any substitutes when the switching costs involved are not high.

2.2.5.5 Slow industry growth

Porter (2008:85) and Ehmke *et al.* (2004:12-13) both explained that the intensity of rivalry will be the greatest when industry growth is slow. Draoui and Liu (2004:12) added that market saturation in slow-growth industries pushes organisations to fight for keeping and attracting new customers in order to earn sufficient market shares, thereby decreasing the prices or increasing the quality of products. Barringer and Ireland (2006:81) stated that in contrast to this, fast-growth industries have enough customers to go around filling the capacity of most organisations, thus making price-cutting less likely.

Slow industry growth turns competition into a market share "game" for organisations seeking expansion, and declining demands result in more rivalry, as organisations fight to maintain revenues and market share. With declining demands, market share competition is a great deal more volatile than the situation in which increasing demand ensures that companies can improve profitability just by keeping up with the

industry, and where all their financial and management resources are consumed by expanding within the industry (Reddy, 2002:8; McCray, 1985:51-52).

2.2.5.6 High strategic stakes

Draoui and Liu (2004:12) highlighted the fact that the intensity of competition in a particular industry shows strong instability and severity as long as some of the well-diversified rivals reveal a strong ability and willingness to pull further resources and capabilities in that industry. This action offers them the opportunity to hold a competitive position over the other rivals in the industry. McCray (1985:57) and Reddy (2002:9) added that rivalry in an industry becomes even more volatile when a number of organisations have high stakes in achieving success there.

2.2.5.7 Exit barriers

Exit barriers are economic, strategic, and emotional factors that keep organisations competing in business even when they are earning low or even negative returns on investment (McCray, 1985:58; Reddy, 2002:9). With specialised and durable resources, employees that are entitled to job protection, and management's devotion to a particular business, barriers to exit are substantial (Grant, 2008:77; Porter, 2008:85). As excess capacity remains in use, the profitability of healthy competitors suffers while the sick ones hang on (Porter 2008:85).

2.2.5.8 Previous empirical results

In the publishing industry Giannelos (1988:140) found that an expanding market had been the major factor in reducing competition and had provided excellent financial results for the major competitors where attention had been concentrated on meeting demand. Therefore the limited nature of competition could be ascribed to the growing market which had provided a "place in the sun for all". Giannelos (1988:140) concluded that should the market continue to grow at the forecasted rates, it was anticipated that this pattern was going to continue.

Draoui and Liu (2007:41) concluded that competition among rubber subcontractors was rigorously intense. The lack of opportunity to sell differentiated products, a slow-growth industry and the high overhead costs faced by all existing subcontractors

resulted in intense competition with low switching cost for car manufacturers. This automatically pushed the case company and its rivals to focus mainly on a price-competition strategy that typically led to price-war among the subcontractors. Eventually, all these factors formed a big challenge on the competitiveness of the case company and its whole industry.

2.2.6 CRITICISMS AGAINST THE PORTER MODEL

Reddy (2002:4) identified the linkage of strategy only to the external environment as the fundamental criticism against the Five Forces approach. Reddy (2002) and Grant (1991) highlighted the resurgence of interest in the role of the firm's resources as the foundation for firm strategy. This reflects dissatisfaction with the static, equilibrium framework of industrial organisation economics (like the Porter model) that dominated contemporary thinking about business strategy. These criticisms resulted in a renewed interest in older theories of profit and competition associated with the writings of Ricardo (1891), Schumpeter (1934) and Penrose (1959).

Grant (1991) recommended the Resource-based framework for strategy analyses based on a five-stage procedure:

- Analysing the organisation's resource base;
- Identifying and appraising the organisation's capabilities;
- Analysing the rent-earning potential of the organisation's resources and capabilities;
- Selecting a strategy; and
- Extending and upgrading the organisation's pool of resources and capabilities.

Grant (1991) and Reddy (2002:5) argued that, in a world where customer preferences are volatile, the identity of customers is changing and the technologies for serving customer requirements are continually evolving, an externally focused orientation does not provide a secure foundation for formulating long-term strategy. When the external environment fluctuates, the firm's own resources and capabilities are a much more stable basis on which to define its identity. Consequently, a

definition of business in terms of what it is capable of doing offers a more durable basis for strategy than a definition based on the needs the business aims to satisfy.

Reddy (2002), as well as Hamel and Prahalad (1993), suggested that industry structure analysis is not sufficient, and recommended an alternative framework, in which the concept of stretch supplements the idea of fit. Likewise, instead of looking within the accepted boundaries that defines competition, a new market space framework was suggested by these authors where managers can systematically look across such boundaries. The boundaries of competition (as defined by industry) focus on rivalry, whilst creating new market space encompasses substitute industries (Reddy, 2002:5; Kim & Mauborgne, 1999).

Hamel and Prahalad (1993:75) and Reddy (2002:5) emphasised that, irrespective of the depth of understanding into the various elements of competitive advantage, it is only the *what* of competitiveness that is being understood and not the *why*. Understanding the *what* of competitiveness is a prerequisite for catching up, while understanding the *why* is a prerequisite for getting out in front.

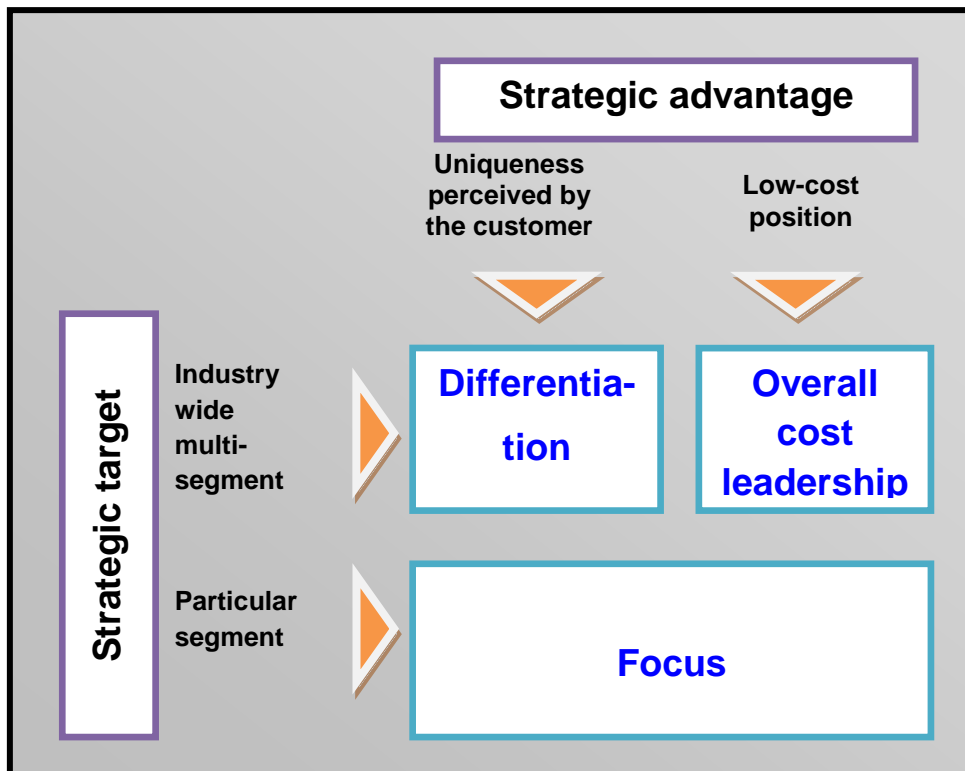
Ormanidhi and Stringa (2008:55) noted that an improved understanding of organisations' competitiveness serves as input to improve policies concerning competition and related issues which in turn provide valuable support to efforts of continuously developing markets and businesses. According to these authors, the Porter model is preferred above other approaches like Structure-Conduct-Performance, Resource-Based Perspective and Market Process Economics, due to the model's popularity, clarity, simplicity, feasibility and presumed generality. Ormanidhi and Stringa (2008:56) viewed the model as an insightful and convenient approach to an organisation's competitive behaviour analysis.

Despite the critics, the author of this dissertation still decided to use the Porter Five Forces model, as this model has been successfully applied in multiple studies in the past, and the model claims to have a broad application across various industries. Apart from the fact that external environmental analysis models are lacking for service organisations, the Porter model have been mostly applied to manufacturing industries, and this case study would test the flexibility, usefulness and relevance of the model to be applied across service industries as well.

2.3. GENERIC STRATEGIES ANALYSIS

Best (2008:224) explained that the Generic Strategies developed by Porter are rooted in his analysis of the impact that the five competitive forces has on organisations' profits. In order to deliver superior shareholder value, strategies have to be developed that will combat the competitive forces better than a rival's strategy. It is submitted that the same holds true for firms in the assurance industry. The Generic Strategies framework of Porter identifies two dimensions; the strategic advantage and the strategic target. This is diagrammatically summarised in figure 2 below:

Figure 2: The Generic Strategies



(Source: Porter, 1980:39)

Strategic advantage can either be achieved through differentiation or overall cost leadership. Strategic targets vary between geographical targets, customer segments served and the range of products. The combination of the two dimensions gave rise to the three main strategic alternatives developed by Porter: differentiation, overall cost leadership and focus (Ormanidhi & Stringa, 2008:57). Porter (1985) recommended focus in two distinct variances; cost focus or differentiation focus.

Given the intensity of the five competitive forces, these strategies are the options that give organisations the ability to secure a favourable position in the industry. Porter also advised organisations to only follow **one** of the recommended strategies. Porter prescribed that the choices among the Generic Strategies are mutually exclusive if an organisation wants to achieve above-average performance.

While explaining his three main strategic alternatives, Porter (1980:35) asserted his view that effectively implementing any of the Generic Strategies requires total commitment and supporting organisational arrangements, which are diluted if aimed at more than one primary target. In the 1998 edition of his book, that was first published in 1980, he reinforced this argument by stating that a common misunderstanding revolves around the need to choose between overall cost leadership and differentiation. He argued that being the lowest cost producer and being truly differentiated and commanding a price premium are rarely compatible. Successful strategies require choice as they could easily be imitated, with a recipe for disaster lying in not choosing a definitive strategy, and being “stuck in the middle” (Porter, 1998:xiv). Ormanidhi and Stringa (2008:57) concurred that the only position not recommended by Porter is being “stuck in the middle”.

The three potentially successful Generic Strategies that could be adopted by an organisation to outperform others in the industry (Giannelos, 1988:49) are discussed in 2.3.1 – 2.3.3 below, followed by criticisms and alternative strategic models in 2.3.4.

2.3.1 OVERALL COST LEADERSHIP

Under this strategy, management aims to cut the costs of providing services and products to below that of rivals (Best, 2008:222). Both the profitability and the market shares controlled by these organisations are substantial, because low cost leaders are capable of matching the prices of their most efficient competitors. Cost advantages have shifted to companies benefiting from low labour cost (e.g. Chinese and Indian companies) and those taking advantage of new technologies (e.g. Skype). These organisations will usually target groups of consumers who have basic, unsophisticated needs, requiring cheap and low quality products and services. However, to achieve cost leadership, the organisation has to obtain a high relative

market share, which requires capital investment in product research and development and manufacturing, as well as aggressive pricing (Gurau, 2007:370; Grant, 2008:226). Giannelos (1988:49) added that the strategic logic of cost leadership requires an organisation to be *the* cost leader rather than one of several organisations battling for this position.

2.3.2 DIFFERENTIATION

Differentiation in an organisation occurs when it provides a unique service that is valuable to buyers beyond simply offering a low price (Porter, 1985:120). Giannelos (1988:50) mentioned that with such a strategy the organisation concentrates on creating a highly differentiated product, delivery system, marketing program, and other factors which are perceived as unique by buyers in the industry. Differentiation can be achieved on the basis of any specific organisational skill or competence that represents a competitive advantage in comparison with other organisations. The aim is on differentiation through superior quality and service in order to develop a unique market proposition. A differentiation advantage occurs when a price premium is obtained through differentiation that will exceed the cost of providing the differentiation. With differentiation, organisations aspire to create price loyalty and price inelasticity which can create entry barriers for direct competitors, and mitigate the power of buyers who lack comparable substitutes (Gurau, 2007:370-371; Grant, 2008:241).

Ou and Chai (2007:483) and Best (2008:222) contended that a successful differentiation strategy allows organisations to provide services of premium perceived value to buyers. The intangibility of services complicates their measurement, and a favourable corporate reputation is consequently identified as a resource that fosters differentiation as it simplifies the marketing of an organisation's services. It also results in business survival and profitability, and is an effective mechanism to accomplish or maintain competitive advantage (Ou and Chai, 2007:484). Building a strong reputation requires a strong organisational culture which develops with cross-functional teams, strong client orientations and brand-supporting climates within an organisation cluster (Chen & Hsieh, 2008:46-48).

Giannelos (1988:50) highlighted the fact that organisations pursuing this strategy have major strengths in research and development, design, quality control and marketing. These strengths provide the organisation with brand loyal customers who are less sensitive to prices and therefore less likely to be lost to competitors. Giannelos (1988:51) further identified that a differentiation strategy differs from that of cost leadership in two fundamental ways:

- In an industry with various highly-valued buyer attributes, there can be multiple successful differentiation strategies, while only one organisation can be the cost leader; and
- The concept of perceived exclusivity, which differentiation is based on is incompatible with high market share and therefore possibly excludes the organisation from gaining an exceptionally large market share.

2.3.3 FOCUS

A focus strategy is aimed at improving an organisation's long-run return on investment by avoiding the substantial investment and margin pressure inherent to serving a mass market. Instead, the organisation focuses its efforts on serving a segment or group of segments in the market very well, rather than going after the whole market (Best, 2008:222; Giannelos, 1988:51). Gurau (2007:371) elaborated by arguing that an organisation is sometimes able to develop a highly specialised expertise in satisfying a clearly defined group of customers, with specific needs and demands. A strategy of focus is usually followed by small organisations that lack the level of resources to develop a cost leadership or a differentiation advantage at overall market scale.

Low cost leadership and differentiation strategies are aimed at achieving organisational objectives on an industry-wide scale, whereas the focus strategy is built around serving a particular target well. The principle inherent in this strategy lies in the organisation's belief that it can serve its narrow strategic target more effectively and efficiently than its competitors, who are competing more broadly (Giannelos, 1988:51). An organisation becomes acquainted with the needs of its target segment/s and focus is attained through either low costs (cost focus) or differentiation (differentiation focus) or both within each segment. While the focused

organisation is not an industry-wide leader it does achieve leadership in its specialised market segment (Giannelos, 1988:52).

2.3.4 CRITICISMS AND ALTERNATIVE STRATEGIC MODELS

2.3.4.1 Introduction

Ou and Chai (2007:477) conducted a strategic analysis of a PSF, and using Porter's Five Forces model as a framework they recommended the strategies of cost leadership and differentiation for PSFs. With their analysis of a large Taiwanese engineering consulting firm, they argued that managers in such firms had to often improve their project management capabilities and enhance their corporate reputation. Clear descriptions of what the firms did and how they added value to clients had to be provided as a marketing tool to differentiate the firms from their competitors, increasing their competitiveness.

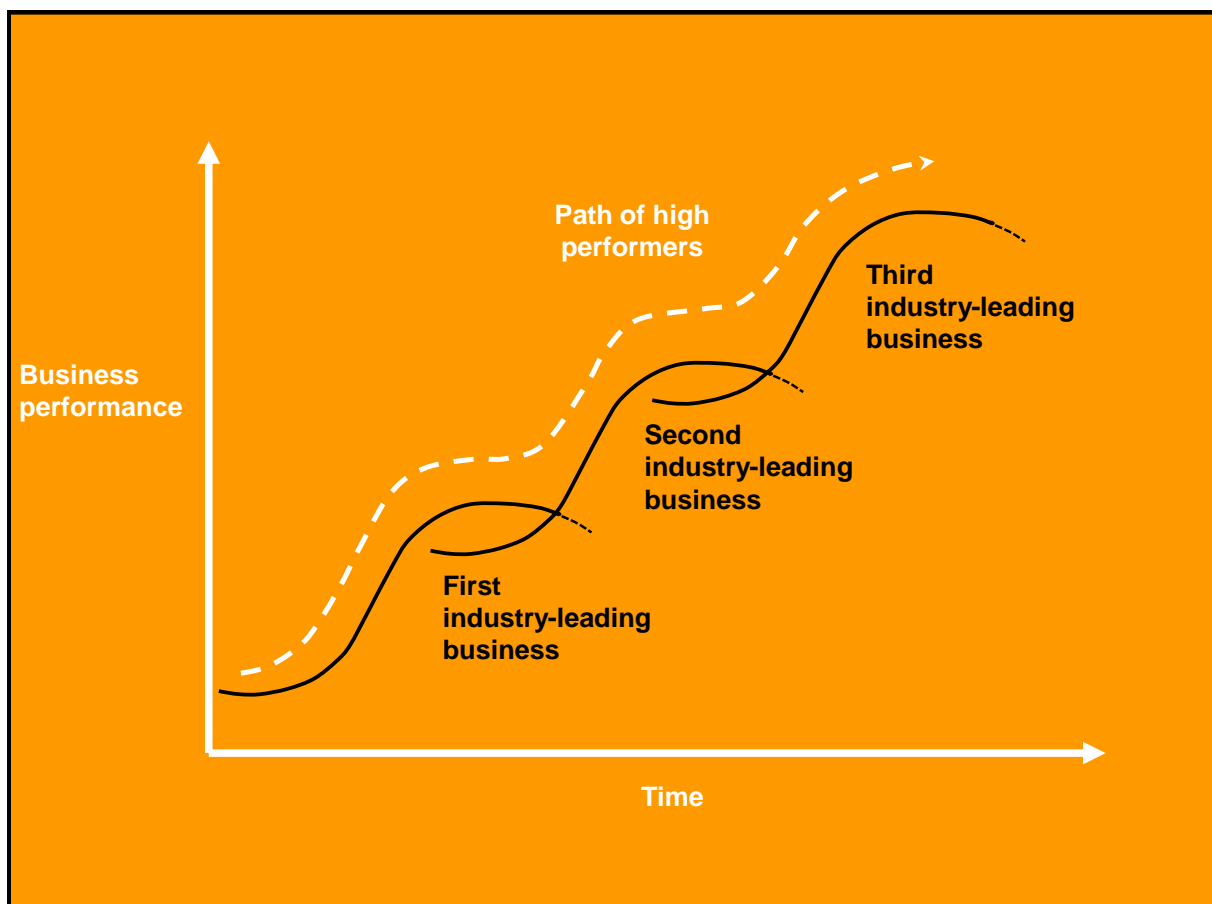
However in a study by Rosenkranz and Weitzel (2007:143) they allowed firms to allocate their budget optimally among the two strategic options of cost reduction and product differentiation, and warned managers that a polarised notion of cost leadership and product differentiation as two mutually exclusive options might lead to suboptimal results. Thus this contrasted Porter's advice that the strategic options should be treated as mutually exclusive. They found that the optimal allocation of resources for strategic positioning changed distinctly when a firm entered an alliance; the general investment level decreased with a shift towards more cost reduction and less product differentiation. Alliances and independent organisations in larger markets were found to invest more in both strategies, with investment driven towards product differentiation. They concluded that the attractiveness of following cost leadership or differentiation changed through industry evolution (Rosenkranz and Weitzel, 2007:135).

Due to the inconsistency in the Porter model's strategic approaches found between Rosenkranz and Weitzel and Ou and Chai above, other available strategic models were also considered and briefly discussed in 2.3.4.2 and 2.3.4.3 below.

