CAD - 02189

cc Sir Adrian.

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Sir Adrian Cadbury
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Dear Adrian,

FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

Thank you very much for sending me a copy of your draft Report.

I enclose a paper which argues for a firm line on clarifying the role of the audit and the responsibilities of auditors. This is based on a presentation I gave recently to the senior management in Europe of one of the 'Big 6'. It includes some background drawn from NERA's study for the European Commission.

I hope that this paper is useful to you. It does not conflict with the proposals in your draft Report, but in some ways would go further.

Yours ever,

Dermot

DRG/pbc

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COMPETITION IN EUROPEAN ACCOUNTING, AUDIT INDEPENDENCE AND REGULATION

Presentation by Dermot Glynn, Managing Director, National Economic Research Associates (NERA) June 1992.

A. Introduction

It is now just over two years since NERA started its research into competition in the EC market for audit and consultancy services. The study lasted for a year and the main report has just been published by the Lafferty Group.[1]

The study was commissioned by DG IV, the European Commission's Directorate for Competition Policy, as part of its ongoing research programme into competition within major sectors of the EC Economy. The objective was therefore to apply competition analysis techniques, well known to us, to determine how the forces of competition worked within the sector. NERA is very familiar with competition policy work in the context of both EC Articles 85 and 86 and merger regulation and US anti-trust.

This was a study however, rather than an investigation, which gave us a "free hand", to focus principally on how competition actually works in this market and give a fully independent assessment.

Rather than simply summarising our work, I would like to proceed as follows:

- first, I shall comment on the background to the study and outline the main findings;
- second, I should like to focus on the issue of auditor independence, and comment on some of the different regulatory rules we found in the various member states in this area; and
- finally, I shall conclude with some personal thoughts on how I see this debate on independence regulation progressing, and on how the leading accountancy firms might seek to influence developments in this area.

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1 "Competition in European Accounting: a study of the EC audit and consultancy sectors". NERA report published by Lafferty Publications, May 1992.

B. The NERA Study

1. Background to the Study

The study was of interest to no fewer than 3 separate directorates within the Commission:

(i) DG IV was interested in the effectiveness of competition between the accounting firms, particularly in the light of accounting firm mergers and the worries about restrictions on cross-border trade imposed by the network agreements;

(ii) DG III was interested in the progress made towards the completion of the single European market in audit and consultancy services; and

(iii) DG XV was interested in what the study might reveal about links between audit and consultancy work within the accounting firms, and the implications for regulation of auditor independence.

Our client was DG IV, so our principal focus was on the competition aspects. In many respects, however, the most interesting public policy agenda arises in the area of DG XV's interests, and this is where my talk will turn after a brief description of our findings.

2. Main Findings

We did not find anything of great significance to concern the competition authorities in our review of accounting firm competition. Our main findings, none of which will have come as a great shock to leaders of the accountancy firms, were as follows:

[SLIDE 1]

a. A Separate Market Exists for Big Company Audits

In France, for example,[2] the 40 largest accounting firms were responsible for just 25% of the market. Yet, if one takes auditing of the largest 100 French companies, the Big 6 alone appear to have over 80% of that market. In the UK, the Big 6 have 20% of the audit market as a whole, but audit nearly all the top 100 companies.

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2 Data published by the *Centre de Research et de Documentation Ath*.

This at least raises the spectre of competition problems and limited choice. There are substantial differences between the Big 6 firms and their nearest competitors, and (in most member states) no realistic prospect of these differences being overcome. Nevertheless, the existence of 6 major suppliers in a market (as I need scarcely remind you) is not a bad starting point for healthy competition.

The main conclusion we would draw from this (though DG IV may not share our view here) is that further mergers between Big 6 firms will be looked at closely for their effects on competition in this separate market for large company audits. Other accounting firm combinations are unlikely to raise any concerns.

We also found some suggestions (volunteered by those we interviewed) of the Big 6 firms exchanging fee rate information, possibly as a basis for some sort of informal price collusion. We pursued this by looking at standard fee rates, but found considerable dispersion between the Big 6 members in each member state, and hence no evidence of successful collusion (see Figure 1 for dispersion of chargeout rates for newly qualified accountants).

[SLIDE 2]

Even the remotest suggestion of such collusion could, however, land the accounting firms in very deep water with the Commission. Given the Commission's substantial powers, my advice is that you should be careful in what is said at inter-firm meetings.

b. There is no Single Market in Accounting Firm Services

This conclusion, greeted with some publicity and comment in the press coverage of the study, should come as no surprise. Separate national markets are ensured by a combination of professional qualification differences, regulatory factors and the accounting firm network agreements. The differences are amply illustrated by inter-state fee rate differences (see Figures 2 and 3).

