Something New on the Audit Front

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Accountants are making headlines again, as the financial crisis spurs controversies about fair value and marking to market. But another, largely unnoticed recent event may have a more structural impact.

On 21 April, Ernst & Young, one of the 'Big Four' global networks which dominate the market for large-scale corporate audits, announced the merger of its European operations and the creation of an integrated firm covering the Europe-Middle East-India-Africa region. Another integrated firm will cover Asia, except Japan.
This is little short of revolutionary.

The Big Four are a paradoxical reality. They present themselves to clients, staff and the public as global organisations, closely integrated under a strong brand. But this façade hides opaqueness and fragmentation.

One of them claims loftily that 'transparency underpins our commitment to quality and integrity', but as the three others, it only discloses scanty information.

Each network is a collection of national firms which cooperate through one or several global entities, respectively incorporated in Switzerland in the case of Deloitte and KPMG and in the UK in the case of PricewaterhouseCoopers (PwC) and Ernst & Young. But publicly available information does not describe the precise role of these network hubs.

Deloitte points out that neither its Swiss *Verein* 'nor any of its member firms has any liability for each other's acts or omissions'. By contrast, PwC states that 'each PwC firm is fully accountable and responsible to the entire PwC network of firms for the quality of its performance', even though it fails to specify how this accountability is exercised.

In one case, several global entities co-exist, some registered in the Cayman Islands. For each network, there is a 'global leadership team' with a functional and representational role, but no clear managerial authority over national firms.

On the financial side, at global level there is no public information whatsoever on anything except revenues. The global profitability of the Big Four, or the shape of their combined balance sheets, are closely guarded secrets.

At national level, in the UK they publish detailed financial reports. In France each legal entity files individual accounts, which are accessible to the public. But elsewhere, including the US, there is no disclosure at all below the revenue line. This is technically warranted by the firms' legal form of partnership, but disturbing given the Big Four's role as a key pillar of public trust in financial markets.

Accountants claim that the fragmentation stems from the risk of legal liability for malpractice that the auditors may have overlooked or, worse, knowingly tolerated. The fall of Andersen in 2002, following the Enron scandal, has shattered the profession.

An 'independent' national firm can be dropped if it blunders, without dragging the rest of the network down. Exactly that happened last year to PwC's Japanese arm.

But the concern to isolate national damage also implies that the Big Four have serious misgivings about their own ability, past and present, to enforce a high level of audit quality throughout their networks.

The lack of transparency is also unhelpful in key current policy discussions, especially about auditor liability and the concentration of the audit sector among four global players.

These debates are thwarted by the fact that policymakers have no idea of the Big Four's profitability, liabilities, or insurance costs. The issue of market concentration is a competition problem (a recent UK study finds that, all things equal, it tends to drive prices up) but also a potential obstacle to audit quality. The Big Four are aware that public policymakers do not want one of them to disappear, and this implicit 'too-few-to-fail' insurance may negatively affect professional discipline over time.

There is no magic bullet to solve this problem, even if one considers radical change, such as the UK Financial Reporting Council's proposal to deregulate audit firms' ownership. But better information about global risks and profits would shed much useful light.

Other efforts have been made. PwC has created 'eurofirms' which group some functions for continental Europe; KPMG last year merged its German, Swiss and UK firms; Mazars, fifth biggest in France, has published global consolidated accounts since 2006. A European directive which enters into force this year will provide some more transparency.

But the Ernst & Young initiative is a bigger step. By creating a single firm for the whole of Europe and grouping its Asian operations, it is paving the way for a radical reduction in geographical fragmentation. Beyond the obvious potential for synergies and enhanced quality control, this holds the potential of greater public accountability of the large regional groups thus created.

In contrast to 2002, the current financial crisis has hit the ratings agencies hard but has so far largely spared auditors – perhaps because audit quality has improved since the Enron shock. But it is probably just a lull.

KPMG has come under criticism for the collapse of New Century, a California-based mortgage lender, and investors have sued Deloitte as auditor of Bear Stearns' infamous hedge funds.

Public authorities may once again have to tighten the screws of regulation. But it would be better if this were only a last resort. Reform will be more effective if it comes from the profession itself.

In this respect, it is to be hoped that Ernst & Young is successful in carrying forward its transformation, but not only that. It should be the prelude to improved financial and organisational transparency on the part of all Big Four audit networks, in Europe, Asia and, let us hope in the near future, at global level as well.

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