2.3.4.2 *Jumping the S-curve*

“Jumping the S-curve: how to beat the growth cycle, get on top and stay there” is a revolutionary model recently introduced by Nunes and Breene (Nunes & Breene, 2011a). They revealed how the best companies succeeded in reinventing themselves time and time again. Drawing on nearly a decade of research in which they examined thousands of companies worldwide, the authors argued that most leaders managed their companies to their visible S-curve – that of revenue growth – in which a business started out slowly, grew rapidly until it approached market saturation and then levelled off. High performers, by contrast, actively managed hidden S-curves – of competition, capabilities and talent – that reached the end of their lives well before the financial curve peaked. By jumping these S-curves early, while the core business continues to thrive, companies lay the foundation for lasting greatness. A graphical depiction of this model is presented in figure 3 below:

Figure 3: The climbing and jumping of S-curves



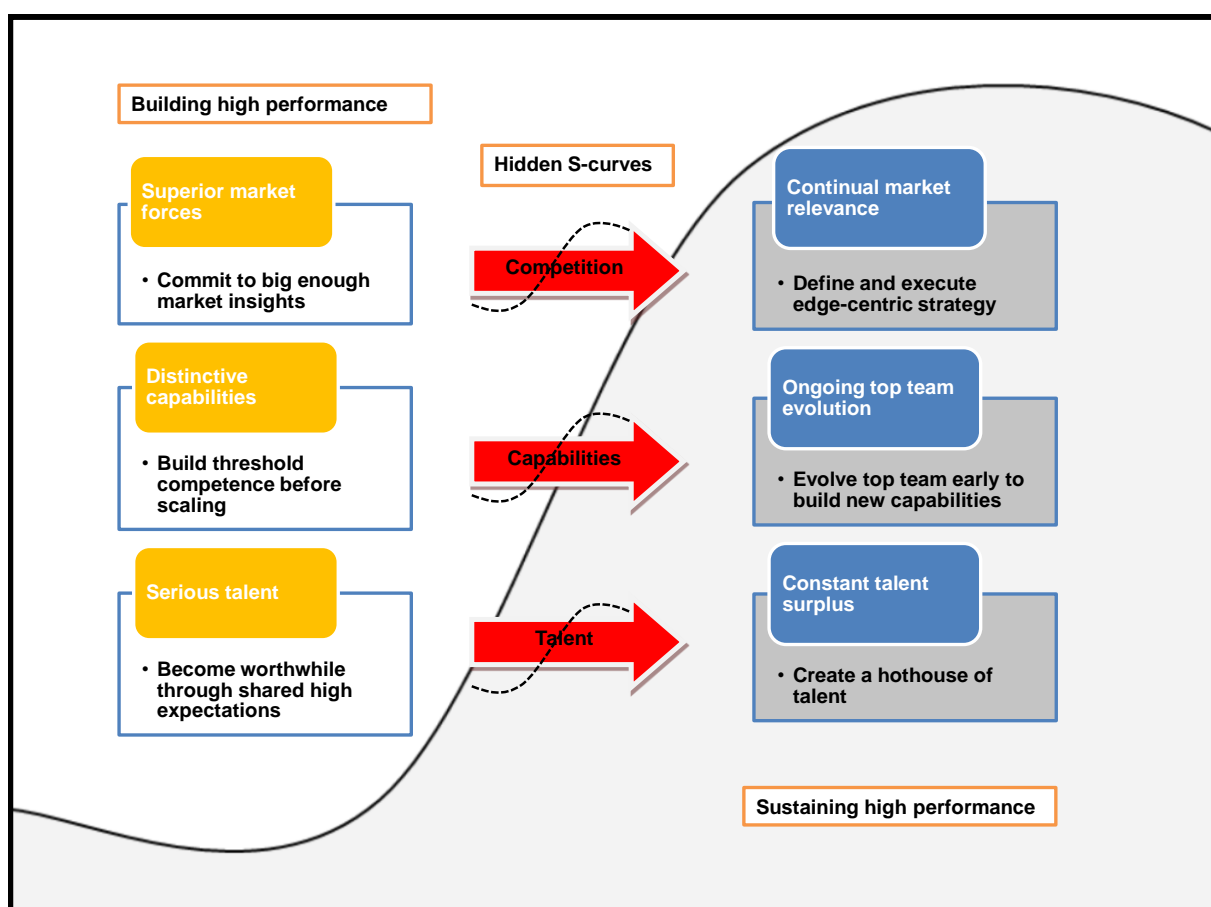
(Source: Nunes & Breene, 2011b:3)

Nunes and Breene (2011a) identified the business elements organisations have to master to climb an S-curve as:

- Seeing the big enough market insights that could take you to the top of an industry;
- Reaching threshold competence before deciding to scale the business; and
- Becoming worthy of the efforts and commitment of serious talent.

These elements are graphically portrayed in figure 4 below:

Figure 4: What it takes to climb and jump S-curves



(Source: Nunes & Breene, 2011b:7)

2.3.4.3 Blue Ocean Strategy

In their book “Blue Ocean Strategy: how to create uncontested market space and make the competition irrelevant”, Kim and Mauborgne (2005) advised that companies had long enough engaged in head-to-head competition in search of

sustained profitable growth. They fought for competitive advantage, battled over market share and struggled for differentiation. Yet in today's overcrowded industries, competing head-on results in nothing but a bloody "red ocean" of rivals fighting over a shrinking profit pool. Challenging the known requirements for strategic success, the authors contended that, while most companies compete within such red oceans, this strategy is increasingly unlikely to create profitable growth in the future. Based on a study of 150 strategic moves spanning more than a hundred years and thirty industries, Kim and Mauborgne argued that tomorrow's leading companies will not succeed by battling competitors, but by creating "blue oceans" of uncontested market space ripe for growth. Such strategic moves – termed "value innovation" – create powerful leaps in value for both the firm and its buyers, rendering rivals obsolete and unleashing new demand. Figure 5 below identifies the main differences between Blue and Red Ocean Strategies:

Figure 5: Red Ocean versus Blue Ocean Strategy

Red Ocean Strategy	Blue Ocean Strategy
Compete in existing market space	Create uncontested market space
Beat the Competition	Make the competition irrelevant
Exploit existing demand	Create and capture new demand
Make the value-cost trade-off	Break the value-cost trade-off
Align the whole system of a firm's activities with its strategic choice of differentiation <i>or</i> low cost	Align the whole system of a firm's activities in pursuit of differentiation <i>and</i> low cost

(Source: Kim and Mauborgne, 2005:18)

The Blue Ocean Strategy provides a systematic approach to making the competition irrelevant, and is the author of this dissertation's recommended strategic approach.

In their frame-changing book, Kim and Mauborgne presented a proven analytical framework and the tools for successfully creating and capturing blue oceans. Examining a wide range of strategic moves across a host of industries, they highlighted six principles that every organisation can use to successfully formulate and execute Blue Ocean strategies. The six principles of Blue Ocean Strategy were identified as:

- Reconstruct market boundaries;
- Focus on the big picture, not the numbers;
- Reach beyond existing demand;
- Get the strategic sequence right;
- Overcome key organisational hurdles; and
- Build execution into strategy.

Kim and Mauborgne (2009:73) emphasised that instead of letting the environment define an organisation's strategy, organisations have to craft a strategy that defines their environment.

2.4. SUMMARY

Porter's model for the development of a competitive strategy requires strategists to first undertake a structural analysis to understand the interaction at work within their industry. The strength of the five competitive forces is determined by industry structure and its underlying economic and technical characteristics, and the relative strength and interaction of these forces determine the profitability of the industry (Giannelos, 1988:54). Giannelos (1988:54) added that a thorough knowledge of these forces enables an organisation to position itself in the market in terms of its own strengths and weaknesses. Reddy (2002) identified the linkage of strategy to only the external environment as a fundamental criticism against the Porter model. Grant (1991) recommended that a firm's resources should be the foundation of strategy, upon which he developed the Resource-based framework based on a five-stage procedure.

Porter (1980:35) and Giannelos (1988:54) proposed that a cost leadership, differentiation or focus strategy could be pursued by organisations within any

industry; but to overcome environmental threats and internal weaknesses, Ou and Chai (2007:485) recommended professional services firms to follow strategies of cost leadership or differentiation. Rosenkranz and Weitzel contrasted this and warned that a polarised notion of cost leadership and product differentiation as two mutually exclusive options might lead to suboptimal results. A Red Ocean Strategy supports the recommendations of Ou and Chai, while a Blue Ocean Strategy follows the Rosenkranz and Weitzel argument.

Despite the critics, the Porter model was still applied in this case study, due to its historical success of application on multiple studies across various industries. This case study also aimed to test the flexibility, usefulness and relevance of the model to be applied upon a professional service firm, for which incredible alternative strategic models was available, while models for analysing their external environment appeared to be lacking.

Based on the literature study in this chapter and the background of the industry discussed in Chapter 1, the semi-structured interview questionnaire was designed (Appendix 1). The Porter Five Forces model and the Generic Strategies, together with additional questions to gain further insight into the major industry concerns, challenges and developments in the assurance industry were discussed with the participants from Organisation X. The details of participants and the interview results are discussed in depth in Chapter 3 before final conclusions and recommendations are made in Chapter 4.

CHAPTER 3: COMPETITIVE ENVIRONMENT ASSESSMENT IN PRACTICE: AN EMPIRICAL STUDY

3.1. INTRODUCTION

Through the empirical study performed in Chapter 3, the strength and importance of each force in the assurance industry can be determined by identifying the economic and technical characteristics which form the assurance industry structure, and ultimately determine the strength of each competitive force as well as the assurance industry's profitability. Best (2008:222) defined the profit potential of an industry, determined by the collective strength of the forces, as the "long-run return on invested capital" of the industry. The strategy of an organisation has to take into account the effect that the Five Forces will have on the organisation, as it will determine its future growth potential and profitability. An in-depth analysis of each of the Five Forces will give strategists a better understanding of the important factors influencing their industry and therefore also the individual factors that should be considered for an organisation to be successful in the long run.

In Chapter 2 the literature on the five competitive forces and the three Generic Strategies to obtain a competitive advantage were examined to establish a sound theoretical base on which the empirical study could be built. In this chapter the research method is discussed in detail, including the specific objectives of the study and the data collection procedure used. The forces affecting Organisation X in the South African assurance industry are analysed and the fundamental aspects within each force are identified. The current strategy implemented by Organisation X to obtain a competitive advantage is then compared to the strategies suggested by Porter. The results of these observations, inspections and interviews are also presented and summarised.

As suggested by Porter and implied by the researcher, the dominant competitive force within the assurance industry was not as apparent as believed, as the results found that the rivalry among the existing competitors within the assurance industry was not the strongest and most influential force. It was also discovered that Organisation X has smartly incorporated elements from all three suggested Generic Strategies into their organisation's strategy, thus confirming Rosenkranz and

Weitzel's finding (Section 2.3.4.1) that treating the strategies as mutually exclusive options will lead to suboptimal results. These and other interesting findings will be discussed in further detail later in this chapter.

3.2. RESEARCH METHOD

3.2.1. INTRODUCTION

The research method is an explanation of how the study was conducted. The discussion starts with the type of research and the objectives of the empirical study. This is followed by a high-level description of the data collection procedure used, semi-structured interviews and the sample of participants used to obtain information. Finally it is discussed how the semi-structured interviews were conducted, and how the empirical results are presented.

Sekaran (2000:6-7) identified two distinctive purposes with which research can be undertaken:

- Applied research: Research done with the purpose of applying the results to solve specific problems currently experienced by the organisation.
- Basic or fundamental research: Research done mainly to enhance the understanding of certain commonly occurring problems in organisations, and seeking methods to solve them.

The research type used in this study was basic or fundamental research. The partners of a leading organisation in the assurance industry, referred to as 'Organisation X' throughout this document, were selected as the research participants in this research project. A more detailed description of the sample is included in Section 3.2.5 below.

To allow for appropriate depth of analysis, the method of empirical research was a case study of the forces affecting the competitive assurance environment from the perspective of Organisation X. This was supplemented by observations, inspection of policies and other strategic documents, and interviews, as explained below:

- i. Observation of the forces affecting the competitive environment in which Organisation X operated, as well as how the organisation responded to these

forces (the fact that the researcher was an employee of Organisation X with sufficient experience in the industry at the time of the study facilitated such observation).

- ii. Inspection of policies, strategies and similar documentation (e.g. mission and vision statements that gave strategic direction to the organisation).
- iii. Semi-structured interviews with partners and relevant members of senior management of Organisation X to determine the industry concerns, challenges and developments, competitive forces affecting the industry and the strategy followed by the organisation.

3.2.2 OBJECTIVES OF THE EMPIRICAL STUDY

The objectives of the study as applicable to Organisation X and determined in Section 1.6 included the following:

- I. To formulate an assurance industry analysis incorporating the concerns, challenges and developments as perceived by experienced industry participants;**
- II. To perform a literature review of Porter's Five Forces model and an external environmental assessment of these forces as interpreted by experienced industry participants;**
- III. To perform a literature review of the different strategies an organisation may employ to obtain a competitive advantage and to apply these strategies to the assurance industry;**
- IV. To reach conclusions and make recommendations on all of the above, with Porter's theory in mind.**

The procedures performed to achieve these objectives are summarised as follow:

- Observation and enquiry around the concerns, challenges and developments experienced in the assurance industry. Semi-structured interviews were mainly used, to attempt to address this objective.
- An examination of the participants' perceptions of the strength and importance of each of the five competitive forces in the assurance environment and an enquiry into the current methods used by Organisation X to analyse the

external business environment. The semi-structured interviews attempted to address this objective.

- An analysis of the strategy Organisation X selected to obtain a competitive advantage and a comparison of this strategy to the Generic Strategies suggested by Porter. Again, it was attempted to address this objective mainly through the semi-structured interviews, supplemented by observation and inspection of relevant documentation.
- Conclusion and the development of recommendations as to the above. This objective will be addressed extensively in Chapter 4.

3.2.3 DATA COLLECTION PROCEDURE

The research consisted of semi-structured interviews held with eight partners of Organisation X. The interviews were guided by the questionnaire as set out in Appendix 1, and were recorded with the permission of the participants to ensure the reliability and completeness of the data. Although the data collection procedure relied mainly on the semi-structured interviews, the understanding gained from these was supplemented by observation and inspection of relevant documentation so that a comprehensive case study was carried out.

The semi-structured interviews are thoroughly motivated in Section 3.2.4, while the sample of participants is described in Section 3.2.5 and the process followed to conduct the interviews is discussed in Section 3.2.6.

3.2.4 SEMI-STRUCTURED INTERVIEWS

Cameron and Price (2009) defined a semi-structured interview as an interview with a clear framework of issues which you want your interviewee to address, but in which some freedom is allowed as to how it is addressed. Crowther and Lancaster (2009:147) clarified that in a semi-structured interview, the questionnaire centres on the researcher taking the respondent through pre-determined issues and topics, but not necessarily in a rigid manner or order.

Cameron and Price (2009:372) considered semi-flexibility, semi-openness, some comparability, some generalisability, relatively high face value, easier analysis than

totally unstructured interviews and harder analysis than structured interviews, as both the advantages and disadvantages of a semi-structured interview.

Sekaran (2000:250) highlighted the following advantages and disadvantages of face-to-face interviews:

- Advantages: i) establish rapport and motivate respondents; ii) can clarify questions, clear doubts and add more questions; and iii) non-verbal cues can be read.
- Disadvantages: i) takes personal time; ii) cost increases with a wide geographic region; and iii) respondents can terminate the interview at any time.

Cameron and Price (2009) added that the advantage over a fully structured interview is that questions may be designed according to the interviewer's own preconceptions, and will therefore 'discover' more or less what he/she already thought. The disadvantages are that 'steering' a semi-structured interview requires a high level of skill, and analysing results can be a significant challenge.

A fully structured interview format was considered to be inadequate as more than a 'yes/no' answer was required, while time constraints made unstructured interviews impracticable. Therefore the semi-structured form of interview was chosen for this study to exploit the advantages thereof as identified above.

3.2.5 PARTICIPANTS IN THE STUDY (SAMPLE)

The empirical research was conducted on the Johannesburg office of Organisation X; the largest South African office of the Big Four professional services firm. The research was specifically focused on the assurance service line within the organisation and consisted of guided semi-structured interviews (refer to Appendix 1) with eight partners of the firm (referred to as 'the participants') across different assurance sectors. The participants consisted of selected senior staff and members of management responsible for either, or both, service delivery and strategy development and implementation in the assurance industry. Although data was gathered from eight individual members of senior management, the unit of analysis was the organisation as a whole (case study method).

The participants were selected based on their position and function within the organisation. The interviewees included the Chief Operating Officer for the assurance business across the African sub area, the market segment leader for assurance, the assurance market leader for accounts, business development and marketing as well as the managing partner for the African sub area. The participants had a combined experience of 142 years in the assurance industry, of which 110 years were spent in service of Organisation X. They were selected across the different sectors in which Organisation X provided assurance to obtain a comprehensive view of the industry across all sectors. The participants interviewed had experience in the following sectors: automotive; banking; capital markets; communication; consumer products; entertainment; financial services; industrial products; manufacturing; mining; oil and gas; public sector; retail; technology; and utilities (water and electricity). The participants from senior management were responsible for developing and implementing the strategies Organisation X used to compete in the industry.

Because of the case study methodology that was chosen to address the research objectives, only one firm was selected, to allow for sufficient depth of analysis. Although results could therefore not necessarily be generalised to the whole population of all firms in the assurance industry in South Africa, it is submitted that the intensity of analysis that was possible at one organisation provided meaningful insight into the challenges commonly faced by assurance firms, especially the larger ones; this deep analysis and corresponding identification/confirmation of key themes also assisted in laying the foundation for further study in this scarcely-researched area.

3.2.6 HOW THE SEMI-STRUCTURED INTERVIEWS WERE CONDUCTED

The face-to-face, semi-structured individual interviews were conducted in a less than formal manner and were designed to be focused in terms of topics covered and yet flexible in that it was possible and often desirable to steer questions into directions that appeared promising from the point of view of providing rich data and/or additional insights in answering the research questions.

The semi-structured interview questionnaire (Appendix 1) was developed based on the literature study and the research objectives discussed in Chapter 1 and consisted of two sections, namely:

- i) A general section to gather background information about the participants; and
- ii) A section to gather information about the concerns, challenges and developments in the assurance industry, factors affecting profitability, the competitive external environment based on Porter's Five Forces model, competitive advantages in the industry and the strategy Organisation X implemented to compete.

This questionnaire was newly developed by the researcher for purposes of this study and, because it was based only on the literature review in Chapter 2 with the research objectives in mind, it is submitted that this was a valid and complete instrument. It was only used as a checklist to prompt discussion; the researcher attempted only to lead the discussion in the desired direction to answer the research questions, but the semi-structured nature of the interviews, with open-ended and supplementary questions, allowed for the participants to identify and describe the key themes that emerged, themselves (i.e. the research had characteristics of qualitative research).

The participants had to answer the questions based on their knowledge and experience. After consulting with the individuals concerned, mutually convenient times and locations on the premises of Organisation X were agreed upon. The objectives and confidentiality of the research were highlighted, and all the interviews were tape-recorded to ensure the reliability and completeness of the data and that all answers given were interpreted correctly in the reporting of results. These recordings were meticulously analysed and summarised (manually) to identify and describe the emerging themes.

3.2.7 EMPIRICAL RESULTS

The empirical results consist of the responses from participants as well as industry observations and other strategic documentation inspected. The value of the empirical results lies primarily in its descriptive value, and is presented in the following sections:

3.3 Industry concerns, challenges and developments in the assurance industry.

3.4 Porter's Five Forces in the assurance industry.

3.5 The Generic Strategies in the assurance industry.

3.3. INDUSTRY CONCERNS, CHALLENGES AND DEVELOPMENTS IN THE ASSURANCE INDUSTRY

3.3.1 INTRODUCTION

To obtain experienced industry participants' perspectives on the assurance industry, they were requested to identify the major developments and factors affecting profitability within the industry (which could either be considered a concern or a challenge). Participants described the assurance industry as "not operating in a vacuum", with several external factors directly influencing the industry. There were four themes that strongly emerged from the interviews, and they are discussed in the following order below:

- Regulation (discussed in Section 3.3.2);
- Globalisation (discussed in Section 3.3.3);
- Skills shortages (discussed in Section 3.3.4); and
- Pricing pressure (discussed in Section 3.3.5).

3.3.2 REGULATION

Regulatory changes are experienced in the sense of an increase and tightening in regulation, driven by the major corporate collapses (as discussed in Section 1.2). The financial crisis and economic failures experienced worldwide facilitated the need for increased regulation in the assurance profession. Before these corporate failures, the regulatory environment was perceived as far more relaxed, and more based on the professional judgement of the auditor. South Africa always had a strong regulatory environment, but on a global scale the industry became much more regulated and this also affects South Africa. The reality experienced by the participants was that most regulations were trying to implement first-world regulation onto a developing market context which was experienced, by them, as problematic, and encompassed a cost, profitability and risk impact.

An increase in the complexity of the business environment, accounting and auditing standards is experienced since the pre-IFRS (International Financial Reporting Standards) days. The assurance industry is subject to various regulatory requirements around audit quality reviews, and the increased complexity in technical standards aroused a far bigger need to consult for technical opinions on IFRS and auditing standards. The increased number of standards that assurance providers have to comply with and the extensive documentation required in this regard, has a material time and correlated cost impact for the organisation. More employee time is spent with regards to internal controls, risk management and compliance to regulation – all in an attempt to improve the quality of the audit each year and to avoid the increased auditor risk of liability litigation.

Significant new auditing standards were released for the December 2010 year ends and Organisation X adjusted its global audit methodology to respond to these changes. Organisation X ensures that regulation is read, understood and the procedures to respond to the requirements are built into the audit methodology.