[SLIDES 3 AND 4]

This conclusion should only surprise those who have taken the 1992 propaganda at face value. There is hardly a single business not affected by the trend to internationalisation, but many markets (particularly in the service sector) will never converge to a single EC-

wide market. This conclusion simply reflects the localised nature of supply and not any failure of the Commission or the firms concerned to take the necessary Single Market measures.

c. Network Agreements are not Anti-Competitive

This is another feature of our study which attracted much comment, not all of it accurate.

Network agreements clearly prevent (or a least discourage) inter-state trade between network members. There are two ways of looking at this.

The first is to note that, once regulatory and other trade barriers are removed, the network agreements will be the only force preventing inter-state trade, and as such will be seen to be anti-competitive. The second is to argue that these regulatory and professional factors are the only factors currently preventing the development of the unified multinational accounting firm, offering the global service which clients require. If accounting firms were allowed to become truly multinational, many would no doubt jump at the chance and the question of network agreement restrictions disappears altogether.

The former view makes for more interesting headlines, but the latter interpretation seemed to us to be nearer the mark. During the course of our study, DG IV itself cleared the BDO network agreement's restrictions under Article 85 in recognition of the need for accounting firms to offer an international service to international clients.

NERA's conclusions did not find complete favour with all interested parties in the Commission. Given the variety of interests, this is understandable. We were nevertheless grateful that the Commission gave permission for us to publish the study as a NERA document.

C. Auditor Independence

Although competition rather than auditor independence was the main focus of our study, we were able to make many interesting observations and comparisons in this area.

1. <u>The Different Approaches to Independence Regulation</u>

Among the rules operating in the EC to protect auditor independence are the following:

- bans on the provision of consultancy by audit firms or audit clients: these are most prevalent in France and Italy;

- compulsory periodic re-tendering of the audit contract with limits on extensions: most notably in Italy, but also applying in Spain;

- limits on auditors' dependence on any single clients: some such rules are present in almost all member states;

- limits on audit firms' market shares: notably in Portugal; and

- minimum and maximum remuneration levels: most notably in Italy, though other restraints on audit firm competition exist in Germany and elsewhere. (I note that the ethics body of the ICEAW has recently produced a paper recommending limits on "predatory" price competition for audit work).

Most of these measures are based on a view that carrying out audit and consultancy for the same client creates conflicts of interest which might compromise auditor independence.

2. Effects and Effectiveness of the Restrictions

We were able to collect some information on the extent to which the major accounting firms are indeed dependent on audit clients for their consultancy income, and this comparison shows some interesting inter-state comparisons (see Figure 4).

[SLIDE 5]

Despite the professional restrictions seeking to separate audit from other services, Figure 4 reveals substantial links in most member states. Dependence on audit clients is highest in Belgium, Ireland, Luxembourg and the UK. Even in France and Italy, where such links might appear to have been successfully contained, there is considerable doubt in practice as to the true picture. In several cases we suspect that the true nature of audit-consultancy links was suppressed in some of the questionnaire returns from these countries.

The business areas most closely linked to the audit tended to be accounting advice, tax compliance and information technology consulting related to the design of accounting systems.

The overall impression is that attempts to limit audit-consultancy links are rather ineffective. Many other regulatory interventions (including minimum fee rates in Italy and maximum permissible market shares in Portugal) seem also to have been largely ineffective.

Compulsory audit rotation stands out as being a radical approach to regulation which cannot be evaded, and which has caused considerable disruption in the Italian market. It stands to do the same in Spain when the period for rotation expires. I note with interest that the Cadbury Committee's draft report favours compulsory rotation of audit partners in the UK. If this principle were to be established, it might be a small step to audit firm rotation.

3. Principal-Agent Problem

I am increasingly convinced, however, that none of these regulatory rules or approaches to the independence problem adequately meets the objective.

Rules which can be circumvented through inter-locking partnerships or non-observance are at best a waste of time, and at worst a waste or resources. Efforts expended in avoiding regulations are a classic instance of "deadweight loss", to use the economists' term.

Rules which do work still leave the audit partner with a substantial conflict problem. The audit of a public company is typically a large contract in its own right, and the audit partner's remuneration is bound to be tied to success in retaining that important client. As long as this is so, the auditor is caught in the middle of a conflict of interest between the outside shareholders (the principal) and the management of the company (the agent).

