

CRA Competition Memo



Accountancy Mergers Revisited

The disintegration of the Andersen global accountancy network presented the European Commission with a difficult problem. After its 1998 investigations into the Price Waterhouse/ Coopers & Lybrand merger (and the abortive KPMG/ Ernst & Young deal) it seemed that the Commission had accepted that a “Big Five” market could operate competitively, but drew the line at a “Big Four” outcome.¹ Given this, how should it approach the proposed mergers between Andersen and rival Big Five networks?

In both cases, the key market of interest was the provision of statutory audit and related services to large clients, for which the parties and Commission agreed only the Big Five global practices could compete effectively. In its latest rulings, the Commission has cleared a Big Four market structure in the UK, Germany and France. What caused the apparent change in the Commission’s attitude?² This Competition Memo explores this question with particular emphasis on the French market, as this is where the parties had the highest combined market shares.

Single firm dominance

The Commission’s investigation of the French market for statutory audit and audit-related services to large companies revealed a large range of possible market shares for the parties, depending on the information source and calculation method used. Many of these methods generated combined market shares above 40%, leading the Commission to pay serious attention to the issue of single firm dominance. However, the concern was finally resolved on the basis of a combination of factors:

- **Bidding market**

The market has the economic characteristics of a bidding market, with competition taking place through competitive tenders. The Commission found that all the Big Four would remain credible bidders post-merger, and were demonstrated to have competed actively against each other in the past.

- **Share shrinkage post merger**

According to the Commission, the merged entity will

inevitably lose clients, which will reduce its post merger market share relative to the parties’ combined pre-merger shares. These sources of loss include perceived conflicts of interest, Enron-related losses, and losses of work referred-in from the rest of the Andersen network.

- **Co-auditor competition**

Competition between the appointed co-auditors will continue even where one of these is a “second-tier” firm. The French system of co-auditors is discussed in more detail below.

The Commission’s acceptance of these points in its decision to reject single firm dominance, even in the face of relatively high market shares, shows a realistic approach to the measurement of market power. Rather than being bound by static measures of concentration, the Commission was willing to take into account the nature of competition in the market. Moreover its benchmark of assessment was the market structure that could be reasonably expected in practice in the absence of the proposed merger, as opposed to some unobtainable ideal. This required a detailed analysis of the regulatory environment, including the idiosyncratic nature of the French auditing system.

The French co-auditor system

An important feature of the French regulatory environment for audit and accountancy is the existence of the COCAC (*Co-Commissariat Au Compte*) system in France. Under this system all large and state-owned companies must appoint at least two co-auditors who jointly sign off on the company’s statutory accounts. Although there are various ways in which the work can be split between these co-auditors, usually it is divided roughly between services that could only be handled by a Big Five player (work requiring an international network, credibility on the international capital markets, and the flexible resource allocation available to a large firm), and services that could also be conducted by a national “second-tier” firm.

The Commission’s decision relied on this system in two respects. First, the Commission concluded that COCAC would lead to inevitable client loss. There were many instances of large clients who had previously used both Ernst & Young and Andersen as co-auditors. As a result of the merger, one of these mandates would have to be given up. The Commission accepted therefore that a simple

¹ See Lexecon’s *Competition Memo* “Lessons from the Accountancy Mergers” for a discussion of the competition issues arising from the 1997 cases.

² Lexecon Ltd advised Ernst & Young in its mergers with Andersen France and Andersen Germany.

addition of the parties' pre-merger market shares was not an appropriate basis for a competitive assessment of the merger, but rather that these unavoidable client losses should be taken into account.

Secondly the Commission accepted that there would continue to be some degree of competition between co-auditors. Although the Commission did not consider second-tier auditors to be in the same market as the remaining Big Four firms, it found that there is nonetheless some indirect competition stemming from these players' links with large customers through the COCAC system. The Commission accepted that strong links with two auditors might enable a client to respond to any attempted exercise of market power (e.g. a price increase by the merged parties) by threatening to transfer some audit-related work to the co-auditor (even where that co-auditor is a second-tier firm).

What about collective dominance?

Even when using the lower market shares generated by taking client losses into account, the post-merger market still appeared highly concentrated. Despite this the Commission found that there was "no causal link" between the merger and any possible situation of collective dominance. This was because the Commission took a pragmatic approach to its assessment of the most realistic non-merger benchmark scenario. This could be seen as a generalisation of the "failing firm" defence: the basic principle underlying both arguments is that in such cases pre-existing market shares are *not* an accurate reflection of what the market would look like in the absence of a merger. It is necessary to take into account the changing dynamics of the marketplace.

In this case, the Commission accepted the parties' arguments that a reduction in the number of players from five to four was inevitable due to the unravelling of Andersen's international network (without which it could not be expected to compete in the relevant market). This differed from a typical failing firm defence in that there was no claim that Andersen's assets (primarily its human capital) would exit the market absent the merger. On the other hand, just as in a failing firm scenario, it was accepted that the number of independent competitors would have inevitably decreased by one even without the merger.

The Commission compared the merger outcome with a range of alternative scenarios, including the merger of Andersen with each of the other Big Four firms, and a redistribution of Andersen's clients across all these firms (the outcome if Andersen were allowed to simply fragment). It found that the Ernst & Young merger did not create a situation more conducive to collective dominance than any of these alternative outcomes.

The *Airtours* test

The Andersen cases constituted one of the first major tests of the Commission's approach to collective dominance following its defeat in the *Airtours* appeal at the Court of First Instance. Although the cases have some unusual features (not least the "falling firm" issues mentioned above), the approach taken by the Commission was consistent with the test for collective dominance set out by the CFI. The Commission's decision followed this test by identifying the conditions necessary for a finding of collective dominance as transparency (the ability to monitor a tacit agreement), sustainability (sufficient incentives not to "cheat" because of a credible punishment mechanism) and inability of firms outside the collectively dominant group to undermine price rises.

The collective dominance assessment was undertaken on the basis of a comparison between the likely post-merger market structure and alternative scenarios which might occur in the absence of a merger. Crucially, none of the conditions necessary for a finding of collective dominance was enhanced by the merger *relative to the no-merger comparator scenarios*. For example, any increased transparency caused by the exit of Andersen would occur whether the merger happened or not. This is encouraging as it makes explicit the need to assess how industry characteristics might enhance firms' ability to coordinate. This requirement was a key theme in the CFI's *Airtours* judgment.

Conclusion

The recent accounting merger decisions have several interesting implications for future cases. First, the Commission accepted that a simple addition of the parties' pre-merger market shares is inadequate as a measure of post-merger market power. In particular, it accepts that adjustments to take into account post-merger losses of share are appropriate where such losses can be predicted with reasonable certainty. This has applications in other industries where merger-related losses of business can be predicted (e.g. where dual sourcing is common). Second, the Commission accepted that it must demonstrate a *chain of causation* from the merger to any competition problem. This requires a careful assessment of the "but for" world: of what would have happened in the absence of the merger under a range of alternative scenarios. Finally, the cases provide some early hope that the Commission is prepared to embrace the framework for collective dominance set out by the CFI in its *Airtours* judgment. These are all welcome developments in EC merger control.

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