The new Companies Act (South Africa, 2008) and the Auditing Profession Act (South Africa, 2005) were identified by the participants as the most important pieces of legislation affecting the local assurance industry, while the impact of the Competition Act (South Africa, 1998b) and Sarbanes-Oxley Act (Sarbanes Oxley Act, 2002) could not be ignored. The documentation of risk management practices increased, as the recently-introduced Auditing Profession Act is complex and requires more documentation on file, with much more partner oversight required at assurance clients. Moreover, the South African listed companies have to consider the JSE listing requirements and the King III code on corporate governance, while the Barnier Green paper was developed in Europe to specifically address the concerns regarding the assurance monopoly currently held by the Big Four firms.

The threats and opportunities posed by the various acts, as identified by the participants, are discussed below:

Companies Act (No. 71 of 2008)

The new Companies Act enforces an audit for most companies, except for the limited circumstances under which audits are not mandatory for so-called 'owner-

managed' companies. These companies can choose to either have a full audit, or a new substitute product (from an assurance provider's point of view), the independent review. Listed companies are however still obliged, by law, to have a full audit, and the Johannesburg Securities Exchange (JSE) also enforces the audit of the subsidiaries of all listed clients (whether owner-managed or not). Therefore the new Companies Act might have left a hole in the market, as smaller assurance organisations that focuses on the audit of owner-managed companies, experience the risk that their buyers (clients) are not going to buy any more (i.e. not going to make use of their audit services).

Due to the cost structure of Organisation X, performing these smaller audits are uneconomical, as costs incurred will already exceed the audit fee earned after the planning phase of the audit. Therefore smaller assurance organisations are affected more than Organisation X specifically. Organisation X conducted an impact analysis of the new act and it was found that it would not affect Organisation X's industry significantly as their clients would continue to request an audit to be done.

The implemented legal requirement for engagement partners to rotate every five years had the unintended consequence of assurance organisations losing people with skills and experience. Clients require people with deep sector experience in their industries and in order to become a partner and meet this requirement, a person has to spend his/her entire career in a specific market sector. Moreover, the knowledge of the risks in a client's business can only be acquired over time, and the increased time it requires for different partners understanding these risks increases the cost to the firm. After partners spent their entire career in a sector, gaining all the necessary skills and knowledge to service the client, they now have to rotate to service other clients every five years as a consequence of the new Companies Act.

Consequently, some partners developed an interest and wanted a stable career in a specific sector but did not necessarily have the opportunity within the assurance environment any longer and hence left the firm to move into the corporate sector. In this way the organisation loses significant human capital investment and people with irreplaceable knowledge and skill.

Auditing Profession Act (No. 26 of 2005)

The assurance industry developed from being self-regulated to compulsory regulation by the Auditing Profession Act. The act refers to the International Standards on Auditing (ISA) which affect the organisation. Included in ISA is ISQC (International Standard on Quality Control) 1, which contains the internal control framework for assurance organisations, stipulating how they should conduct their business. ISQC 1 addresses client acceptance, staff training, recruitment and development of staff, documentation of audit work, archiving on time and monitoring technical consultations.

The act increased the oversight over the assurance industry by requiring more partner oversight with regard to clients and increasing the required documentation in an audit file, thus inherently increasing the cost of an audit further. The act was seen by participants as a complex, onerous and stringent piece of legislation and it puts the onus of reporting 'reportable irregularities' on assurance providers (thereby increasing audit risk). Reportable irregularities require a lot of senior time for which the organisation is not financially rewarded, and simultaneously strains the relationship with the client. The Auditing Profession Act further clarifies prohibited services to assurance providers and legislates, mandatory engagement partner rotation.

Although onerous, in light of increased complexity in the general business environment experienced and regulators visiting firms on a regular basis to check the compliance to the requirements of the act, it was perceived to be very important to assurance organisations, which are set up in such a way that they achieve the essential compliance with this act.

Sarbanes-Oxley Act of 2002

SOX affects Organisation X only to the extent that their clients are US listed subsidiaries. This is by far the minority in terms of the local market, as the South African branches rarely form a major part of a US group of companies. In the global market the effect was significant for a period of time but due to competition with other firms, the high level of work that was being done was not necessarily what was envisaged by the act.

For the assurance industry the implementation of the act had a big once-off revenue contribution, as assurance hours increased significantly in 2002, while the annuity factor through provision of SOX services was not that big. Companies became used to having their controls in place and the assurance procedures performed, are now integrated into the audit, with a much more control-based approach of testing followed. Both internal controls and financial results are now audited, and in reducing the hours spent on SOX, the cost also decreased. The act however continues to be an act that holds both risk and opportunity for assurance organisations.

Competition Act (No. 89 of 1998)

The implication of the Competition Act was not perceived to be very significant in the assurance industry due to the Big Four and other assurance providers competing in good spirit, and the nature of assurance services not lending itself to anti-competitive behaviour. Each organisation has different strategies of winning the market and therefore price collusion would be difficult to achieve even if assurance organisations wanted to. Even though part of the same profession, the Big Four firms operate individually, but it was mentioned by some of the participants that assurance organisations sometimes have to be warned about making public statements to each other.

It could perhaps be argued that the Big Four firms practise anti-competitive behaviour in respect of the salaries of their trainee accountants and employees, as the differences in salaries between the Big Four firms were perceived to be only marginal. However as salary cost is driven by market forces rather than price collusion among the Big Four, thus the act will not be applicable. The participants described the act as “keeping all the audit firms, law abiding citizens”, and the importance of compliance with the act, was stressed by them as well as the fact that Organisation X has processes in place to ensure its compliance with this legislation.

The organisation ensures that it is constantly aware of, monitoring, analysing and commenting on regulation and discussion papers, and adapting its audit procedures and business accordingly for any changes. The organisation also plays a part in the whole process of developing regulation, providing its views and helping regulators to shape regulation in a sensible way to the best of its abilities.

Participants mentioned that the change in accounting standards, auditing standards and the renewed focus of regulators on compliance to these standards have the biggest impact on the organisation, bigger than any of the other acts. Increased regulation however holds great revenue opportunities for assurance providers when the associated costs can be recovered from their clients.

3.3.3 GLOBALISATION

As clients become more globally integrated they want to deal with an equally integrated organisation that is able to service their needs globally. Organisation X is able to successfully address these needs as it is more integrated and only cuts across a few geographical regions, able to interact quickly with other partners or offices.

Organisation X

Organisation X has a team available across the globe in any of the locations where the clients are located. As a result of globalisation Organisation X in South Africa was able to develop itself from a single affiliated practice to a brand which is now part of a national, African and globally integrated organisation. It has greater access to technology and deeper industry knowledge, and possesses vast and constantly updated knowledge databases where information about any industry can be readily obtained. This assists Organisation X to a great extent in addressing clients' questions about industry developments and global trends, as well as developments in the accounting and auditing industry. With the research already conducted for the organisation it is able to access these databases easily, which gives it the significant ability to interact with its clients at the right level, as well as to obtain a competitive advantage over its competitors. The benefits of this are, easier access and ability to reach a global client which was much more difficult previously.

The global structure of Organisation X entails that the organisation forms part of one income statement, and this gives employees more mobility as people are moved around a lot easier with the ability to work across borders and various secondment opportunities for staff. Employees can temporarily work at almost any location in the world and then come back to the local office with more experience. Although training staff at one central place involves travelling costs, the advantage is that these people

can then act globally. With its global structure the organisation is able to bring in experts and specialists into the South African market whenever necessary on a long or short term basis, or just for a specific assignment to deal with particular and peculiar problems or issues their clients experience. This access to specialists worldwide increases the organisation's knowledge base, potential and number of people available to service clients.

Big Four

Clients who operate globally view the Big Four as being more competent, having a global reach and understanding and a wider footprint compared to the smaller assurance providers. Their global reach and understanding come from seeing more and experiencing what is happening globally and in Africa. The knowledge obtained can be applied locally; something smaller local organisations are perceived to be unable to do. Big Four firms experience a significant advantage over the mid-tier organisations as the latter's tendency is to operate on an office, rather than a country basis, let alone a continent basis. As they are not able to offer their services in each country, they get left behind. The Big Four operate across the continent and are represented in most of the African countries; for them it is about finding a way to work across the continent.

The Big Four are able to give, in addition to assurance, complex tax, transaction and technical accounting advice. Clients that conduct deals and transactions prefer having a Big Four signature on their audit reports, and the Big Four are viewed as having better quality staff and paying their people more. The Big Four are also able to charge a price premium, due to the high quality and wider range of products offered, their global reach and the cost of remaining a Big Four firm.

Global fee negotiations

Servicing the biggest companies in the world as clients does, however, incorporate an element of pricing pressure on the work of Organisation X, and buying power crystallises in the global fee negotiations. Together with this, global integration companies started to appoint their auditors for the global account, based on a single negotiated fee for providing the assurance services worldwide. This was described by a participant as follows: "If each Financial Director negotiated its own assurance

fee the total fee would be much more than when the fee was globally negotiated”. Therefore the global negotiations result in a smaller proportionate fee to each country. The bigger global impact is that the audit still has to be conducted according to global standards, while the global fee is not necessarily profitable. However, when it is a good client, which all the assurance organisations want to service, they are forced to make initial investments and incur set-up costs and then look for efficiencies in performing the audit in the subsequent years.

Global profitability

The biggest concern is that certain global engagements taken on are globally uneconomical to perform. Participants mentioned that although developed economies are profitable and manage costs, they are showing either flat, or falling revenues and experience cuts in assurance fees while emerging economies show growing revenues. The emerging South African market Organisation X operates in therefore has to globally share its increased revenues with environments that experience falling revenues. These increased revenues are however often offset through the weakening exchange rates of these emerging economies against the developed currencies of the US Dollar, Pound and Euro when the contribution to global revenue is assessed.

In theory, being globally integrated, the profitability of Organisation X locally is driven by the global profitability. As profit is a global figure, it may therefore be acceptable if more profitable engagements in certain countries offset less profitable ones in other countries. This line of thought is however only appropriate if partners of organisations are entitled to true global profit sharing, towards which participants perceived Organisation X to have moved about 90% of the way.

Hierarchy

A global structure comes with a strict hierarchy, in which decision-making sometimes takes a long time and in an environment where a quick turnaround is essential, one can be hampered by the global structure that hinders quick decision-taking. People feel disempowered as much is determined by the global organisation and locally things have to be done the same way as it is done globally. Aligning the processes between different cities across the globe, has its own challenges, but as all the

branches signed up for the integration, they do their best to make it work. The executive management is however always mindful of the structure and tries to ensure that the structure does not hinder business. Thus they know the structure exists and realise its importance and that it provides appropriate governance in their organisation.

Costs

The major cost to Organisation X is its global connection, working off a single integrated platform for business management and service delivery and implementing the latest technology to ensure that people in the organisation are as inter-connected as possible. A risk of cost accumulation in the global organisation arises due to the cost element of the global structure being very expensive. Moreover, the organisation tries to replicate each one of its offices around the world to look like one another, increasing the cost of infrastructure globally. Air travel expences and paying salaries in foreign currency are expensive (especially in an emerging economy), and employees required to centrally administer the organisation further add pressure to margins.

The global structure gears the organisation for mostly larger clients and some of the organisation's advantages are not relevant to small clients, who consequently are reluctant to pay the premium on the services provided by the Organisation. As discussed in Section 3.3.2, even though the organisation loses out on revenue from the smaller South African entities, the make-up of its cost structure, in essence, causes these audits to be unfeasible anyway. Globalisation constantly results in various new companies entering the market that create numerous opportunities and work for Organisation X to grow its business, revenues and profitability, while the corresponding increased costs also pose threats to the organisation.

African market

In recent times, the work opportunities mainly arose from low cost markets, especially emerging markets (e.g. India and China) where companies were used to a much lower cost base, with a higher skill base for the same level of cost. Globalised companies however did not adapt their mindset when they invested into Africa as they saw Africa as one homogenous group, which it was not. They also had the

perception that Africa had a very low cost base, while across Africa the skilled professionals were actually quite expensive. Consequently a pricing pressure point came about as, given the local make-up, these companies did not put as high a value on local professional services as Organisation X did.

3.3.4 SKILLS SHORTAGES

The level and scale of investment required in the highly regulated assurance industry, is different than many other markets in the world. It is rooted in the requirement for highly skilled employees and the skills shortage in South Africa resulting from the demand for skills overshadowing the supply. In most mature markets in the world, the supply of people is high and the balance of power usually leans toward the side of the employer in terms of salary cost. One participant described the nature of these jobs: “If you do not like it, there is somebody right behind you”. However, in the South African assurance market, having no alternatives, the balance of power is actually in favour of the employee, with only one designation that may sign audit reports – Chartered Accountants (CAs); only one system producing CAs – universities; and only one set of exams written to become a CA – the Board exams. The participants perceived the shortage of CAs in South Africa to be as the result of schools and universities not producing enough CAs, or not recruiting enough people that will undertake the CA route.

Transformation and BEE

Firms in the industry are under a lot of pressure to transform and to recruit and retain black staff and black partners. A major challenge with regard to recruiting, training and retaining black professionals, is to increase their numbers so as to represent the demographics of the country, and to adhere to the CA Charter, which heavily advocates black economic empowerment (BEE). Transformation with regard to adding black entrants into the profession is a critical factor for the buyers (clients) and the stakeholders and is taking a lot longer to implement in South Africa than the country would have liked.

The supply of black CAs is very poor as schools and universities were perceived by the participants, as not producing enough black CAs. Consequently there are a number of small black firms which operate in the space of Organisation X and

receive work that they would not have gotten under normal circumstances (i.e. without the additional element of BEE). It was experienced by the participants that the BEE audit firms do not have sufficient capacity, methodology, skill or experience to do the work, but are still getting the work due to their BEE status.

People challenges

In the assurance industry the reality experienced is that most trainee accountants come into the firm to complete their training contracts and then carry on with their careers outside of assurance. The many people leaving assurance is a natural progression as the CA degree is an excellent business degree which prepares the holder thereof for a career in business and naturally a high percentage of people would want to leave the assurance industry.

The crucial factor and “major people challenge” experienced internally by Organisation X is staff retention, as it is “one thing to get a guy and another to keep him” (as put by one of the participants). The war for talent is critical to the organisation’s success, and although the employees are paid well, the very talented individuals are always able to find something better out in the market. For Organisation X, managing its people is an ongoing challenge, which requires a heavy investment in research and skills development.

Organisation X’s investment to develop and retain these people has an impact on profitability, and one participant argued that the main people costs actually relate to training the individuals and not in salary payments. Therefore, due to the high level of investment involved in training new staff members, an internal pressure is experienced to retain the young ambitious trainee accountants with their desire of experiencing the world and travelling after the completion of their training contracts.

Attracting more people to the industry may counter the dilemma as, even though a high percentage leaves, attracting more people will ultimately result in a greater number of people staying. The participants also experienced that quite a lot of people come back to assurance after a stint in the corporate industry and the challenge is to effectively sell Organisation X to those people, so they would return to Organisation X as staff, and not get hired by other rival assurance organisations.

The skills shortage has a big effect on profitability as organisations cannot obtain staff cheaper elsewhere, with the high demand for the skills resulting in salary cost, which is one of the foremost expenses of an assurance provider. Market forces determine salary costs of employees and an artificial control over these costs can only be maintained during the training contract of employees.

Internally Organisation X strives towards a strong people culture and exceptional client service. Investment in its people has a long-term effect on the service delivery to clients, but is quite costly when the people cannot be retained long enough to reap the benefits from these investments. Local regulation makes operating in the industry a lot more onerous, as it impacts on people's willingness to join the industry. With a lot more pressure on the people, the industry is not the ideal place to work in, and as a result of this, difficulty is experienced in attracting new people to the industry.

3.3.5 PRICING PRESSURE

Pricing pressure has been a big issue since the economic downturn, and is experienced across all sectors in the economy. The effects of the downturn and credit crunch in the three years since 2008 had caused companies to fail which resulted in a squeeze on margins. Companies felt immense pressure to be sustainable, and as a ripple effect the companies required their suppliers (including assurance providers) to lower their costs. Fee pressure was and still is experienced from these clients who want to keep their costs down, and as assurance services are seen as a "grudge purchase" (i.e. enforced on companies by legislation), the assurance providers do not have much bargaining power in this regard.

Margin squeeze is experienced as over a period of time following the credit crunch after which the profits ending up in the auditor's "back pocket" were reduced. In recessionary times clients are only willing to pay fees when they themselves are making profits. The performance of the economy is therefore a determinant factor as unprofitable business causes assurance organisations to fail. Clients were assessed as very risk averse after the credit crisis, and were not able to pay assurance providers that much anymore, which introduced the risk that the low audit fees assurance providers allowed to help these clients out, would become the new benchmark for fees.

Pricing structures were judged by the participants to be incorrect due to auditors' face-to-market (i.e. how auditors approach the market with their services and how the market perceives the services provided by them) being wrong – auditors demonstrate the inability to shift the increased cost of regulation onto their clients. As a profession the assurance providers became willing to incur losses on engagements in order to win or retain engagements following the economic downturn. It had also been detrimental of regulators to increase regulation; as a result of the losses incurred on engagements, assurance organisations are actually not fulfilling their regulatory requirements.

At the time of the study, cost inflation in the assurance industry was estimated at between 12% and 15% due to the high salary and technology costs in the industry, while some clients were only willing to pay Organisation X an inflationary increase according to the inflation rates in their industries; a far lower percentage. The response by the assurance providers to the pricing pressure, following the economic downturn, was to look at reliance points in the client's controls and information technology systems, as well as being more efficient in performing the audit. To a very large extent the assurance business is volume-based and, as one of the participants put it, by "chucking a lot of hours at the clients at low margins the assurance organisations could still make a decent profit". This verified the statement by Nanda (2004) that for PSF's productivity has the strongest effect in increasing profitability.

3.3.6 CONCLUSION

The challenges mentioned above were identified based on the interviews with the participants and put into context based on the researcher's own experience and observations in the assurance industry and the literature review in Chapter 2. Based on the inspection of documents at Organisation X, its top five challenges in the global and local assurance industry were:

1. Engagement profitability;
2. Aggressive targeting by competitors (including mid-tier firms);
3. Securing new clients to grow the revenue line;
4. Manage risk and engagement quality; and

5. Recruitment of skilled resources across Africa.

Due to the Big Four having similar global structures, the challenges faced by the Big Four are reasonably expected to be similar; with the deciding factor being how to manage these challenges. With various ways to solve a problem the question was asked whether Organisation X had the correct management model to manage the risks and challenges. How an organisation decides on the best solution is what management is all about, and the essence of being competitive lies in solving the challenges better than your competitors can.

3.4. PORTER'S FIVE FORCES IN THE ASSURANCE INDUSTRY

Before performing the Porter analysis, it is imperative to gain an understanding of what Organisation X is currently doing, in terms of an external environment analysis, in order to assess the need for conducting a Porter analysis within the organisation, and to reach appropriate conclusions and recommendations to management regarding their external environmental analysis.

3.4.1 EXTERNAL ENVIRONMENT ASSESSMENT AT ORGANISATION X

Organisation X is structured as a service line and markets function and invests heavily in its markets function, which is designed to gain insight into competitor intelligence, competitor actions and what can be learnt from competitors. The organisation assesses who its competitors are, and identifies their strengths and weaknesses while the business development unit looks at competitive behaviour. Organisation X assesses the competitor and client landscape (in broad economic terms) and from there it devises a strategy it believes can really succeed and grow in the market. It aims to understand the market and devise what it considers to be an appropriate strategy, to react to it. It looks to where the organisation has relationships in the market which it can build on, what the market is looking for and needs and searches for new tenders for work. The gaining of market intelligence was considered by the participants to be crucial so as to identify the trends in the economy and the direction in which investments are headed. To identify industry trends the Organisation performs external scanning and research, commentator surveys and company interviews.

Since Organisation X follows a growth strategy based on growing certain segments in the market which it considers to be important, it is crucial to identify whether investments in the continent of Africa are made into any particular sector or any particular geographical areas. A great deal of time is also spent at international offices of this global organisation, with assurance partners travelling to different parts of the globe – North America, China, India and Europe – to find out from companies there, what they are looking to invest in, what opportunities they are looking for and how Organisation X can assist them. Furthermore, apart from the first-hand insight into clients' investing activities across all the sectors and industries through providing them with services, the organisation also performs its own surveys, surveying clients and listening to them to identify where they are investing and what they are concerned about, and what they see as the risks applicable to their situations.

Two of the models used by Organisation X to assess the external environment are the “Jumping the S-curve” and “Blue Ocean” models (discussed in Section 2.3.4). It also uses the Du Pont model which is widely utilised by companies in the manufacturing sector and developed their own model derived from it for use in their professional services firm.

The S-curve theory asserts that each industry goes through a stage where nothing really happens; then something phenomenal happens. Similarly the assurance industry experiences growth every time something enforces additional regulation on the industry (for example corporate collapses like Enron and Worldcom, the adoption of IFRS and conversion from US GAAP to IFRS). The question then arises: “What is going to be the next S-curve, and do assurance organisations want to be dependent on these external factors all the time when they want to grow?” In the past there had been external forces Organisation X used to their maximum potential as they occurred. The Organisation does not want to build a business that is solely dependent on these external forces, but a business that is successful irrespective of the external forces, but also able to exploit the opportunities to their maximum potential as they are presented by the external environment.