The only exception to this is where the auditor is completely disinterested in the audit, as was the case until recently in Greece, where a government-appointed auditor was sent in to perform the statutory audit. It is not at all clear that this provided any assurance of audit standards, and I understand that this arrangement has recently been abandoned.

4. The Solution

The real problem lies where the interests of the managers and owners of a company diverge. Since the audit is performed for the benefit of the outsiders, but the auditor is for practical purposes paid and appointed by the insiders, there is a clear financial temptation for the auditor to fail in its duties towards outside shareholders.

To find a solution to this problem, it is necessary to go back to basics. Since the audit is performed for the benefit of the outside shareholder, how can the audit contract be defined so that the duties of the auditor to the consumer of the product are made clearer?

5. The Airline Analogy

Let me develop this point through an analogy between auditors and commercial airlines.

As airline customers, we want competitive prices. We also want, and are prepared to pay for, high safety standards.

When aeroplanes crash, the fault may lie with the airline (if it has failed to carry out maintenance checks), with the airport (if it has neglected baggage security checks), with the aircraft maker (if it has been negligent in construction) or with outside forces (such as a random terrorist attack).

As consumers, we know it is important for these responsibilities to be clearly defined, and to be understood by those concerned. This is not so much because we need to know who to sue if there is a crash (this may provide very poor comfort) but rather because, once clear duties are defined, each party knows its responsibility and must, acting on self-interest, ensure that these duties are discharged.

The airline's responsibilities are clearly defined in its operating licence, and its maintenance standards are periodically inspected. When aircraft crashes occur, the liability of the airline is assessed against these obligations. No one seriously suggests that airlines should not carry out their own maintenance because of a conflict of interest. As long as the rules (and the penalties for breaking them) are clear, the incentive to take short cuts on aircraft maintenance is removed.

In auditing, "crashes" occur infrequently, but when they do claims against the auditor often evaporate in the expectations gap. If every aircraft crash resulted in an unresolved squabble between the airline, the airport and the aircraft manufacturer regarding responsibility, would you feel happy about travelling by air? I may have laboured my airline analogy, but this is precisely the perception created by recent audit scandals.

D. A Way Ahead

There is clearly pressure for public policy intervention in Europe to improve auditor independence. Let me illustrate this by reading to you from a recent (15 May) 'Financial Times' leader, which is quite representative of influential opinion.

> "... it is important to remember that audit failures in the 1980s were not solely to do with the uninformative nature of the auditor's report. There is a weak link in the chain of accountability, in that the auditor's fees, though formally sanctioned by the shareholders, are for all practical purposes in the gift of the management on whose stewardship the auditor is supposed to pass an independent opinion. The quality of audit judgments has also declined as the big accounting firms have come to regard the audit function - privately, if not in public - as a loss leader for lucrative consultancy services. To make matters worse, the judgment in the recent Caparo case limited the auditor's liability for negligence to present shareholders, leaving third parties wholly unprotected.
>
> A tighter framework of accountability is needed. And it may not be enough simply to call for disclosure of consultancy fees from audit clients, as the Cadbury committee is shortly expected to do. The auditor must be seen to be free from such conflicts of interest. Whether that can be achieved without restructuring the accountancy profession is a moot point. But such an upheaval may, in the end, be unavoidable. In the meantime, a statutory clarification and extension of the auditor's responsibility to all stakeholders in the business is badly needed."

If these pressures result in draconian restraints on audit and consultancy links, or compulsory rotation in the Italian model, they represent a real threat to the accounting firms, imposing possibly large disruption costs and distortions on the way your business is organised.

What is more, they do not in my view really address the principal/agent problem.

The question which the leading firms should be addressing is how might moves to heavy-handed regulation be replaced by a more rational solution?

The answer I would venture lies in a combination of the following:

- independent inspection of audit standards (this is already here, and must be made to work effectively);

- demands by consumers (the outside shareholders, perhaps assisted by non-executive directors) for the safeguards they want and are prepared to pay for; and

- moves by the suppliers (the auditors) to anticipate consumer demands and to justify their fees and services they provide.

By way of conclusion, I would add two observations on this.

First, none of these three measures stands to work unless the obligations of the auditor are clarified. Competition cannot possibly work whilst there is such uncertainty as to what the auditor's signature means. In this connection, persistence with the "true and fair" claim is the worst possible strategy for the accounting firms, since this vacuous phrase minimises transparency whilst exaggerating the value of the audit.

Second, it seems to me that the best audit firms are failing to exploit their own competitive advantage if they do not act to encourage the emergence of an effective "consumer movement" in the audit market. Not only is this the best way to prevent heavy-handed (and ineffectual) regulation being imposed on the auditor. It also represents an opportunity for good audit firms to differentiate themselves from competitors with inferior standards.

Imagine a situation where airline safety standards lost public support due to laxity or ineffective monitoring. This would have two effects. First, it would bring airlines generally into disrepute, discouraging air travel. Second, it would mean that high class airlines would be undercut in the market by "cowboy" operators acting within the letter of these inadequate standards. The quality airlines *could* respond by cutting standards and costs themselves, but this would be commercial madness.

What better way for the best airlines to compete with the cowboys than to set out their superior safety standards, backed by appropriate guarantee, and opening their operations up to public scrutiny? In airline safety, as in audit standards, there is every reason to suppose that consumers will willingly pay for a demonstrably higher quality product.

The way ahead on audit regulation must surely be for the best of the 'big 6' accountancy firms to take the initiative on the expectations gap problem, and thereby to encourage the development of an effective consumer movement in audit standards.

D R Glynn/D Ridyard
N/E/R/A
June 1992

MAIN FINDINGS

- Separate Market for Big Company Audits
- No Single European Market
- Network Agreements are not Anti-Competitive