The Blue Ocean / Red Ocean theory on strategy advocates that an organisation can either decide to compete with all the big sharks in the Red Ocean, where the

competition is fierce, or it can decide to go to a different part of the ocean (Blue Ocean) where new markets are identified and invested in.

Organisation X claims to understand the operational key performance indicators very well and knows what levers to pull in order to be more profitable. The Professional Services Firm formula/model is applied in the organisation, with the main focus on productivity, utilisation, and leverage. The basis of this model is that profitability of a PSF is measured as profit per partner. The profit per partner is then broken up into fifteen different variables that were identified as determinants of profitability. Taking into account the relevant factors, the organisation developed key performance indicators (KPIs) for its people to focus on. Examples of the KPIs implemented by Organisation X are utilisation, rate per hour and efficiency. The goal set by the organisation is to maximise each of the KPIs selected.

The difference between the Professional Services Firm model and Porter's Five Forces model can be associated with the level of detail in the model. The Professional Services Firm model is more of a micro detail model, while Porter's model is more focused on the macro competitive environment.

Organisation X places a huge emphasis on competitor actions, and the researcher suggests that its strategic models could be implemented with even greater success when the other four relevant market forces, which impact any industry (as identified in the Porter Five Forces model) are also taken into account. Moreover, the Porter analysis will also give valuable insight into the macro competitive environment which is currently lacking in external environmental assessments.

3.4.2 RANKING PORTER'S FIVE FORCES IN THE ASSURANCE INDUSTRY

Literature revealed that the configuration of the Five Forces differs between the various industries, with an industry's profitability determined by the strongest competitive force, which ultimately becomes the most important to strategy formulation. As the strongest force (as well as the ranking of the forces in the assurance industry) was not apparent, the empirical study aimed at ranking the forces in order of their strength and importance. During the semi-structured interviews the participants were requested to assess the **strength** of each of the competitive forces as they affect the assurance industry as High, Medium or Low. In

addition they ranked the forces in order of **importance** (1 - 5) of their effects on the assurance industry. The results from the interviews are presented in 3.4.2.1 – 3.4.2.3 below.

3.4.2.1 STRENGTH OF THE FIVE FORCES

The responses from employees regarding the assessment of the strength of the forces based on a High, Medium or Low basis is summarised in table 4 below:

Table 4: Strength assessment of the Five Forces

Force	High	Med	Low	Total
The threat of new market entrants	12.5%	50.0%	37.5%	100%
Bargaining power of suppliers	12.5%	62.5%	25.0%	100%
Bargaining power of buyers	87.5%	12.5%	0.0%	100%
The threat of substitute products or services	0.0%	0.0%	100.0%	100%
Rivalry among existing competitors	87.5%	12.5%	0.0%	100%

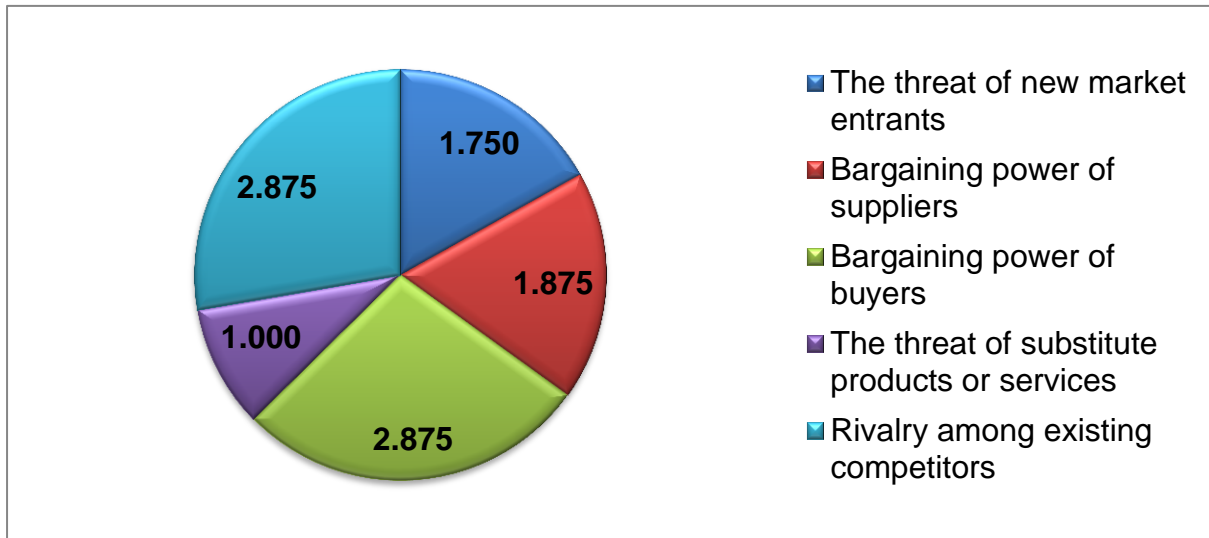
To obtain a view of the overall ranking of the strength of the forces, a value was assigned to each of the High, Medium or Low evaluations in table 5. For High, a weighting of 3 was given, while Medium and Low were attributed weightings of 2 and 1 respectively. The values assigned were as follows:

Table 5: Values of the strength assessment of the Five Forces

Force	High – 3	Med – 2	Low – 1	Total	Rank
The threat of new market entrants	0.375	1.000	0.375	1.750	4
Bargaining power of suppliers	0.375	1.250	0.250	1.875	3
Bargaining power of buyers	2.625	0.250	0.000	2.875	1
The threat of substitute products or services	0.000	0.000	1.000	1.000	5
Rivalry among existing competitors	2.625	0.250	0.000	2.875	1

The above results are presented graphically in figure 6 below:

Figure 6: Strength assessment of the Five Forces



The interview results indicated that participants observed the strength of the rivalry among competitors and bargaining power of the buyers as equally important when assessing the assurance environment. The threat of substitute products was assessed as the weakest force by all participants, while the bargaining power of suppliers and threat of new entrants were ranked third and fourth respectively.

3.4.2.2 IMPORTANCE OF THE FIVE FORCES

Participants were requested to rank the Five Forces in order of importance to the assurance industry. The results from this assessment are presented in table 6 where 1 represents 'most important' and 5 'least important':

Table 6: Assessment of the importance of the Five Forces:

Force	1	2	3	4	5	Total
The threat of new market entrants	0.0%	0.0%	62.5%	37.5%	0.0%	100%
Bargaining power of suppliers	12.5%	0.0%	37.5%	50.0%	0.0%	100%
Bargaining power of buyers	37.5%	62.5%	0.0%	0.0%	0.0%	100%
The threat of substitute products or services	0.0%	0.0%	0.0%	0.0%	100.0%	100%
Rivalry among existing competitors	50.0%	37.5%	0.0%	12.5%	0.0%	100%

Rivalry among competitors was assessed as most important by 50% of participants and second most important by 37.5%. Bargaining power of buyers was considered most important by 37.5% of participants and 62.5% considered this force to be

second most important. These results therefore appeared to confirm those reported in table 4 above.

To confirm the initial assessment made above, a value was once again assigned to the participants' assessments in table 7 to determine which force scored the highest value according to the rankings. The following scorecard method was used to assess the rankings given by the participants:

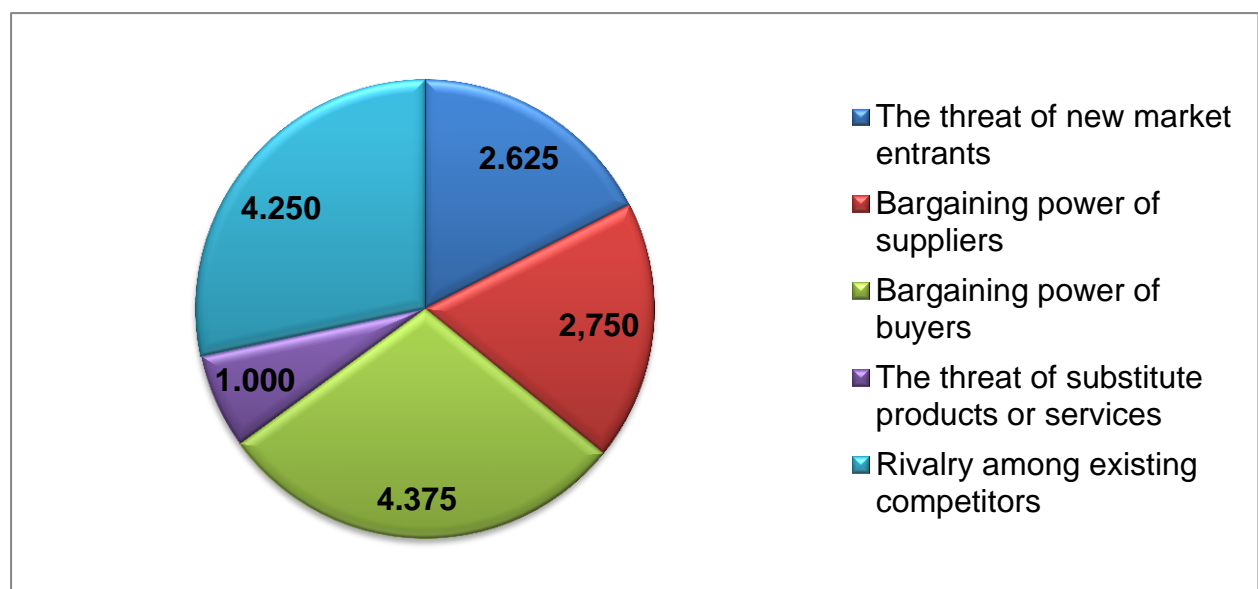
For the percentage in category 1 the weighting attributed was 5 (most important); and similarly category 2 = 4; category 3 = 3; category 4 = 2 and category 5 = 1 (least important).

Table 7: Values of importance assessment of the Five Forces:

Force	1	2	3	4	5	Total	Rank
The threat of new market entrants	0.000	0.000	1.875	0.750	0.000	2.625	4
Bargaining power of suppliers	0.625	0.000	1.125	1.000	0.000	2.750	3
Bargaining power of buyers	1.875	2.500	0.000	0.000	0.000	4.375	1
The threat of substitute products or services	0.000	0.000	0.000	0.000	1.000	1.000	5
Rivalry among existing competitors	2.500	1.500	0.000	0.250	0.000	4.250	2

The above results, which revealed the bargaining power of buyers as the most important force, are once again presented in figure 7 as follows:

Figure 7: Importance assessment of the Five Forces:



3.4.2.3 COMBINED ASSESSMENT OF THE FIVE FORCES

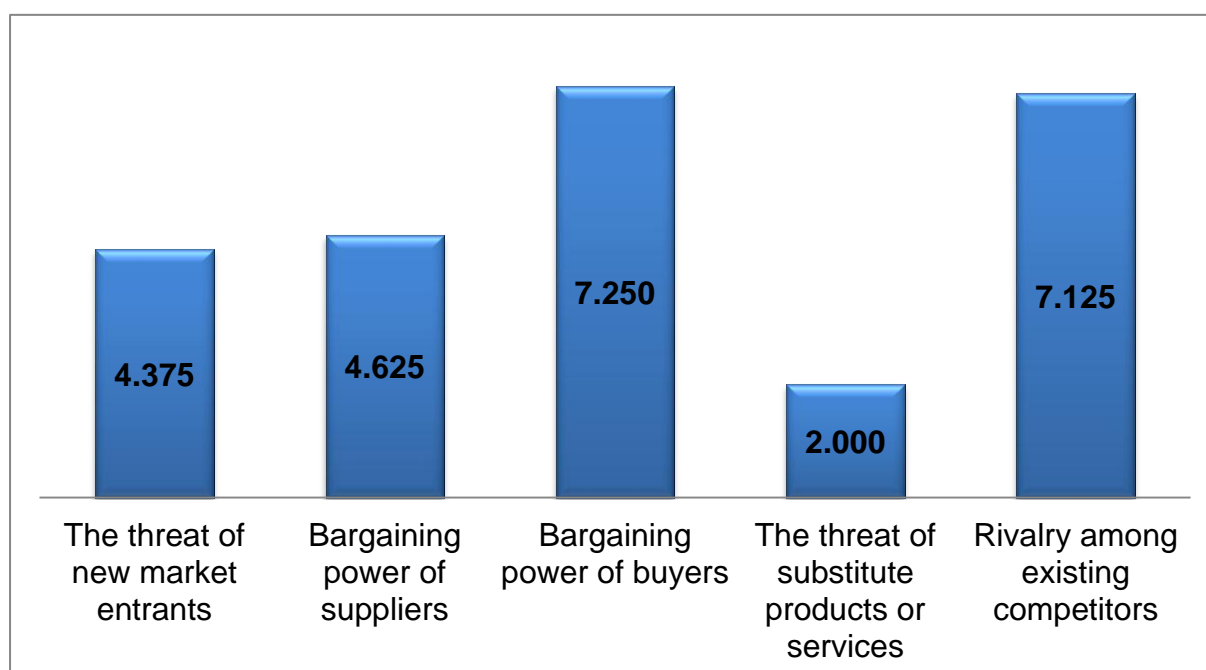
To ultimately rank the forces in the assurance industry based on their perceived strength and importance, the values appointed to the strength and importance assessments were combined in table 8. The total number of points scored on the two assessments, based on the participants' rankings, determined the final ranking and assessment of the forces within the South African assurance industry.

Table 8: Combined assessment

Force	Strength	Importance	Combined	Final Ranking
The threat of new market entrants	1.750	2.625	4.375	4
Bargaining power of suppliers	1.875	2.750	4.625	3
Bargaining power of buyers	2.875	4.375	7.250	1
The threat of substitute products or services	1.000	1.000	2.000	5
Rivalry among existing competitors	2.875	4.250	7.125	2

The combined assessment is also presented in figure 8 below:

Figure 8: Combined assessment



The combined rankings revealed that participants evaluated the bargaining power of buyers to be the most influential force in the assurance industry, followed closely by

the rivalry among competitors, trailed by the bargaining power of suppliers, the threat of new market entrants and lastly the threat of substitute products which appeared to be a weak and unimportant force. The detailed narrative evaluation as perceived by the participants is presented in Sections 3.4.3.1 to 3.4.3.5 in the order of their rankings as assessed by the participants.

3.4.3 CHARACTERISTICS OF THE INDIVIDUAL FORCES IN THE ASSURANCE INDUSTRY

The literature study revealed that industry structure is manifested through the five competitive forces, and that understanding these competitive forces and their underlying causes, reveal the core of the industry's current profitability while providing a framework for foreseeing and affecting both competition and profitability over time. Industry structure further determines the strength of each competitive force, which grows in turn out of a set of economic and technical characteristics or "drivers". These underlying causes and "drivers" of the Five Forces in the assurance industry are presented in Sections 3.4.3.1 to 3.4.3.5 below:

3.4.3.1 BARGAINING POWER OF BUYERS

The strength of the bargaining power of buyers was identified as high by 87.5% of participants while 12.5% assessed this force as having a medium strength. Moreover, 37.5% identified it as the most important factor affecting the assurance industry while 67.5% considered it to be the second most important factor. Overall it was determined as the most influential force affecting the assurance industry (refer to table 8). The relevance of the drivers of the bargaining power of buyers, as identified in the literature study, was confirmed through the empirical research, and is presented below:

Buyer's group concentration

In the assurance industry buyers can choose between enough key players (one of the Big Four and second or mid-tier organisations) to conduct their audits, with the ability to play them off against one another, thus reducing the assurance fees. Section 2.2.3.1 revealed that suppliers' profitability is affected by the ability a few large buyers, buying from a large number of suppliers, have to pressure their suppliers to lower their cost. In the South African assurance market however, it was

found that even though the concentration of the buyers far exceeded that of suppliers, they were still able to apply significant pressure on the fees.

Significant buyer costs

The cost of assurance fees do not represent an integral part of the buyer's total costs or purchases (Section 2.2.3.2), and therefore buyers should be less sensitive to price. The study however, revealed that buyers consider an audit as a product they have to buy; they only have to decide where and who to buy it from. As an audit is a boiler plate type service, where buyers are of the view that an "audit is an audit", which many buyers consider to be nothing more than a "grudge purchase", the buyer's perceived importance of the product (Section 2.2.3.6) is low, and therefore they are price sensitive towards assurance services, and play firms off against one another in order to obtain the lowest price.

Degree of standardisation of supplier's products

The highly regulated assurance industry (Section 3.3.2) has resulted in homogenous assurance services that encompass a high degree of standardisation (Section 2.2.3.3). Together with buyer's perception that the quality of service is the same across all of the Big Four firms, they can easily swap a Big Four assurance provider for another, which further increases the bargaining power the buyers have over their suppliers.

Switching cost

Switching cost (Section 2.2.3.4) in the assurance industry revealed interesting perspectives and dynamics regarding the industry. As audits are required by regulation and legislation for qualifying companies (Section 3.3.2) the assurance services provided are a necessity to the relevant buyers (which represents the majority of Organisation X's clients) as they are unable to switch to another product/service. Buyers on the other hand retain the same assurance providers for extended periods and they are often comfortable with whom they have been dealing with, which from the perspective of the assurance provider that wants to attract new clients, makes convincing buyers to switch between assurance providers very difficult.

Whenever a buyer decides to switch its auditors, its accounting and financial staff need to deal with the discomfort of helping the new auditors to understand their business and processes, while the auditors, as a result of the intense rivalry among competitors (Section 3.4.3.2) often have to incur losses and make heavy investments to lower their prices only to win a new client. The possible cost saving in switching to a new auditor would most likely outweigh a buyer's opportunity cost of the discomfort of its impacted staff. The switching cost is therefore definitely low for buyers and high for suppliers, leaving the power balance in the hands of buyers.

Threat of backward integration

Due to the service nature and strong emphasis that is placed on the independence of assurance providers, a threat of a backward integration (Section 2.2.3.5) in the industry is considered to be highly unlikely.

Additional considerations

Buyer bargaining power depends on the state of the economy and the respective profitability of buyers within the industry (Section 2.2.3.6). In a struggling economy buyers have a lot more power as they reduce their purchases of non-audit services (like tax and advisory) and put additional pricing pressure on audit services. The high bargaining power originates from the companies' ability to push suppliers for prices due to the negative economic conditions experienced.

With relatively low switching costs, buyers are spoilt for choice and look at size, price, relationships (who they feel comfortable working with in terms of their values and who they are), quality and global reach when deciding on an auditor. The buyers have to decide how much they are willing to pay for an audit, with the service providers challenging each other's prices and competitors who are always willing to do an audit at a cheaper rate. Consequently organisations have to invest in differentiating themselves as much as possible, and the competitive response is to make it tough for buyers to switch. Assurance firms have to strengthen the relationship with the buyers (clients) by investing in the accounts and bringing them leading edge thinking.

As much as Organisation X wants to serve more assurance clients, so do the other three Big Four firms, making it very difficult to grow market share. As assurance organisations try to keep their current clients, they are forced to drop their prices, with the ripple effect of pricing pressure, a tight squeeze in margins and profitability constraints in the assurance industry (confirmed in Section 3.3.5).

While assurance providers perpetuate the stigma of an audit being a grudge purchase and do not believe they provide a value-added service to the client, they are considered their “own worst enemies”. A critical factor identified by the participants was to change the perspective and mindset of the buyers regarding an audit – to see that the audit actually adds value to their business by differentiating the process of an audit, instead of the outcome (an audit report). Although the buyers have a lot of power, ensuring that they see value in what they get and are happy with the level of quality of service, may result in them not using their negotiating leverage to go and bargain with other organisations. The extent to which Organisation X keeps innovating the way it services its accounts, results in the buyers having no reason to switch to a different supplier.

3.4.3.2 RIVALRY AMONG EXISTING COMPETITORS

Rivalry among competitors was rated most important by 50% of the participants, second most important by 37.5% and fourth by 12.5%. The strength of the rivalry among existing firms was identified as high by 87.5% of the participants, while 12.5% considered it to be low. Overall the rivalry was considered the second most influential force affecting the assurance industry (refer to table 8), with the intense rivalry in the assurance industry originating from a combination of the desire for growth and the number of competitors.

Numerous or equally balanced competitors

South Africa has highly effective competitors in a small market, and the concentration of competitors results in intense rivalry and fierce competition at a macro level. Assurance services are mainly concentrated in the Big Four, with a number of mid-tier assurance organisations present as well, and therefore it is assessed that the industry contains numerous and equally balanced competitors (Section 2.2.5.1).

Big Four

The majority of work received from clients was seen by the participants as purely due to the fact that Organisation X is part of the Big Four, which enables them to charge a premium and negotiate a better price compared to other organisations. This is however only relevant among listed and big company clients, as smaller companies who do not require as much from their assurance providers make use of mid-tier organisations as they neither see the need of having a Big Four assurance provider nor for paying the premium.

The high risk of rivalry originates from the fact that the Big Four are intensely and constantly competing for one another's clients. Participants stated that every bid for a new client is fiercely competed for and one highlighted that Organisation X has a 25% (one in four) chance of winning the clients it tenders for. The competitive environment was seen as a very healthy environment to continue to engage in and Organisation X is able to compete successfully as it "wins as much as the others lose and it loses as much as the others win".

From a competitive perspective, the Big Four do not come together and agree on fees to charge, as the Competition Act (Section 3.3.2) would then come into play. With staff charge-out rates that are similar among the Big Four firms as rates are driven by market forces, it is therefore strange how the Big Four can undercut each other by up to 50% when pitching for new clients. Organisation X's ability to compete with the other Big Four firms was assessed by the participants as "very good", "being very competitive", "having all the ability to compete", and the "quality of people the organisation has enables it to compete with the other Big Four firms". Organisation X competes with the other Big Four on a daily basis and this is "what it does for a living". When assessing the competition within continental Africa, South Africa is considered to be a launch pad into Africa and Organisation X has to compete head-on with the other Big Four firms as well as with the big consulting houses (which are more focused on advisory services).

Mid-tier organisations

For the middle segment and lower end of the market, Organisation X has to compete with mid-tier organisations that audit a fair amount of the listed companies in South

Africa, of which Organisation X admittedly would not mind “getting a piece of the cake”. To be able to compete with the mid-tier firms, the pricing strategy of Organisation X has to be significantly competitive, and the application of the auditing and accounting standards by the Big Four is perceived to be a bit different than the mid-tier organisations – which are seen to be a bit more lenient than Organisation X.

High fixed or storage costs

With the major fixed cost being staff cost, employees have to be utilised as much as possible due to the various tenders from rival organisations for new and existing clients in the market, all of them focused on bringing the price of assurance services down. Other major fixed costs are technology, infrastructure and professional indemnity insurance; while the variable costs are actually quite low. Section 2.2.5.3 revealed that rivalry increases when fixed costs are high relative to variable costs, and organisations will take on marginal business at any price as long as it covers variable costs.

At first glance the price premium appears to be a great playing card for the Big Four firms. However, on closer inspection the reality is quite different. Although the market definitely places a premium on Big Four services this does not necessarily result in assurance firms being able to earn the premium charged. The main factor that drives their pricing is the cost structure that makes Big Four firms’ pricing more expensive in the market. The buyers of the products do not solely pay for the fact that these products are provided by the Big Four; the fees are also driven by the underlying cost structure of these firms. Organisation X has to pay global fees and licence fees, and has to employ a lot of technology in its business, which all amounts to a huge cost, which smaller organisations do not incur, as they do not form part of a global network. The cost that accompanies the global network forces Organisation X to ensure that prices charged are sufficient to recover these global costs.

Hence, as the higher prices may be perceived as a premium, it is actually a function of the cost structure. The competition among the Big Four has also resulted in there being no significant premium any more. One participant mentioned that an employee from another mid-tier firm that has a very different cost structure, said that the firm he works for was no longer able to compete with the lower prices of the Big Four. This

does not necessarily apply to all the smaller firms, but the participant's comment provided thought-provoking insight into the situation.

Slow industry growth

The relevance of the slow industry growth, identified in Section 2.2.5.5 was accentuated as a limiting factor in the South African assurance market due to the slow growth that existed at the time of the study. The managing partner highlighted that if the market could just grow at a rate of 2-3% there would be a lot of work for everybody. The tough economic circumstances, due to the financial crisis increase the rivalry between the organisations as they are not only competing for work but for people as well. The challenges are both to attract the best people and to win the best clients and to negotiate effectively, so that the organisation can provide the services. In the assurance industry organisations need people to be successful – not buildings and computers and other tangible things. Another participant disagreed somewhat and argued that the industry growth in assurance was good and that the industry should be growing faster than the economy, due to the added reporting complexity and regulation.

High strategic stakes

Literature revealed that competition shows strong instability as long as some of the well diversified rivals show a strong ability and willingness to pull further resources and capabilities in the industry. In order to hold a competitive position over rivals in the industry, a global assurance organisation often wants to take over a specific market sector in a certain country. With an investment from them into that market the local assurance organisation is able to offer a lower price than its competitors to perform services in that market sector. Locally, organisations are willing to accept this lower fee, since the reduced revenue earned on the specific engagement will be recovered through the investment from the global organisation, and wherever true global profit sharing is achieved by organisations, the lower revenue should not be a concern at all.

This is one of the strategies through which the Big Four become their own worst enemies as they have the tendency to keep on setting these lower price benchmarks in the market. Through such investments, the South African subsidiaries are

“subsidised” to get the best clients they can get within the South African market, which is a real threat as other organisations are not necessarily able to match these low prices in the specific market sector.

As all the assurance organisations have high stakes in achieving success in the assurance industry this causes the industry to become even more volatile (Section 2.2.5.6). The opportunities and challenges are similar among the Big Four, but from a strategic point, Organisation X audits the top one of two companies in many of the sectors, and was perceived by the participants to dominate certain sectors, while still lacking sufficient market representation in others. Organisation X is perceived to have a very strong brand in the market – one that was regarded by the participants to be of equal strength or even stronger than those of the other Big Four.

Competition

Participants identified the main aspects organisations compete on as price, skill and differentiation. Differentiation will be covered in detail in Section 3.5.3, and participants identified the biggest actions to combat rivalry as ensuring the organisation’s cost is as low as possible and that it has the people with the best skills.

The number of people an organisation has and the intensity of the desire to win over the client were identified by the participants as the main determinants of the level organisations are willing to drop their prices to, and some organisations are prepared to cut their fees more than others. Organisation X’s cost has to be kept low, since cost is where the biggest pressure comes from and it requires the best people to be able to deliver a quality service to its clients as productively as possible. Assurance organisations all compete for the same skills and therefore have to be efficient. Maximum utilisation of employees ensures that its fixed salary cost can be distributed over more chargeable hours to clients, ensuring that more of this cost is recovered.

Other considerations

Due to the service nature of assurance, the capacity increasing in large increments (Section 2.2.5.2) would not affect the industry to the same extent as it affects a

manufacturing industry. No significant exit barriers (Section 2.2.5.7) were identified, and the relevance of the lack of differentiation or switching cost (Section 2.2.5.4) was discussed under the bargaining power of buyers in Section 3.4.3.1 above.

3.4.3.3 BARGAINING POWER OF SUPPLIERS

A major theme identified through the empirical research was that, as identified in Section 2.2.2.6, labour has to be recognised as a supplier that possesses great power in many industries. Literature revealed that labour power depends on the degree of organisation and the available labour pool, and labour power increases in highly organised and unionised industries where the available labour pool is limited. Scarce, highly skilled employees, tightly unionised labour and skills shortages could bargain away a significant fraction of potential profits in an industry.

As selling assurance services requires people, time and skills, qualified people are identified as the most important suppliers to the industry, making the bargaining power of staff and potential staff very relevant. Other suppliers in the assurance industry are those who supply infrastructure, technology (for audit tools and research) and professional indemnity insurance. The two major levels people exert bargaining power over the organisation are on a recruitment/trainee accountant level and qualification/management level, and is discussed in detail below.

Recruitment / trainee accountant level

The universities and education system provide the skills and the people to assurance organisations in the form of trainee accountants which, with the war for talent, creates competition since all organisations try to attract the best talent into the profession as they all want the “cream of the crop”. But, as the reality of life is, organisations cannot attract all the best students, so they end up with a blend of graduates coming to them. The competition created is artificial, as trainee accountants cannot assert authority other than deciding which organisations they desire to work for and complete their training contract (which is an internship or apprentice program) with.

The industry is seen as important to the trainee accountants’ career aspirations as they want to finish their university degrees, complete their training contracts, become

Chartered Accountants and then move on, most often outside of assurance. A big concern identified was the number of employees leaving the organisation after their three-year training contract period. Also, the “Training Outside Public Practice” (TOPP) program initiated by the South African Institute of Chartered Accountants (SAICA) a few years ago took roughly a third of the supply away from the public practice (assurance industry).

Trainees who do decide to get training in assurance want to get the best training possible, and although there used to be a shortage of supply, fortunately most graduates want to work at the Big Four and the assurance industry has a relatively constant supply of trainee accountants. As the trainees (suppliers) are not a body or group of people, but rather “every student for himself trying to get into practice”, they do not really have power. This continues for the duration of their training contract, as SAICA infuses vigorous penalties for trainees that do decide to break their training contact and move to other organisations – these penalties often extend the duration of the training period for the trainees before they can become CAs.

Therefore, during the training contract the bargaining power of employees is very low. Another view expressed by some of the participants is that trainee accountants are not considered to be suppliers as they form part of the delivery model of the organisation. As there is not a pool of trainee accountants out in the market saying “I will supply my service to you and therefore I can determine price, timing, etc.” they cannot be seen as suppliers.

Qualification / management level

After qualifying as a CA there are much more opportunities and stronger competition for management skills. Historically the bargaining power of employees as suppliers was not a great barrier as the profession was seen to be profitable, with enough people available to supply the needs of Organisation X. More recently however, the skills shortage in the country has put more pressure on organisations to spend money on retention, career programs and learning and development. In addition employees are trying to institutionalise, drive and manage their career plans and organisations have to ensure people see a career ahead of them, and there is a

meaningful prospect for them in the organisation in order to remain with the organisation longer.

Among managers and partners the attrition out of one assurance organisation to another is very low, as most people who leave go into the corporate sector. The bargaining power among the managers and senior managers are high on the basis that the better managers are reaped up and employed by the corporate sector companies that pay them better salaries. Assurance organisations train employees and spend a lot of money on them, but once an employee gets to the level of Associate Director or Partner he is “pretty much stuck where he is”, as one of the participants described the relative lack of career advancement opportunities in the assurance industry.

Therefore, when suppliers are interpreted loosely so as to include employees, they definitely have bargaining power in the profession in South Africa, but the level thereof is not the same for all suppliers in the profession. The market has the added dimension of Black Economic Empowerment (BEE), which put the country under pressure to transform its demographics to rectify past unfairness. Black African CAs are seen to have greater bargaining power due to the BEE pressures on assurance organisations to transform. The added dimension of BEE and the need to attract black African CAs have increased the bargaining power of that portion of the labour force and one participant mentioned that in this regard the bargaining power of suppliers is not driven by the organisation, but driven by regulation.

3.4.3.4 THE THREAT OF NEW ENTRANTS

The threat of new entrants was collectively assessed by the participants as fourth in line of the forces affecting the assurance industry. The relevant drivers of the force from the literature and empirical study conducted are discussed below:

Economies of scale

The Big Four have established themselves quite powerfully in servicing the market segment of large multi-national corporations. The barriers to entry into this market are high considering that any major new organisations have to also have a global reach, therefore probably disqualifying them from being able to serve this market.

Being a global organisation involves high costs of infrastructure, technology and investment, very good systems and quality processes, making it difficult for a start-up organisation to compete and enabling the Big Four to achieve economies of scale (Section 2.2.1.1).

Product differentiation

The main strategy to compete for the large established assurance organisations (like Organisation X) is differentiation – they possess advantages of brand recognition and customer loyalties which stem from past advertising, customer service, differences in service delivery and market approaches, and simply being the first organisations to operate on a global scale. These organisations have invested heavily in advertising and customer service to establish their brand and to try and overcome the existing customer loyalties to other organisations. These drivers identified from Section 2.2.1.2 have made new entry on the same magnitude as the Big Four very difficult, and new entrants would not really affect the Big Four unless it was a powerhouse.

Capital requirements

For new organisations desiring to provide assurance services on a small scale, the capital requirements are limited, as the organisation does not need much capital and start-up costs (Section 2.2.1.3). The required skills can be obtained by recruiting competent staff from other assurance organisations and all that a start-up organisation really needs, is to find the clients who require, and are willing to buy their services.

Cost disadvantages

Among the medium-sized organisations there is a growing realisation that they can no longer function as local practices and need to combine or join global networks to become more successful. With announcing global mergers or global tie-ups or networks, the medium-sized organisations are building up capacity and strength. The increased regulation also makes the sustainability of small organisations too expensive, and therefore mid-tier assurance organisations are merging to become stronger and to overcome these cost disadvantages (Section 2.2.1.5). Regarding

new entrants, participants did not foresee a new big assurance organisation arising, but rather the consolidation of established organisations, and this consolidation would create more competition in the industry.

History saw the consolidation of power in the assurance industry from the Big Eight to the Big Five and then to the Big Four as we know them today. For the threat of new entrants to be feasible, it has to be driven by regulation, and regulators want increased competition for the Big Four. Because of the significant barriers to enter at the large scale the Big Four are operating at, the barriers can only be overcome by regulation. New legislation and the Barnier green paper are looking into this and the profession foresees an increase in the number of big competitors in the near future. The Barnier green paper attempts to break the monopoly of the Big Four; pending regulation in Europe may lead to companies having joint audits or firm rotation. Therefore the threat of new entrants does not necessarily relate to new firms but the effect of new regulation. Implementation of firm rotation will force organisations to give up their portfolios every five years, and in this regard the South African assurance industry will be influenced by the decisions made on an international level.

Government policy – BEE

According to the CA Charter, assurance organisations have to be 32% black-owned by 2016 (SAICA, 2011). The question is whether enough black CAs are coming through the qualification system in order to meet this requirement. A threat in the South African environment is the growth in the number of emerging black assurance organisations due to government's policy (Section 2.2.1.6) to develop black entrepreneurs. The BEE firms have a competitive advantage over others, even if it is only a perceived and not a real advantage.

Every company's BEE status has to be independently verified, a market which is dominated by a company named Empowerdex. When looking at the credentials and criteria promoted by the CA Charter the BEE firms are not necessarily performing better than other organisations but the perception is that they are. According to the participants they focus on their high percentage black ownership, and by playing the political card they are able to attract work from the government and public sector

they would otherwise not be able to get. Other factors like skills development and community development tend to be neglected by these firms, thus when one looks at the BEE firms overall, they are not really performing any better than other organisations in terms of the CA Charter.

As the emerging black assurance organisations in South Africa get stronger and bigger they will pose a real threat, especially in the “rivalry among competitors” force. This threat has to be understood by assurance providers, as corporate and state-owned entities have to show their support for BEE to improve their own scorecards. Strategic alliances between existing firms and emerging black firms are also seen, for example the merger between Gobodo and Sizwe Siloba. After the merger this organisation became the fifth biggest assurance provider in the country, with a very high black ownership which holds a huge reputational advantage. This merger was foreseen by the participants to have a big impact on the public sector and the merged organisation would most probably get a lot of work from government and empowerment structures.

The magnitude of the BEE threat can be significant as, even though the mergers do not result in organisations the size of the Big Four, they definitely take away some of the work in the government and private sectors. These firms seize the opportunity offered by the South African environment and claim that they are not getting a fair share of the assurance work, with their only focus on black ownership whilst ignoring all the other aspects they are not performing on. BEE accounting organisations accuse the big assurance organisations and government that all work is going to the major firms, while on the bigger clients some organisations are forced to share the job (have a joint audit) with one of the smaller black firms, to train and coach them.

3.4.3.5 THE THREAT OF SUBSTITUTE PRODUCTS

The threat of substitute products was identified as the weakest and least important force by all the participants, with no real threat of a substitute product identified except for the independent review which arose from the new Companies Act (Section 3.3.2). This was due to the view that “an audit is an audit”; to be an auditor you have to be registered with the Independent Regulatory Board for Auditors (IRBA) and many companies are forced to have an audit by regulation. It was also noted that the players in this sector are not just the Big Four as there are many others, and

in this regard the major threat was identified as buyers choosing a substitute supplier rather than a substitute product.

With the development of technology and globalisation, it is foreseen that assurance will be performed even more electronically, in contrast to the combination of manual and electronic techniques currently used. As companies themselves get more sophisticated and adopt more technologies, the assurance providers will be forced to embrace technology as well.

The core audit remains a regulated service and participants did not foresee that this was going to change, with no immediate new substitutes identified in the assurance industry. Other areas over which assurance may be provided that are currently developing, are the areas of integrated reporting, non-financial information and climate change. Integrated reporting and the non-financial information which auditors have to provide assurance on, over and above financial accounting, will turn the market on its head in terms of substitute products, as people with different skill sets will enter the market in order to provide assurance over matters auditors do not necessarily have adequate knowledge or expertise on. The new assurance market of climate change opening up, is a notable new sector that still “earns fairly low revenues today but that will grow tomorrow”. Overall the surfacing of new products and substitutes foreseen are not really a force to consider today, but it is imperative that their effect on the medium term should be considered to ensure Organisation X can capitalise on the benefits which may arise when these become the new S-curves in the industry.

3.5 THE THREE GENERIC STRATEGIES IN THE ASSURANCE INDUSTRY

3.5.1 INTRODUCTION

The main consideration in obtaining a competitive advantage is choosing the correct strategy that will focus the organisation’s time, effort, capabilities and resources toward the goal of obtaining a competitive advantage over rivals. Porter developed his Generic Strategies into three mutually exclusive categories, namely overall cost leadership, differentiation and focus. In this section the application and relevance of following these recommended strategies in the assurance industry and specifically Organisation X will be discovered. Organisation X possesses advantages that could

drive any of the different strategies suggested by Porter, but chose to compete via a strategy of differentiation with a specific market sector focus. This is considered to be very similar to the strategies followed by other Big Four and smaller assurance organisations as well. The application and relevance to Organisation X of the different Generic Strategies identified by Porter are discussed in 3.5.2 – 3.5.4 below:

3.5.2 OVERALL COST LEADERSHIP

In the assurance industry the management of costs is essential; but not with the target of publicly claiming to be the lowest cost organisation in the industry, as is usually found in the manufacturing and mining industries. Proclaiming this, would achieve the opposite of what is intended, as buyers would insist to pay lower fees and the organisation may lose its skills as employees move to organisations with increased cost regarding salaries – thus offering better compensation. A strategy of cost leadership is therefore more appropriate when producing and selling goods than when professional services are rendered. Such a strategy may be a bit of a “death spiral” as once the organisation focuses on cost, then every audit will focus on cost and the organisation will be cutting costs each year while further cutting to catch up with where everyone else is at. Considering the fact that tenders for new and existing clients are mostly won by the organisation with the lowest fee, cost leadership is in fact what assurance organisations compete on; an incorrect basis considering the nature of assurance services.

Managing costs is not a public statement or a big key performance indicator (KPI) in Organisation X, but there are a lot of areas and dynamic strategies and plans to optimise and reduce the cost price, specifically regarding logistics, infrastructure and the locations of offices relative to clients. There are initiatives to monitor costs everywhere the costs are incurred, whether technology-wise or on the jobs, by performing margin comparisons, leverage and pyramid structure analyses (refer below for an explanation). The cost advantages of cost leadership will arise from running a very effective and efficient business, and Organisation X internally focuses on leverage (involving the right mix of people in this context); productivity/utilisation; and gross profit.

For example, if the audit requires one hundred hours, it is essential to identify whose hours they should be, as it could either be trainee or manager hours. A pyramid structure / optimal ratio exists in which more profits are generated from a first-year trainee versus a manager, and an organisation has to get this balance right. The more work the organisation can get out of its lower-level employees, whilst not compromising on the quality of the service, the bigger profit margins will be. Even though it is the same cost, the organisation shifts the cost around in its business and improves profitability, and thus cost management is a very important factor in the organisation. Even though it is just an internal matter, if the structure is right, the organisation uses cheaper employees to do the audit because the focus is right.

This means that the organisation can increase its employment of cheaper employees while still charging buyers the same price. The more expensive employees can then be utilised elsewhere; assigned more complicated work and do what they ought to be doing and not occupying their time with trivial tasks. The cost structure is therefore essential and the Organisation has to have the correct structures as even though it is only shifting people around internally, it will have an impact on costs.