Figure 1: Charge-out rate dispersion

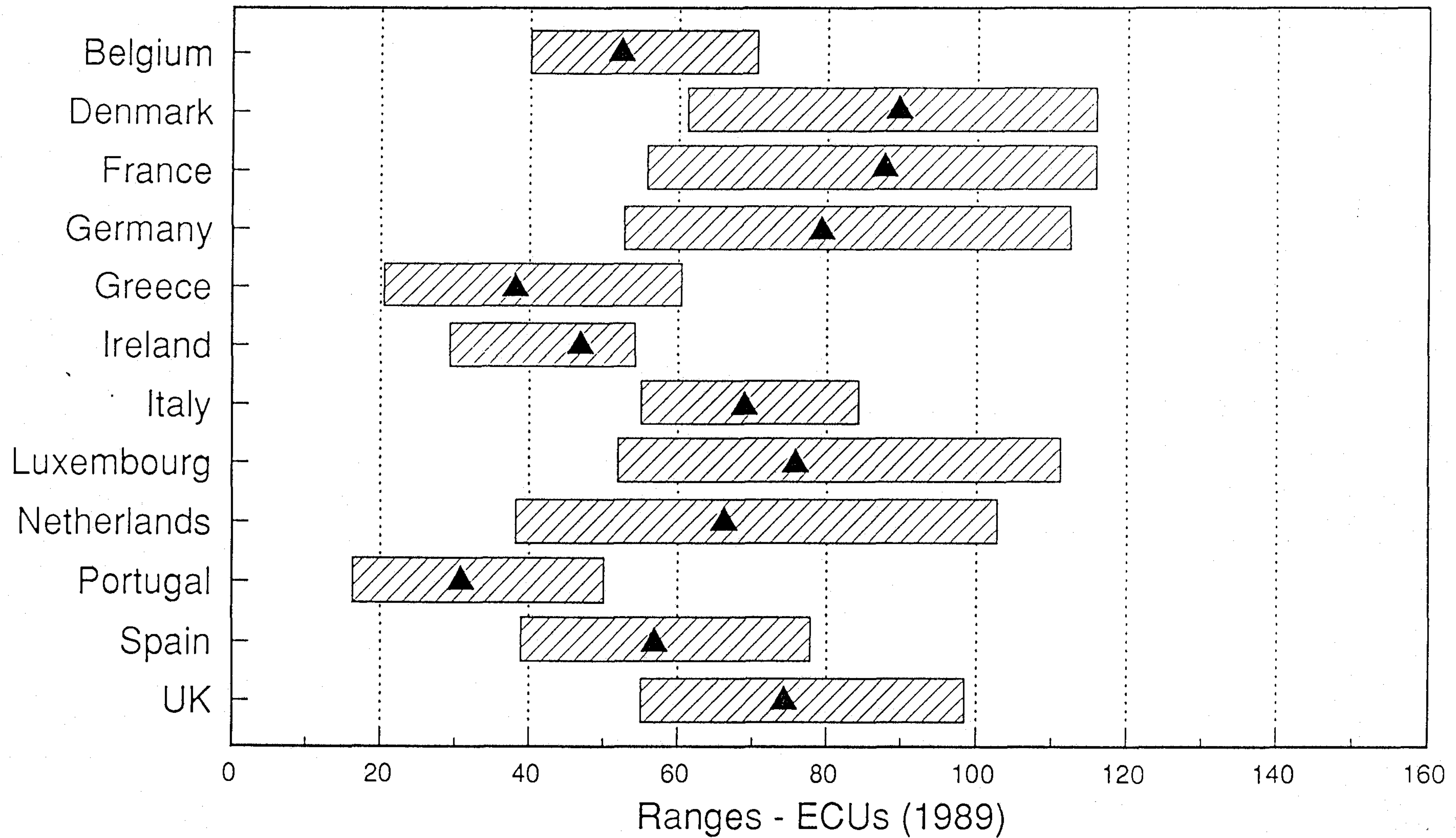

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Figure 2: Average charge-out rates for newly qualified staff

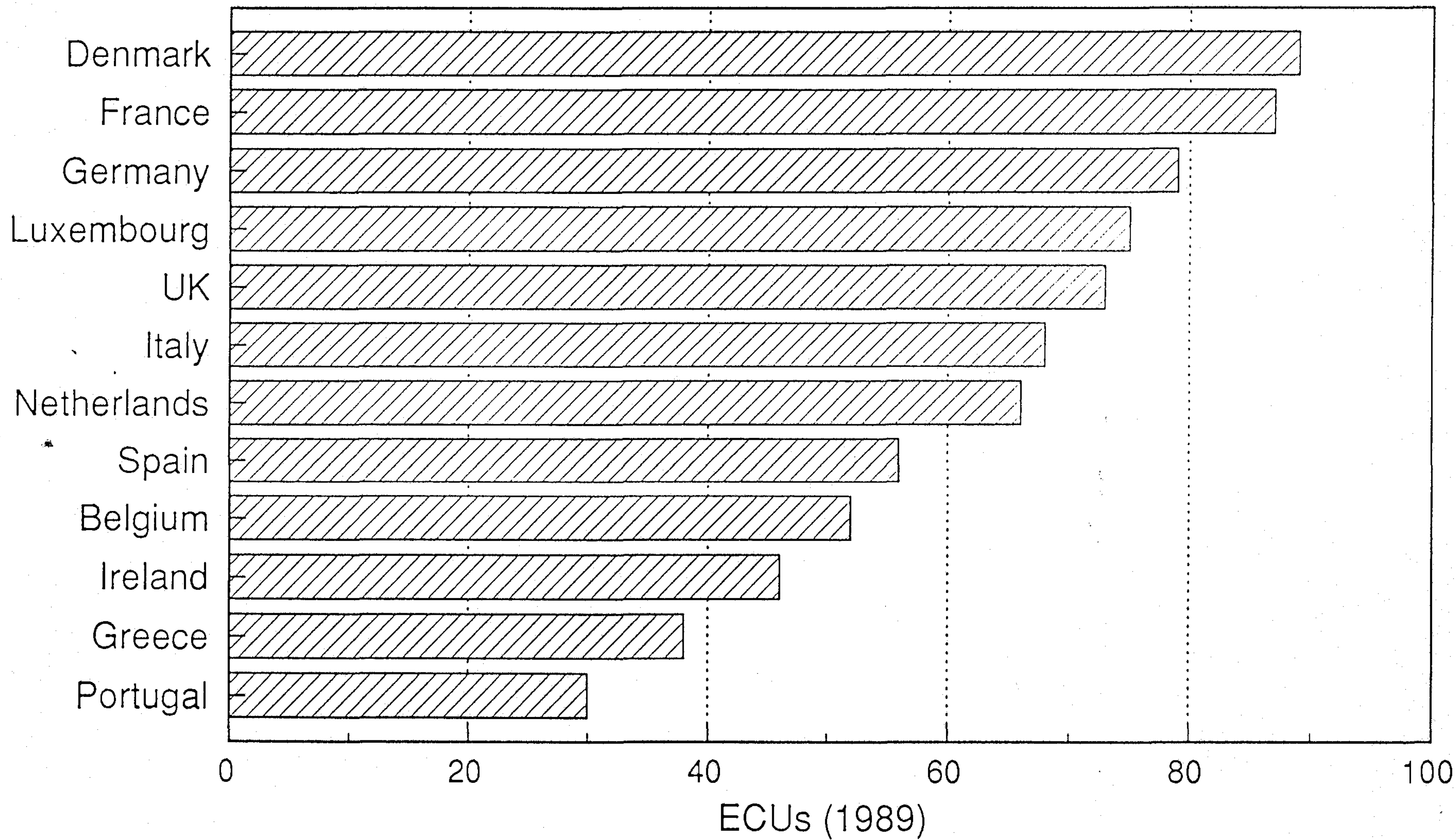

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Figure 3: Average charge-out rates for partners