3.5.3 DIFFERENTIATION

Differentiation was identified as the most appropriate strategy to be followed by Organisation X as it needs a strategy to differentiate itself from the other Big Four and the BEE market contingent. An audit is a process with an undifferentiated outcome, as in the end all audit opinions look similar, therefore the outcome is unimportant but the audit process has to be differentiated. Basing a strategy on this is, however, easier said than done, as one of the participants put it: “but how can you assure clients that your process is different, when you have not shown them the process yet?” Within differentiating its audit process, Organisation X, therefore, identified several areas in which it can distinguish itself clearly from its rivals, these areas, discussed in more detail below, can be summarised as its global structure, markets, people, BEE, and unique service offerings

Global structure

Organisation X’s main differentiator and strategy to compete is centred on selling its globally integrated network to the market and clients. The organisation has a

commitment to be integrated across Africa, Europe and across the globe, and was claimed by the participants to be one of the most integrated firms across Africa. Organisation X is able to confidently tell and comfortably demonstrate that it can deliver exceptional client services across the globe, wherever the clients are present. It operates as one voice with one leadership team and is able to match the client's integration with Organisation X's. Participants considered this factor as making Organisation X very competitive as they regarded a global structure as something that the other Big Four did not have yet. The benefits of the competitive advantage are maximised by continually selling and proving the benefits of the organisation with its global integration as one of its hallmark selling points, by which major accounts have been won. Therefore globalisation improves the organisation's revenue and footprint around the world and enables it to compete and also attain a competitive advantage.

People

Participants claimed that compared to the other Big Four, the organisation has a more definite focus on creating a people-based organisation with a "people culture". The organisation looks for the best people with potential and talent, recruits and retains them. Employing the best people enables it to deliver the best quality work to clients, and when the market sees that an organisation recruits good people, it anticipates receiving good service. The people-focus ensures that Organisation X has the best people it can get and that they create an environment people enjoy working in. A major shift in this regard was the open plan of the office building which achieves a lot in aiding staff to socialise more and to break the barriers between trainees and management. The quality of people is also reflected in the Board exam results, and the people culture is emphasised by the organisation's inclusion in the "best company to work for" nominations, which contributes to the organisation's people differentiation factor.

With suppliers identified as staff and skills, being a people-based organisation promotes Organisation X and people want to work for the organisation, therefore marketing the firm to potential employees does not cost the organisation that much. The challenge experienced is, as the organisation grows, the difficulty of getting

people to feel the same way, see things the same way and know each other increases.

Markets

The organisation aims to focus on and protect its current clients while it gets out into the market place to build relationships and the organisation's profile, creating awareness of the organisation's brand and winning new clients. To achieve this, sector focus and a market strategy are essential, and the organisation hopes to win the market by demonstrating that it possesses adequate knowledge. Organisation X "faces the market with sectors" as each sector has specific challenges, and the organisation therefore tries to employ people in the sectors that are relevant to the clients, and tailors its service offerings to the client's needs. In each country it operates in, Organisation X aims to grow one place in its chosen markets and geographies, implementing a strategy to "grow one more". These markets are classified into mega accounts, priority accounts and what it calls "butterflies and caterpillars" – the strategic growth market (SGM) clients.

Therefore, in South Africa the organisation aims at moving one place up in terms of its position, regarding market representation in each of the six chosen markets (discussed in Section 3.5.4 below) its strategy focuses on, and to increase the number of mega accounts in its portfolio by one more (which can only be achieved through winning a major client). The priority accounts are the current clients that are very important for the Organisation to retain, and therefore special effort is given to attend to client relationships with these clients. As the SGMs present a lot of opportunities in an emerging economy, the SGM strategy was being developed by Organisation X at the time of this study. Through implementing several initiatives to grow the SGM space, Organisation X looks for the smaller, more profitable clients which may develop and turn into future priority, or even mega accounts.

In recent years, the organisation operated what the participants referred to as an "unbalanced scorecard" which was focused more on the market and less on internal developments. The focus had previously been on quality and growing and retaining people, and as the organisation now has the people and quality to serve the clients, the current challenge is to find the new clients which these people can serve.

BEE

Specific to the South African environment, compliance to the CA Charter and BEE scorecard is an essential part of the strategy. By making this a priority, participants considered the organisation as able to increase its diversity numbers required to meet the CA Charter and BEE requirements, faster than the other Big Four firms. Achieving a good BEE rating and status is very important in South Africa and contributes to the organisation's differentiation, as it allow them to be competitive with the next-tier black firms, especially when it comes to government related work.

Service and product offerings

Being innovative in the service and product offerings to clients enables Organisation X to differentiate itself. Organisation X invested heavily in technology, in order to develop facilities in which time is spent with clients to help them develop their corporate strategies, helping them to do business globally and across Africa. Organisation X further adds to its differentiation through creating brand awareness and through its thought leadership publications. Organisation X develops and communicates to their clients meaningful thought leadership publications with constantly renewed industry knowledge which can be applied by them. People are also encouraged to go talk to the clients regarding the publications and the knowledge they have of the clients, thus stimulating verbal communication and relationship building with the client.

3.5.4 FOCUS

Focus can be described as “not shooting with a shotgun”, but a strategy based solely on focus would not be appropriate in the South African assurance industry, given the wide reach of the Big Four promoted by their global structures. Participants did not believe that one could limit the area of focus to such an extent from an organisation perspective. There is no doubt that industry focus is important in terms of strategy, but not in terms of strategy for the organisation as a whole, but rather as a factor of implementation within the organisation. When one compares the industries to each other in terms of size, the amount of work the organisation would wipe out by focussing only on one sector would be enormous.

Organisation X has created a “focused differentiation” by selling its unique “differentiators” to primarily six out of the fourteen market sectors identified by the global organisation. The strategy has been specifically developed for the emerging African economies (which are considered to be a major focus area) with the emphasis on the industry knowledge that is brought to the clients. Its strategy revolves around the priority sectors (mining, utilities, retail, public sector, financial services and telecommunications) and priority accounts. In addition, Organisation X has a secondary focus on the automotive, construction, real estate and hospitality industries. Sector and industry focus is a very big determinant, as it is one of the structures with which one builds credibility to enable one to go out and sell business as one then has a success story to sell. Clients want the auditors to have skills and knowledge in the specific sectors that they are in as they choose an organisation with strength and presence in their sectors when they decide which of the Big Four to use as an auditor.

3.6. SUMMARY

Local and global concerns, challenges and developments in the assurance profession are similar with an emphasis on regulatory requirements and attracting and retaining the best people in the industry. Regulation has a twofold impact – regarding clients, it increases the revenue opportunities for assurance providers, while simultaneously increasing the cost of compliance when regulation is imposed on the organisation. As a people-driven organisation, the development of the people has to be maintained, while ensuring that employees’ careers are innovatively shaped. The organisation requires highly skilled people to sell a “regulated commodity” and profitability is often lost somewhere in between. Pressure on fees is experienced externally, with the challenge of rivalry not giving organisations the opportunity to demonstrate that they are able to deliver quality services. The biggest challenge experienced with clients is to convince them not to confuse the often frustrating process of an audit with what an audit can do for them. Globalisation increases the revenues of the organisation with a lot of time spent on certain market sectors in different countries across Africa.

It appears that the lack of substitute products (Section 3.4.3.5) and low threat of new entrants (Section 3.4.3.4) are not used to the benefit of assurance organisations.

With regulation and legislation enforcing audits and registered auditors the only legitimate designation to sign audit reports, the monopoly in providing assurance services (lack of substitute products) and the significant barriers to entry, especially to compete with the Big Four on a global scale (low threat of new entrants) ought to be used to the benefit of all organisations.

This can be achieved if the fierce rivalry among competitors is used to the mutual benefit of all organisations (when instead of engaging in a price war, the assurance organisations stand together, facing their buyers and command the prices their services deserve), all within the guidelines given by the Competition Act. “Stop undercutting and start charging realistic prices for the services we provide” was the solution proposed by one participant for the assurance industry to be sustainable. The participants noted that as a profession, assurance providers do not have faith that this is the right way to do it nor do they believe the services they provide to their clients actually add value (while many auditees actually perceive these services as value-adding) and therefore they are willing to sell it to auditees at a less than desired profit margin.

Rosenkranz and Weitzel (2007) warned that viewing the strategies of differentiation and cost leadership as mutually exclusive options would lead to suboptimal results. Concurring with this argument, Organisation X has cleverly combined elements from all three the suggested Generic Strategies to strengthen their competitive advantage in the market. They internally manage costs to enable them to be as efficient as possible. Externally, they have a strategy of differentiation to clearly distinguish them from the Big Four, while focussing on specific sectors in the market. A participant mentioned that most people are able to differentiate between the Big Four, Tier one and Tier two firms, but very few people are able to tell you who the individual organisations within the Big Four are. It is therefore essential that Organisation X has a unique differentiator within the Big Four and that they are seen as experts in the sectors they specialise in. Porter presented the strategy of focus in two categories – cost focus and differentiation focus. An unaided focus strategy is however more applicable to smaller organisations which are unable to compete on an overall market scale, and therefore, they focus on serving a particular target well. Organisation X has globally incorporated the “focus” into their differentiation strategy

by identifying fourteen different market sectors of which six is the focus point for the local African sub-area. Therefore their strategy is not one of differentiation focus, but rather a focused differentiation, by which they can use their unique differentiators to actively pursue their market focus areas.

One participant mentioned that, given what happened with the market crash in 2008, the profession cannot be unaffected and major fallouts in the profession are expected. Fortunately there were, however, no major known lawsuits against assurance organisations at the time of the study. The challenge for the future is to build an organisation that will be successful, irrespective of the external forces affecting them, but which will also be able to use the opportunities provided by external forces to their maximum potential, as they are presented by the external environment (as highlighted in the S-curve theory). Anticipated future industry developments will be discussed in Chapter 4, together with the recommended actions to shape the forces into Organisation X's favour. Furthermore the research is summarised, upon which the final conclusions and recommendations are presented, followed by the limitations on the study and the scope for further research.

CHAPTER 4: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

4.1. INTRODUCTION

The literature study on the Porter Five Forces and Generic Strategies performed In Chapter 2 was applied to the assurance industry through the empirical study in Chapter 3. It was interesting how many of the drivers within the Porter Five Forces, identified through the literature study, were applicable to the assurance industry when one remembers that Porter's model is usually applied in a manufacturing, rather than a service industry. The results of the empirical study were presented in the main categories of:

- Industry concerns, challenges and developments (Section 3.3);
- Porter's Five Forces in the assurance industry (Section 3.4); and
- The three Generic Strategies in the assurance industry (Section 3.5).

The most important concerns, challenges and developments were identified as regulation, globalisation, people and pricing pressure. Participants ranked the bargaining power of buyers as the dominant force affecting the industry, followed by rivalry among competitors, bargaining power of suppliers, the threat of new entrants and the threat of substitute products. Organisation X follows a differentiation strategy with a specific focus on certain industries/market segments. The strategy is focused on global structure, people, markets, BEE and special product/service offerings and the organisation attempts to sell its globally integrated organisation as a hallmark selling point to its clients.

The biggest constraint in achieving their strategy was identified by the participants as time. There is limited time available when looking after a full portfolio of existing clients which makes it difficult to find time for winning new clients. Furthermore the lack of a sales culture within the organisation was found very difficult to change. The ability to go out and win new business requires a specific type of person with specific skills and a whole support framework around that, not just "a few guys going out and winning new business". Accountants are hardly known for their marketing skills and in order to win new clients, Organisation X has to break down a lot of barriers

resulting from clients that have strong relationships with their existing assurance providers or assurance organisations that have entrenched themselves in niche markets.

This chapter provides insight into the expected future developments in the assurance industry (from the perspective of the participants) and suggests actions for Organisation X to shape the competitive forces into the favour of the organisation. A summary of how the research questions and objectives were addressed follows, after which the concluding comments are presented. Lastly the scope for further research is explored and, as in all research studies, the limitations are identified.

4.2. FUTURE DEVELOPMENTS IN THE ASSURANCE INDUSTRY

To get a glimpse of what the future may hold, participants shared their view of what the industry might develop into over the next decade. Considering the innovative way of thinking the “S-curve” theory promotes, these areas will most likely be the different areas where Organisation X can outsmart their competitors and make the most of opportunities presented in the external market. The major future developments in the industry expected by the participants were in the areas of regulation, technology, pricing and skills shortages.

Regulation

With the worldwide development of sustainability, governance and integrated reporting, the scope of the audit opinion and the areas over which assurance will be required are going to change, and the South African assurance industry is expected to benefit from this. The next big thing anticipated, is the assurance over non-financial information in whatever shape or form (triple bottom line).

With increased complexity, the industry is foreseen to be a tough environment to be in, and the regulatory requirements and changes will impact how the industry shapes itself. Audits will become much more regulated on a global basis with IFRS developing outside of the United States, US GAAP (Generally Accepted Accounting Principles) and auditing developments in the US and aligning IFRS and US GAAP to get a single accounting, auditing and regulation system across the globe (so-called harmonisation of standards). Complexity will increase as the speed at which

accounting standards change is significant. It was the view of the participants that recent new developments in accounting standards did not bring IFRS and US GAAP more in line; these two reporting frameworks are supposed to move closer together rather than further apart.

Regulatory changes like the Barnier green paper out of Europe on compulsory auditor rotation will impact the profession significantly, as well as the US considerations to rotate audit firms instead of just partners. In the South African environment, it is mandatory for audit partners to rotate every five years following the introduction of the new Companies Act of 2008. A large portion of the South African economy is state-owned and the government would like to see auditor rotation. The assurance process entails that auditors normally come in with a fairly competitive pricing model in the early years of the audit, hoping to develop economies of scale and efficiencies as they mature with the client. Over the duration of the relationship with the client the assurance provider recovers some of this investment made at the initial stage of the relationship, but with forced rotation every five years the ability to capitalise on these efficiencies may not materialise going forward.

Technology

The increased use of technology is anticipated, with a lot more reliance placed on electronic data assessment. With the increased use of technology in the business environment, companies and transactions are anticipated to become even more complex. Audits are expected to start a lot sooner and to be undertaken hand in hand with the client as opposed to only coming in at key times during the financial year. As Organisation X is already at the forefront of implementing the latest technology in their organisation (demonstrated through the global integration), they are expected to benefit from the increased use of technology anticipated.

Pricing

It is foreseen that either audit fees are going to be more decent and the industry will correct itself, or the current low fees experienced in the industry could become the new base for fees, with the exponential effect in the next decade anticipated to be more than in the last 10 years. Therefore the industry expects that fees are either going to be much more decent, or through competition going to be even lower

compared to the current fees – strangling the profitability of the profession even more. Organisation X must ensure that they price their services correctly to retain their market share within the global auditing market, as giving away ground only results in market share gains for the other major rivals. It is essential that the best people are assigned to negotiating fees with clients, especially when tendering for global accounts.

Skills Shortages

Recent world news shows that the whole social setup is starting to change. Youth does not see the use of studying, as there are other ways to survive rather than entering a profession and working hard. A participant stated that in Germany a person struggled to get a job if he/she did not have a Master's degree 10 years ago, while at the time of this study this was busy changing. The German government supports these jobless people with grants and this socialistic mindset seems to be the order of the day in many first-world countries. This may end up in a huge skill shortage in the audit profession. This argument is supported by the riots experienced in London in 2011. These factors may all increase the magnitude of the current skills shortages in the profession.

A big determinant is having the critical mass; getting the most competent people across the different sectors. The people differentiation factor obtained by Organisation X will benefit them a lot in this regard as people want to work for this prestige organisation, and therefore attracting the best and most dedicated employees who are passionate about their careers. Furthermore, a globally funded investment plan for the African subarea enables Organisation X to find and recruit senior experts in the market as the cost is covered by the global organisation.

4.3 ACTIONS TO SHAPE THE FORCES INTO ORGANISATION X'S FAVOUR

The suggested actions to shape the forces into the favour of the Organisation, are based on the recommendations presented by the participants as well as the researcher to maximise the benefits of each of the Five Forces affecting the assurance industry. In the next decade it will be essential to change the clients' perception of an audit as they have to see it as a value-adding service to their industry, rather than a grudge purchase. Shaping the forces into the favour of the

organisation is not necessarily within the gambit of the organisation to change and will depend on the external factors influencing the organisation. Therefore ensuring Organisation X understands the five external forces will enable them to be well prepared in addressing these forces better than their rivals.

4.3.1 BARGAINING POWER OF BUYERS

Owning the relationship with the client and winning the whole account (including assurance, tax and advisory services) has to be a big thing on the organisation's mind, and can be referred to as "account centricity". It is suggested that Organisation X has to stop approaching the market as service lines with products, but has to verbalise that it sells assurance: assurance over contract risk, outsourcing arrangements, the effectiveness of information technology systems and assurance over sustainability reporting, to name but a few. Therefore the organisation should not go to the market under the name of "audit" but rather under the name of "assurance" (a wider term) and then tell clients that "by the way, the audit is part of it". In this way clients will know that professional services firms have the ability and capacity to really add value to a client's business over and above the statutory audit.

Organisation X has to sell a differentiated product in the sense of value-added services. The challenge experienced is with changing the buyers' perceptions from viewing an audit as just a product they have to buy, to viewing it as a comprehensive assurance service that is worth a lot to their businesses. Promoting the value that assurance brings is the only way Organisation X can deal with the buying power and still command the prices it wants to ask. Thus to convince the client that Organisation X does not just sell an audit, it has to present Organisation X as one of the best brands among the Big Four in terms of experience, unique solutions and quality service, and has to promote the fact that "we did it before and we know how to do it now". Organisation X's brand will be promoted by ensuring it offers excellent quality (because buyers are willing to pay for quality) and exceptional client service (giving the clients what they need in the right way). Organisation X has to increase its visibility in the market for companies to know what knowledge it possesses and how it can help them. Therefore, although the buyers have a lot of power, Organisation X can ensure they see value in the services they receive and are happy with the quality level of service, so they would not have reason to use their power to

negotiate and bargain with someone else. To achieve this Organisation X has to run an effective business and be as efficient as possible, as quality and client service cost a lot of money. Being effective is achieved by managing cash flow, increasing utilisation, performing tasks once and not twice, training the staff well and controlling the internal cost base as much as possible. In addition, it has to “keep the clients it has and try to win new work”.

To be able to bargain the best prices, in light of increased inflation and complexity, employees that face the client and bargains regarding prices, have to be equipped to do so. Building relationships and being close to buyers are vital in this regard. To use the profound words of one of the participants: “when you know what is going on in their businesses, you can make a difference and bring them insights; you can see their problems and use the organisation’s global network of skills and resources to bring ideas to solve their problems”. Therefore, it is not just important only telling buyers what their problems are, but offering feasible ideas to solve these problems.

By investing a lot in thought leadership by way of material, brochures and studies, clients are brought meaningful, competitive information and insights regarding their market sectors. This is information clients do not normally have access to, that can be used by them to add value to their business operations and is currently supplied very effectively by Organisation X. It is critical to build communities as the big thing on everybody’s mind, is doing business across Africa. In investing a lot in bringing chief executive officers and chief financial officers together to spend time in sharing ideas, perspectives and developing strategies, Organisation X will be seen as making a difference to the buyers’ businesses.

4.3.2 RIVALRY AMONG EXISTING COMPETITORS

The rivalry is not foreseen to be something that will just disappear in the near future, as the Big Four will continue to pursue each other’s clients. To mitigate the risk of clients lost due to rivalry, an assurance organisation has to be very clear with reference to its major points of differentiation. As the products sold are homogeneous, a determining factor is the people the organisation uses to implement its products and solutions. It all revolves around the organisation’s ability to implement a solution from beginning to end. The benefit to Organisation X will be

that it sells the assurance product to the market on a different basis, with the approach that “an audit is not just an audit; Organisation X brings something different to the table”.

As only one organisation within the Big Four can claim to be the biggest, the other organisations must all ensure that they are known for what they are best at. When the study was conducted, the participants claimed that the differentiating factor of Organisation X was that it is the organisation that can unlock value in Africa. Organisation X has an integrated model and, according to the participants, is the only truly globally integrated firm. This enables the organisation to be ahead of the competition in terms of the type of buyer questions it is able to answer. Organisation X is able to integrate its services across service lines and across different geographical areas and with the expansion of many multinational companies from South Africa into the rest of Africa, these companies look to Organisation X to help them facilitate this.

A significant advantage is the fact that the integration enables Organisation X to manage its costs on the basis that different offices do not compete with each other within the global organisation or in the continent of Africa. Participants argued that the integrated strategy of Organisation X puts them ahead of other firms as the other Big Four are still competing within themselves. This advantage will remain until such time when the other Big Four firms can also claim to be fully integrated with no internal competition within themselves, but until such time Organisation X will continue to beat them for work across the African continent.

4.3.3 BARGAINING POWER OF SUPPLIERS

As mentioned in Chapter 3, the “suppliers” of assurance organisations are largely their employees. Reviewing the internal cost model and the way Organisation X supplies services, the cost of delivering assurance services has to be reduced. It is suggested that the way to reduce costs is to look at ways to outsource personnel and infrastructure costs currently incurred to low cost markets like India and China. As the labour costs in these countries are much lower, costs can be reduced significantly when certain functions can be performed by them. Making use of the global talent hub and other initiatives developed by the global organisation, the

South African entities can reduce their costs. Within South Africa, Organisation X can also make more use of its offices located in other provinces, as the labour costs of these branches tend to be relatively lower compared to the cost of professional services in the Johannesburg area. The question also needs to be asked as to what extent an audit can be done electronically without being physically present at the client, and which part can be outsourced to a lower cost market.

The benefit to Organisation X is that it is able to manage its cost to a very large extent as a long pipeline of trainee accountants into the market is experienced. Organisation X should continue to attract the best employees in the market, with the challenge to attract black Chartered Accountants and especially black women, as this is considered a significant determinant as to where it pitches itself in the market, especially around state-owned enterprises.

The leverage model addresses the question of whether the organisation has the right level and mix of people. The question should be asked as to whether the organisation needs all the trainees to be graduates, as currently all trainees come in as graduates, write the Board exams and after three years they either stay or leave. The life cycle of a trainee was explained by the participants as follows: “in their first year they think they know a lot but they do not; in their second year they get to grips with what is required and start being more effective; and in the first six months of the third year they are actually very effective; until the last six months come and they start to think what they are going to do the following year, then their minds are gone”. The organisation, therefore, only receives real value from the trainee accountant for two years, for the period of June in the first year to June in the third year of the training contract period. The challenge is how to increase this value curve to, say, four years and therefore double it. Training contracts cannot be extended, but the question can be asked as to whether the organisation needs trainees, or whether it can get other people to come and do exactly the same job. This is done very effectively by Organisation X in the US and Europe as employees that work in assurance are not required to possess an accounting degree.

4.3.4 THE THREAT OF NEW MARKET ENTRANTS

As a culling in audit firms rather than new entrants is experienced, a possible action is to first wait and see where the industry is headed and then act accordingly. After the demise of Arthur Andersen in 2002, the remaining offices of the organisation was grafted into the current Big Four, and specifically Organisation X with great success. There is therefore no reason that the organisation should not be constantly on the lookout for integrating some of the mid-tier firms into Organisation X as well. As the infrastructure is already set and expenses incurred, adding more people and business to the service lines of Organisation X can be very profitable. Mergers with BEE organisations are a possibility to look into, and had been successfully conducted by some organisations in the past (Section 3.4.3.4). In the current South African economic environment, a merger with one of the Big Four is, however, not that attractive to the BEE organisations, as they then lose their competitive BEE advantage and just become part of another “big corporate”.

The crucial action to be taken by Organisation X is to actively endeavour to exceed the CA Charter rating that was implemented and that has to be achieved by 2016. Even if this had not been compulsory, a significantly improved BEE rating will definitely provide Organisation X with more of a competitive edge as it would be able to better compete for state-owned clients.

4.3.5 THE THREAT OF SUBSTITUTE PRODUCTS OR SERVICES

Substitute threats may have been the lowest threat identified, but the opportunities that might arise from this in the future should not be underestimated. The market is developing and new reporting lines are seen in sustainability, “green reporting”, and assurance over non-financial information. Furthermore XBRL (eXtensible Business Reporting Language), a non-assurance financial reporting system, could present major revenue opportunities to the organisation if implemented on the JSE. It is essential that Organisation X makes the most of these “S-curves” as they occur, and to be innovative and in front of competition in anticipating future trends. Following a similar approach to that of Draoui and Liu’s case company (Section 2.2.4) the response of Organisation X should be to add these substitute products to their service line. It is essential for assurance staff to remember that Organisation X is a

global organisation with various departments and service lines, for example tax, advisory, risk and fraud investigation. Although developments in substitute products may not directly affect the assurance line of business, it might present numerous opportunities to other service lines which will eventually benefit the organisation as a whole. Assurance employees may not be the best equipped to perform procedures over the various different aspects over which assurance will be required, and as experts from other markets may have to be brought into the industry they might as well be recruited by Organisation X.

4.3.6 OTHER PROPOSED ACTIONS

The forces can only be shaped into the favour of the organisation by taking the employees' focus from Organisation X itself to its external marketplace, as the organisation's success lies in winning the marketplace. The organisation's strategy firstly states that it has to be in the market to be successful and certain market priorities are identified to focus on. More engagement with existing clients and potential clients are needed around key industry issues and thought leadership. Organisation X has to demonstrate its own capabilities and has to introduce itself to people "to first of all build trust and from there win audits or pieces of work". A more productive sales culture has to be promoted, as professional technical people do not like selling. It is a word that scares them but they have to go and sell if they want to be successful and competitive.

A participant proposed that the industry has to first incur significant losses as a result of the rivalry among the existing firms and only then, the profession might realise that it is not sustainable to keep on incurring losses of such magnitude due to rivalry and, as a result of this epiphany, it may reduce the rivalry. It is quite absurd that, if the hours spent on an engagement of a certain size are more or less constant, one organisation can say it will do the audit at almost half of the cost when pitching for new clients. When the profession faces a significant loss, and as a result of this the profession comes to realise that it is not prepared to stand for this any longer, then this type of behaviour may change. The solution may be to look at a new client with an attitude of "if the previous organisation charged so much based on so many hours, these are the number of hours on which the fee will be based and we will add a few because we still have to understand your business", and then actually charge

the clients a bit more. It is submitted that this action is much more sensible if the profession wishes to sustain itself.

4.4 SUMMARY OF RESEARCH

4.4.1 SUMMARY OF THE RESEARCH QUESTIONS

The research questions raised in Chapter 1 (Section 1.5) were addressed as follow during the study:

- i. What are the concerns, challenges and developments faced in the South African assurance industry and how do they affect the industry and Organisation X specifically?*

The assurance industry is heavily impacted by its external environment and regulation, pricing pressure and skills shortages were all factors identified that is not within the gambits of the organisation to change. The local industry is heavily dependent of what happens globally and globalisation has impacted the industry and the organisation significantly. In future years the major development areas are expected to be regarding increased regulations, either increased profitability or pricing pressure and an increased use of technology within the industry. Skills shortages are expected to increase even further and it is essential for the organisation's sustainability to do their best to retain the people it has so heavily invested in developing. As a professional services firm, they need to have the best people to enable them to produce the high quality of work they have become so well known for.

- ii. Which external market forces affect Organisation X and the South African assurance industry, and how are they assessed and categorised within the Porter Five Forces model?*

The Porter Five Forces were spot-on in identifying the various factors affecting the assurance industry. A thorough implementation of the individual economic characteristics within each force was made on Organisation X, a Big Four firm within the industry, to provide the reader (which normally would not have access to such information) with a modern day industry analysis. The most important force identified, followed closely by rivalry among competitors, was the bargaining power

of buyers. This is where Organisation X should focus their time, capabilities and resources in order to obtain competitive advantages over its rivals. It would, however, be fatal if the organisation ignored the threats and opportunities embedded into the lower rated forces of bargaining power of suppliers, threat of new entrants and threat of substitute products, as these could in fact be where future profitability may arise.

- iii. What is the correct strategic response to obtain a competitive advantage, based on the industry analysis and Porter's suggested Generic Strategies and does the current strategy, developed by Organisation X, respond appropriately?*

The correct strategic response for a professional services firm like Organisation X was identified as one of differentiation. The current strategy developed by Organisation X matched the characteristics of a differentiation strategy, with an additional focus on certain market segments. The organisation continues to sell its global integration as its major point of differentiation and claims this differentiation factor to be incredibly powerful, with the great amount of time spent on differentiation making the difference. The challenge is to now continue to **capitalise** on the organisation's integration.

This research did not identify a significant gap between the current strategy selected by the organisation and Porter's recommended strategy of differentiation, and the two were described by the participants as "pretty much aligned" and "very aligned". The strategy developed by Organisation X, therefore, does respond appropriately, with the real battle identified in **realising and implementing** the strategy; deciding *what* the organisation is going to do and *how* it is going to do it.

4.4.2 SUMMARY OF THE RESEARCH OBJECTIVES

The objectives of the study as they were defined in Chapter 1 (Section 1.6) and how they were addressed in the study are discussed below:

- i. To formulate an assurance industry analysis incorporating the concerns, challenges and developments as perceived by experienced industry participants:**

Through the semi-structured interviews conducted with the participants, an understanding was gained of the industry concerns, challenges and developments from the experienced industry participants' perspective. Their combined responses provided a modern industry analysis which was presented in Section 3.3 and were mainly categorised as regulation (3.3.2), globalisation (3.3.3), skills shortages (3.3.4) and pricing pressure (3.3.5). The future developments expected in the industry were in the areas of regulation, technology, pricing and skills shortages and were presented in Section 4.2.

ii. To perform a literature review of Porter's Five Forces model and an external environmental assessment of these forces as interpreted by experienced industry participants:

The objective of the literature study was to identify the economical and technical characteristics of the industry structure as identified through the Five Forces model which an organisation had to consider; and were presented in Section 2.2. Section 3.4 was dedicated to analysing how Organisation X examined its external environment, ranking the Five Forces in order of strength and importance (Section 3.4.2) and identifying the characteristics or "drivers" relevant to the industry within each of the forces (Section 3.4.3). Proposed actions to shape the forces into the favour of the organisation were also identified and presented in Section 4.3.

iii. To perform a literature review of the different strategies an organisation may employ to obtain a competitive advantage and to apply these strategies to the assurance industry:

The literature behind the Generic Strategies suggested by Porter was addressed in Section 2.3.1 – 2.3.3, with other relevant strategic models available to professional services firms discussed in Section 2.3.4. The Generic Strategies were applied to the assurance industry in Section 3.5, and the strategy most applicable to the assurance industry was identified as one of differentiation.

iv. To reach conclusions and make recommendations on all of the above, with Porter's theory in mind:

Conclusions and final recommendations of the study are presented in Section 4.5 below. From the results and insights gained in the study the researcher identified a gap in the Porter theory as it only focuses on the external environment and does not aid an organisation in developing its chosen strategy. In Chapter 5 the researcher aims to bridge this gap by firstly discussing the case for investment into Africa, and then applying the Resource-based approach for formulating a strategy for the African environment. “This time for Africa” (Chapter 5) concludes the study and provides it with a true African flavour.

4.5. CONCLUDING COMMENTS

4.5.1. CONCLUSION AND FINAL RECOMMENDATIONS

Based on the preceding results, certain conclusions can be drawn and these include the following:

- The assurance environment is constantly changing, being shaped by regulation, globalisation, skills shortages and pricing pressure on fees. The organisation’s success lies in correctly identifying market trends and future industry developments, and to maximise its growth and revenue in the emerging world markets;
- The research identified that Organisation X’s management has recognised the importance of the external environment long ago – and have been actively working in the market to win clients and to improve the organisation’s visibility and credibility in the market place. They deliver quality service and ensure that the people they employ adhere to the organisation’s strategy and values;
- The research also revealed the key force to address is the bargaining power buyers have over assurance organisations. Organisation X has to ensure its perception in the market is impeccable at all times and it delivers quality services to its clients – the result of employing excellent people;
- The current strategy developed by Organisation X to win the market is deemed to be appropriate – with its success dependent on the ability of the organisation to correctly and actively realise and implement the strategy in practice.

- One of the findings of the study was that Organisation X could improve on marketing itself to clients in its relevant markets, and that it depended heavily on its current employees to go out and sell the organisation, while the employees struggled to find the required time and skills to meet this expectation. It is suggested that a dedicated and qualified marketing team should be employed which consists of experienced and suitably qualified individuals with the correct strategic relationships in the market, which will enable Organisation X to focus specifically on growing its organisation while also relieving some of the pressure from its other employees. By winning new clients the investment cost into such a department should easily be recovered over the long term.
- Dedicated training on marketing and negotiations skills will help current employees to sell the organisation better – enabling them to be an active part of marketing the organisation as they deal with clients on a day to day basis. Clear descriptions of what the organisation does and how it adds value to clients has to be provided as a marketing tool to differentiate the organisation from its competitors.
- It is recommended that Organisation X should put more emphasis on the organisation's global achievements and boast even more about its advantages so that not only internally people believe it, but that this is communicated clearly to the clients as well. It should be seen as everyone's responsibility within the organisation to improve business and to communicate the selling points to the market. Even though training contracts are mandatory trainees should develop pride and honour for the organisation so that, at the end of their training contract they would want to stay on at Organisation X.
- Organisation X should strongly look into the possibility of employing people in assurance that does not follow the CA stream as this can decrease cost as well as increase timeframe from which the organisation receives value from their investment in training and developing the employee.
- Considering the current shortages of black CAs, the organisation will have to market themselves much more actively around this portion of the population to be able to improve their BEE rating and meet the CA Charter targets by

2016. Furthermore the black staff currently employed at Organisation X should be retained at all cost.

- The organisation should invest heavily in research and development regarding the potential substitute products of sustainability and “green” reporting, XBRL and providing assurance over non-financial information, and add them to their service lines to ensure the organisation can reap the benefits from these “S-curves” as they arise.
- The organisation has successfully initiated a strategic plan for Africa, and due to confidentiality, its strategies could not be presented as part of the research. The researcher therefore attempted to aid the development of a strategy for the African market by applying the Resource-based approach developed by Grant (1991) to the African environment in Chapter 5. It is recommended that the Resource-based approach (which base strategy on the resources and capabilities of the organisation) and the Porter model (which is focused on the external environment) should be used by Organisation X to assess its current strategy.

4.5.3. LIMITATIONS AND SCOPE FOR FURTHER RESEARCH

Additional research is required to confirm the reliability of the measuring instrument (semi-structured interview questions as stated in Appendix 1) and should also focus on larger samples (i.e. more cases) to improve the confidence in the study findings. Further research could be done on the other Big Four assurance organisations as well as the mid-tier organisations to obtain an overall view of the South African assurance industry.

In the literature, only limited research had been done on the strategies of professional services firms, and the Porter theories may not be the most effective in analysing this environment. Thus conducting further research with the use of the Blue Ocean Strategy, jumping the S-Curve or Professional Services Firm model could supplement the findings of this study by providing some more rich data. Further research on how the clients (buyers) of assurance services view the assurance providers and their services could uncover interesting information for the assurance organisations to use, as in this study the buyers were identified as the most important force affecting the industry.

As with all research studies, this one also had some limitations:

- Due to the time constraints and availability of senior management the study was only conducted with eight partners from Organisation X. This research was therefore based solely on the view of these eight partners and could therefore not unequivocally be interpreted as the overall view of Organisation X. However, as these individuals represented a considerable portion of the senior management of the organisation having much and varied experience in many sectors of the assurance industry, it is submitted that their views nevertheless should in all probability have represented the main views of the whole organisation.
- The study assumed that the participants had a good understanding of the competitive environment and the external forces affecting Organisation X, which might not be the case (although, as discussed earlier, this is unlikely due to the participants' positions and experience).
- The study was only conducted at one of the Big Four assurance organisations in an attempt to gather deep insight into the research problem (case study method). Moreover, due to constraints on the access to data and the confidentiality of the competitive strategies of the organisations, a simultaneous study on all of the Big Four firms would have been awfully difficult in any event.
- Due to the confidentiality of some information supplied by the participants, it could not be reported, as it may have revealed the identity of Organisation X.
- The Porter model was only utilised to a certain extent as it may not necessarily be the most applicable model in the assurance environment. There were drivers in the Porter theory that were not really applicable to the assurance environment as the model was developed more for a product industry than a professional services firm like Organisation X. The Porter model also solely focused on the external environment, without taking into account the internal resources and capabilities which an organisation might possess. Therefore a model for assessing these internal resources and capabilities was discussed in Chapter 5. Nevertheless, it is submitted that this study made a contribution to the scarcer body of research on strategic models in service organisations.

All in all, this research study (despite its limitations) added value to the body of research by providing deeper insights into the strategic challenges faced by assurance providers and how a theoretical model (e.g. Porter) could be used to identify what needs to be done to shape the challenges into the organisations' favour.

CHAPTER 5: THIS TIME FOR AFRICA

5.1 INTRODUCTION

The 2010 Fédération Internationale de Football Association (FIFA) World Cup soccer tournament and the official “Waka Waka” or “This time for Africa” theme song that accompanied it brought the world’s attention to the continent of Africa, and more specifically South Africa. It is imperative for South African organisations like Organisation X to, as the world becomes more aware and has its attention focused on the continent, convince and assist the countries of the world in bringing their investments to Africa as well. Organisation X foresaw a transition of investments moving in the direction of the emerging African economy and has cleverly developed a strategy to capture the growth of this potential “S-curve” into the organisation. Its Africa strategy utilises funds received from the global organisation to grow the business across Africa and to recruit experienced people into the organisation to help expand its brand in the marketplace.

The Porter model applied in this research aids an organisation in analysing its external environment and then in choosing a strategy to compete on, based on the analysis. It is however submitted that it fails to take into account the organisation’s own resources and capabilities, and does not assist an organisation in developing this chosen strategy for gaining a competitive advantage over other market players. To make a valuable contribution to the literature, the researcher therefore deemed it necessary to discuss such a model for strategy development which could be used in combination with the Porter analysis for organisations who wish to expand their operations into Africa.

In this chapter, the case for an investment into Africa is discussed in Section 5.2 based on a recent article by Neil Urmson, while the Resource-based approach formulated by Grant (1991:114-135) will be discussed in Section 5.3. Finally, a conclusion is reached in Section 5.4, which also concludes this case study on the analysis of the competitive environment in the South African assurance industry.

5.2 AFRICA - A CASE FOR INVESTMENT

Urmson (2012) identified that the developed economies of Europe and the United States have lost their lustre, while the thriving economies of China and India are displaying a few cracks in the growth story. Therefore the next place to search for a good investment opportunity is the continent of Africa. Although known as a continent with diseases, poverty, wars, corruption and downwardly progressing economies which only attract those in search of hidden gems and precious metals, Africa is also a continent with rising foreign investment, increasing growth and a rapidly growing technology and telecommunications sector. Urmson describes it as “a cluster of countries emerging from darkness into a region described as the next big growth market”.

The decision to invest in Africa should be no different than any other investment decision as an above inflation return which also compensates an investor for the risks taken should be earned. The African environment inherently poses numerous risks - corruption and fraud; government and legislative frameworks; excessive debt against illiquid, unmatched assets; permanent market failure and incorrect data (Urmson, 2012). As a development model rests on the pillars of political stability, property rights, access to capital and investment in health and education, a few critical components have to be in place to bridge the gap between the emerging African economies and developed nations. These include:

- Establishing sound, sustainable business institutions;
- Opening up the private sector;
- Invest heavily in developing infrastructure, building transport links and constructing solid strategies;
- Transparency and accountability; and
- Low levels of corruption.

For emerging economies their small businesses (or strategic growth markets as defined by Organisation X) are essential as growing companies create a multiplier effect. Secondly they need to create an environment that will better support entrepreneurs, which requires Government to develop policies and incentives that foster ideas, capital, business circulation and development. Urmson (2012) deemed

it foolish to assume only one single strategy for the cluster of 53 African countries, but nonetheless identified a successful investment strategy to be characterised by the following:

- Bottom-up, in-depth analysis of investment opportunities, while allowing for some margin of safety;
- Allow for greater diversity than normal, without compromising on quality;
- A long investment time horizon;
- Fund management with specialist African expertise, with a commitment to investing in Africa for the long term and the resources and practical know-how to execute.

For the brave investor, a pioneering entry into Africa could provide returns that far outweigh the risks. Urmson (2012) counselled to “tread carefully but make an entry for sure”, as the “once dark continent could soon offer gems of a different sort”. Based on the above discussion there appears to be a solid case for investment entry into Africa, and Grant’s Resource-based approach to develop such a strategy will now be discussed in Section 5.3 below.