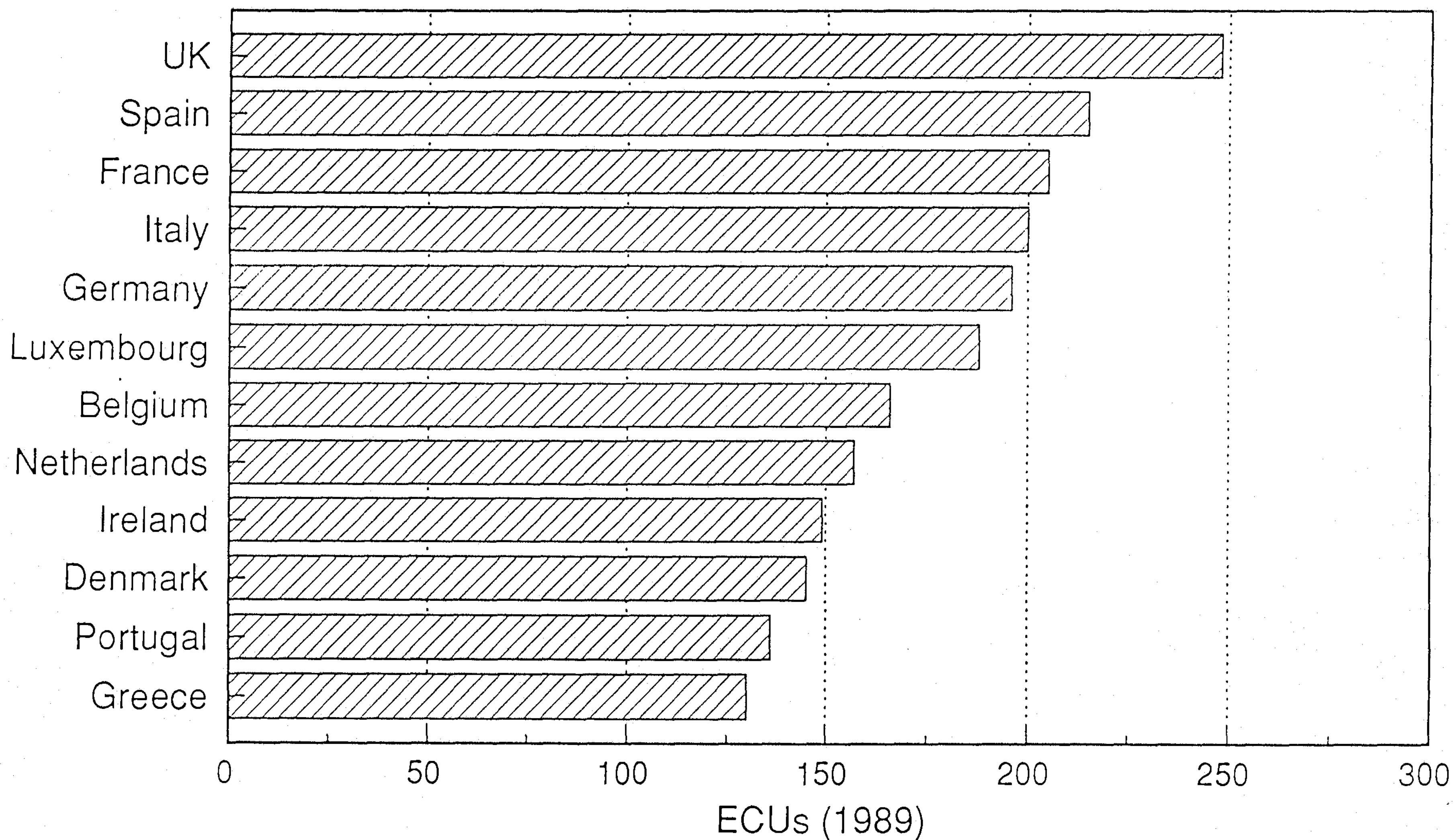

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Figure 4: Dependence on Audit Clients for Non-Audit Income