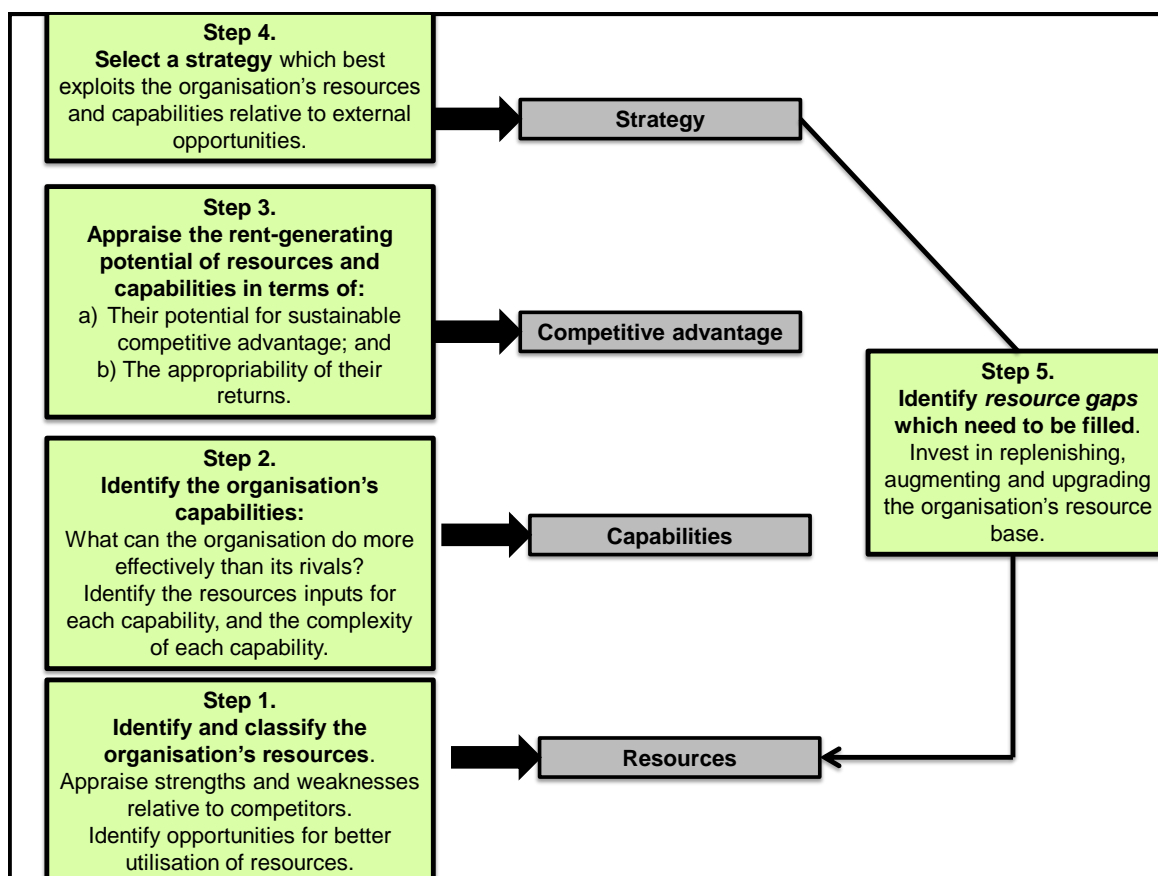
5.3 RESOURCE-BASED APPROACH

An organisation’s resources and capabilities are its fundamental considerations when developing a strategy as they establish its identity and frame the strategy while simultaneously representing the primary sources of the organisation’s profitability (Grant, 1991:133). Furthermore, the key to a Resource-based approach of strategy formulation is, understanding the interaction between resources, capabilities, competitive advantage and profitability (Grant, 1991:133). Of particular importance is understanding the mechanisms through which a competitive advantage can be sustained over time, which requires designing strategies to exploit the unique characteristics of an organisation to its maximum potential.

In addition to the external environment, the resources and capabilities of Organisation X (and any other organisation) therefore need to be considered when developing a strategy (in this case for investing into Africa). As the study conducted has not yet identified **how** to formulate a strategy after assessing the external environment and choosing a strategy to compete on, the Resource-based approach

to strategy formulation (figure 9 below) will address this issue in Sections 5.3.1 – 5.3.5 below. The researcher deems this as able to assist Organisation X (and other assurance organisations) in evaluating its current strategy to match company’s African investments with the high quality of professional services they need and have become accustomed to receiving from Organisation X.

Figure 9: A Resource-based approach to strategy analysis: a practical framework



Grant (1991:115 *adapted*)

5.3.1 ANALYSING THE ORGANISATION’S RESOURCE BASE

Grant (1991) explained that resources are the basic inputs into an organisation’s “production process” which can include capital equipment, skills of individual employees, patents, sources of finance and brand names. Resources can be further classified into the six major categories of financial resources, human resources, physical resources, technological resources, organisational resources and

reputation. The two major questions that need to be addressed under identifying the resources are:

- *“What opportunities exist for economising on the use of resources?”* and
- *“What are the possibilities for using existing assets more intensely and in more profitable employment?”*

For assurance organisations, their people with their skills was identified as the main resource. In Africa specifically the cost of professionals was assessed as being quite high and underestimated by companies investing into Africa. To keep its own costs as low as possible Organisation X needs to ensure that it recruits professionals ahead of time as cost will increase in correlation with the increased demand for these scarce skills.

The financial support from the global organisation will be its major financial resource and the organisation possesses vast technological resources which enable its global integration. The organisation has obtained an excellent reputation and established brand in the market through years of quality services and possesses both the physical and organisational resources to provide professional services in Africa.

5.3.2 IDENTIFYING AND APPRAISING THE ORGANISATION'S CAPABILITIES

The capabilities of an organisation are defined through what it can achieve as a result of all its different teams of resources working together, which is defined and appraised using a standard functional classification of the firm's activities (Grant, 1991:120). The capabilities arise from the collective learning in the organisation, especially how to coordinate diverse skills and integrate multiple streams of technology, an aspect in which Organisation X has excelled in. Capabilities can further be created by coordination amongst people and between people and resources. As an organisation is essentially constructed through a sequence of organisational routines, it is essential to look at the relationship between the resources, capabilities and competitive advantage of the organisation (Grant, 1991:122).

Grant (1991:122) stated that the relationship between resources and capabilities are determined through an organisation's ability to achieve coordination within its teams.

An organisation has to motivate and socialise its members in a manner favourable to the development of smooth-functioning routines. As the routines of an organisation can be compared to the skills of an individual, a trade-off between flexibility and efficiency is likely to occur, therefore to be highly efficient the same routines have to be performed consistently. Unfortunately, being highly efficient in performing the same routines makes it difficult to adapt to unique situations (Grant, 1991:123).

Even though each client is different with unique characteristics and processes, the process of an audit can be seen as quite standardised with the basic steps of planning and risk identification, strategy and risk assessment, execution, and conclusion and reporting. Therefore as people almost always work together in teams on audits, the process can be seen as standardised and Organisation X should be able to create smooth routines and corresponding capabilities.

Similar to the skills of an individual which can only be acquired over time, the skills of an organisation are developed and sustained only through experience, adding to the organisation's "economies of experience". The complexity of the organisation's capabilities will determine how easy it will be for a rival to imitate its "sequence of routines", and becomes extremely relevant when considering the sustainability of an organisation's competitive advantage (Grant, 1991:123). In assurance, when employees leave the firm they take their "human capital" with them, resulting in the organisation's loss of its economies of experience. It is therefore essential that Organisation X implements sufficient steps to ensure that it retains its people better, especially when considering the additional staff requirements for expanding into Africa.

5.3.3 ANALYSING THE RENT-EARNING POTENTIAL OF THE ORGANISATION'S RESOURCES AND CAPABILITIES

The returns earned on an organisation's resources and capabilities depend on two key factors. Firstly the sustainability of the competitive advantage which resources and capabilities confer upon the organisation; and secondly the ability of the organisation to appropriate the profits ("rents") earned from its resources and capabilities (Grant, 1991:123). In order to deliver a sustainable competitive advantage an organisation's resources and capabilities should reflect the four

distinct characteristics of durability, transparency, transferability, and replicability (Grant, 1991:124).

Grant (1991:128) identified that once one looks beyond the statement of financial position and physical assets of an organisation, ownership becomes ambiguous. Organisations “own” various intangible assets, of which the most relevant to an assurance organisation may be its employee skills. In the assurance profession the main suppliers are its employees, which are mobile and therefore it is risky for an organisation’s strategy to be based upon the specific skills of a few key employees. It is also very difficult to distinguish between the technology of the organisation and the human capital of the individual. An organisation’s dependence upon skills possessed by highly trained and highly mobile employees is particularly important in the case of professional services firms (like Organisation X), where employees are the most important resource by far (Grant, 1991:128). When ownership is ambiguous, relative bargaining power becomes the main determinant of the allocation of rents between the organisation and its employees (Grant, 1991:129). By allocating these “rents” fairly between the organisation and its employees (for example through the implementation of profit-sharing schemes as a part of all employees’ remuneration packages), it could result in more motivated employees having a better incentive to stay with the organisation.

5.3.4 SELECTING A STRATEGY

The organisation’s most important resources and capabilities or “crown jewels” which play an immense role in the competitive strategy the organisation pursues, are those which are durable, difficult to identify and understand, imperfectly transferable, not easily replicated and in which the organisation possesses clear ownership and control (Grant, 1991:129). Any strategy needs to be designed to make the most effective use of the organisation’s core resources and capabilities and when formulating a strategy an organisation has to limit its strategic scope to those activities in which it possesses a clear competitive advantage (Grant, 1991:130). The time-frame of an organisation’s strategic planning process will be dependent on the ability of its resources and capabilities to support a sustainable competitive advantage. Grant (1991:131) mentioned that organisations with a strategy based on differentiation need to be concerned not with sustaining the existing advantages, but

with creating the flexibility and responsiveness that permit them to create new advantages at a faster rate than the old advantages are being eroded by competition. This is extremely relevant for Organisation X, when considering that the organisation's strategy is heavily based on its global and African integration, which is rooted in its implementation of the latest technology and could be easily imitated by its competitors.

5.3.5 EXTENDING AND UPGRADING THE ORGANISATION'S POOL OF RESOURCES AND CAPABILITIES

An organisation's strategy needs to consider not only the deployment of existing resources, but also the development of the organisation's resource base (Grant, 1991:131). Porter (1990) identified that in order to maintain international competitive success, an organisation has to demonstrate the ability to continually innovate and to shift the basis of competitive advantage from basic to more specialised factors, which would make them more difficult for rivals to replicate.

To the extent that an organisation's capabilities are acquired and perfected through repetition, capabilities develop automatically through the pursuit of a particular strategy. An organisation must always ensure that its strategy constantly pushes slightly beyond the limits of the organisation's capabilities at any point in time. This will result not only in the perfection of capabilities required by the current strategy, but also the development of the capabilities required to meet the challenges of the future (Grant, 1991:132).

Grant (1991:133) mentioned that to both exploit an organisation's existing pool of resources and to develop future competitive advantages, the external acquisition of complementary resources may be necessary. In this regard Organisation X might consider partnering with established assurance organisations within Africa to obtain access to their labour pools and local knowledge. Partnerships will be essential, especially with regards to the French, Arabic and Swahili speaking communities within the continent. Without partnerships the language barrier may make it nearly impossible for the South African staff to effectively communicate with the various groups of people should they be unable to communicate in English. Recruiting senior

African employees with the required skills and knowledge will enable Organisation X to further expand its resources.

As the poorly developed African infrastructure may not be able to respond to Organisation X's requirement for technology and integration, partnering with other service providers may prove to be very useful in this regard. Fortunately this is not a factor that cannot be overcome as the development in technology only boomed during the last few decades, while basic audit procedures can also be performed with minimal aid from technology. Investing into Africa appears to be a promising opportunity the organisation is presented with, and its efforts and investments into developing an African strategy may prove to be very fruitful in the years to come.

5.4 CONCLUSION

Based on the case for investment in Africa, it appears to be an attractive investment opportunity that should be looked into by all organisations, but due to the risks posed by the African environment the researcher recommends entering with caution. The Resource-based approach provided valuable insights into looking internally to see what an organisation is capable of achieving. It can be concluded that the success in developing a strategy lies in an organisation's ability to consider both its internal resources and capabilities and the external environmental forces which impacts the organisation's ability to compete. Therefore, it is suggested that the Resource-based approach should be used in combination with the Porter Five Forces and Generic Strategies models when deciding on and developing an investment strategy for Africa.

APPENDIX 1: SEMI-STRUCTURED INTERVIEW

The format of the semi-structured interviews is explained below.

The objectives of both the study and the interview were explained to the participant. The following questions were asked:

1. What is your current position held at Organisation X?
2. How long have you been working in your current position?
3. Please describe your role in Organisation X and the market sectors in which you operate?
4. How long have you been associated with Organisation X?
5. How long have you been working in the assurance industry?
6. What would you say are the main factors affecting profitability within the assurance industry today?
7. How does the industry compare with 10 years ago? What were the major transformations and how did it shape the industry? How do you perceive the industry 10 years from now?
8. Porter suggested that a Five Forces analysis should be conducted to analyse the competitive environment within an industry. To your knowledge, does Organisation X conduct a Porter Five Forces analysis when analysing its external environment.
9. What does Organisation X's analysis of its external environment entail?
10. Who would you say are the new entrants, suppliers, buyers, substitutes and rivals within the assurance industry today?
11. What would you say are the most important factor(s) within the following forces that affect Organisation X?
 - Threat of new entrants.
 - Bargaining power of suppliers (assurance providers).
 - Threat of substitute products.
 - Bargaining power of buyers (clients).
 - Rivalry amongst competitors.
12. How would you assess the strength of each of the Five Forces within the assurance industry? (Low, Medium or High)

13. How would you rate the Five Forces influencing Organisation X in order of importance?
14. How would you rate the Five Forces influencing your specific market sector in order of importance?
15. What could be a possible action by Organisation X to shape the high strength forces into the favour of the organisation?
16. What would you say are the biggest challenges currently faced in the assurance industry – both locally and globally?
17. What would you say are the biggest challenges Organisation X is currently facing with regard to the business environment – both external and internal?
18. What is the effect the government has via the implementation of the new Companies Act and the Competition Act (price fixing, rivals combine to share information), Auditing Profession Act and Sarbanes-Oxley Act on assurance as a whole, and on Organisation X?
19. How does the market view the Big Four compared to other assurance firms, and does this enable the Big Four to charge a premium for their services?
20. How would you rate Organisation X's ability to compete with other Big Four firms within South Africa?
21. What would you say are the factor(s) that give Organisation X a competitive advantage over the other Big Four firms?
22. How does Organisation X go about to ensure the benefits of this competitive advantage are maximised?
23. What would the biggest factor(s) or constraint(s) be that reduce Organisation X's ability to obtain a competitive advantage over the other Big Four firms in South Africa?
24. What is the influence that globalisation has on the South African audit branches of Organisation X?
25. What would you say are the advantages and disadvantages the global structure of Organisation X holds when infiltrating the South African market?
26. Please describe the current strategy implemented by Organisation X which it employs to obtain a competitive advantage over rival firms.
27. Porter identified 3 Generic Strategies by which an organisation can obtain a competitive advantage over its rivals. How would a strategy look like for each of these three in the assurance industry?

- Differentiation
- Cost Leadership
- Focus

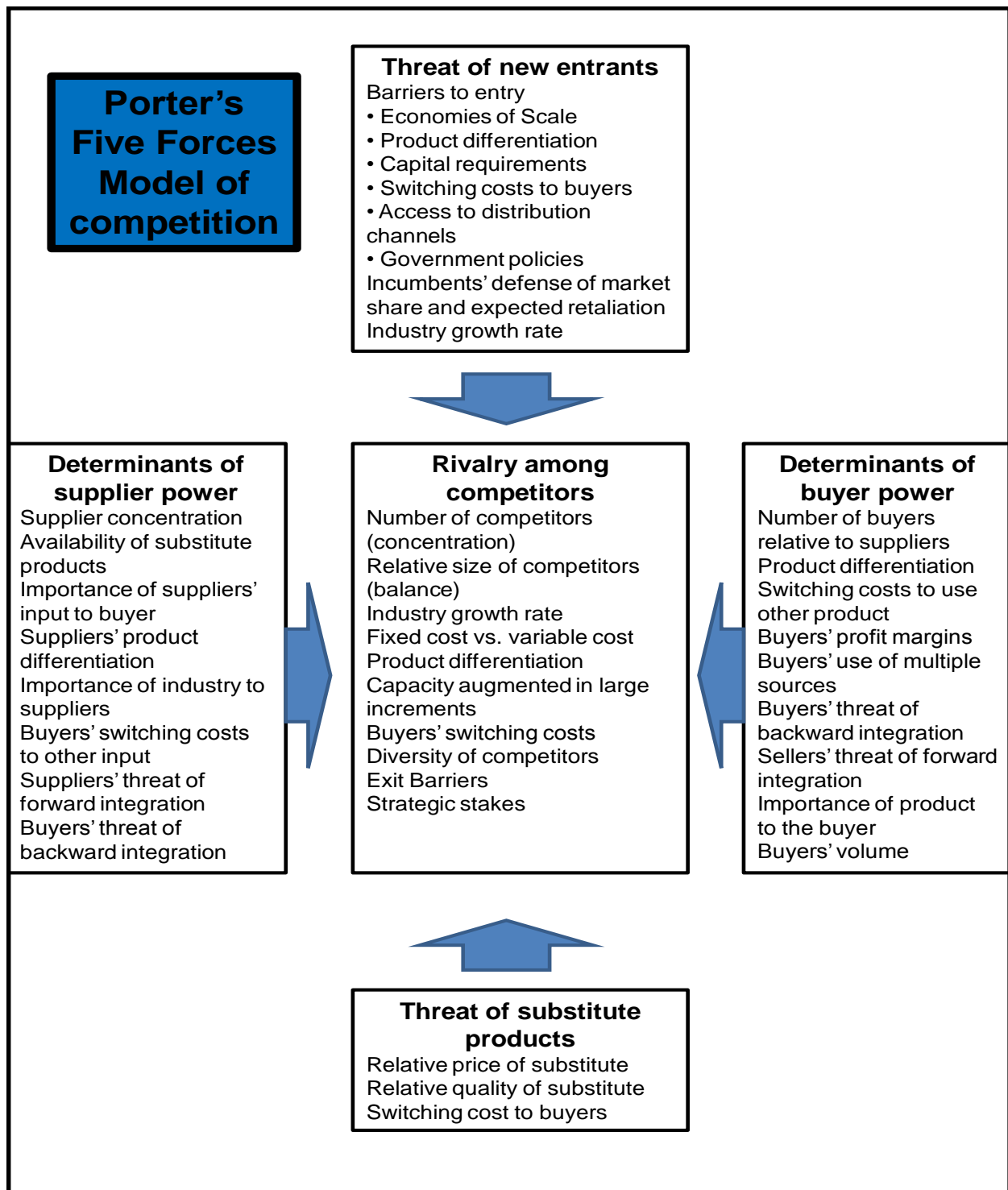
28. Which of the 3 Generic Strategies would you consider most appropriate for Organisation X to implement in order to obtain a competitive advantage over rivals?

29. How can the gap between the current strategy and the chosen Generic Strategy be bridged?

[Continued on next page...]

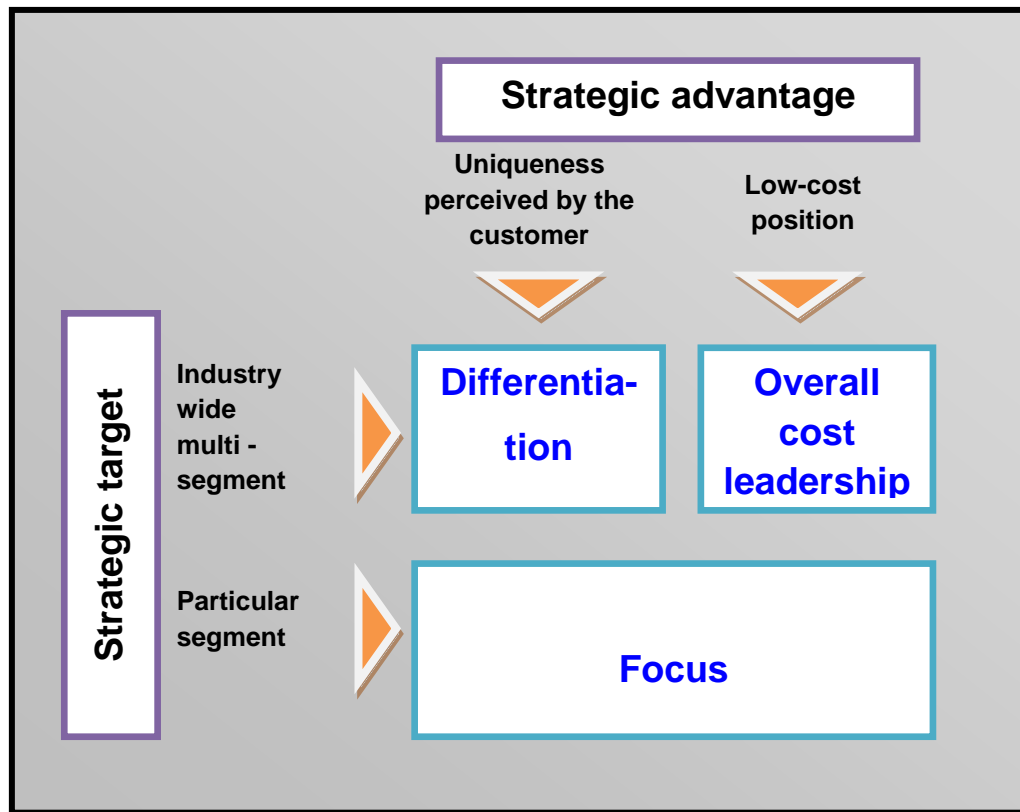
The following diagrams were used as a point of reference during the interviews to discuss Porter's Five Forces and the Generic Strategies with each participant:

Figure 10: Porter's Five Forces Model



(Source: Porter, 1985:6 *adapted*)

Figure 11: The Generic strategies



(Source: Porter, 1980:39)

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