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When Auditors get Audited

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There is a paradox with big audit networks, which assure the accounts of listed groups but do not reveal much about their own finances, except on a purely national basis in some countries. Admittedly, these networks are partnerships and therefore are not accountable to any external financial stakeholders. But, at the same time, this striking example of how “cobblers have the worst shoes” is a telltale of deeper questions about the audit market.

It was therefore not an insignificant step when Mazars, one of the leading independent European audit networks behind the global “big four” (Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers), last month published an annual report which included full consolidated accounts under IFRS. Mazars’ scope of consolidation includes firms in most European countries, which, in the absence of equity ownership (which is not allowed by law for audit firms in many countries), have strong enough legal and financial links with the Belgium-based “parent” entity to justify consolidation (this, at least, is what is claimed by Mazars and its two Auditors BDO and Howarth; some accounting experts do not share this interpretation of IFRS rules on consolidation). Thus, Mazars published global revenue of €479 million for the last financial year and an accounting “surplus” of €105 million, which was shared among the network’s ca. 320 partners. Mazars thus enables its clients, trading partners and public supervisors to know more about its balance sheet, the profitability of its different business lines (even though the business segment information is still minimal), and, in the future, their development over time. These disclosures are a useful step at a time when, after Enron, Parmalat, AIG and other similarly unfortunate cases, many market participants are interested in taking a closer look at audit networks and assessing their independence vis-à-vis their clients.

Why is it that the “big four” do not (yet) publish comparable financial statements? Many years ago, global audit firms published “combined accounts” for their worldwide activities. They also emphasised their identity as integrated organisations and their related economies of scale, investment capability, and uniform enforcement of a high level of audit quality. The reason why they stopped publishing worldwide accounts, and claiming the integrated model, is first and foremost because of an increase in legal risk. In the United States especially, punishment of misbehaviour has become very dissuasive. An indictment of a local office, as in 2002 when only the Houston office of Arthur Andersen was involved with Enron’s financial wizardry, can lead to the collapse of an entire network, and related damages can be sky-high. The publication of worldwide accounts would therefore highlight legal risks in the United States, which would create problems of its own. Conversely,

promoting the autonomy of each national entity of the networks is a way of confining these risks. Mazars, by contrast, has 95% of its activity in Europe and limited direct exposure to the United States. Therefore, it is less constrained in publishing worldwide financial statements and in emphasizing its integrated organization.

The legal liability of the “big four” is a headache for financial regulators, whose nightmare would be the disappearance of another one of them, all the more so because four is already considered an insufficient number by many market observers. If one of the big four were to collapse, the huge existing barriers hindering the emergence of new entrants would probably result in it not being replaced – as in the case of Andersen four years ago. When KPMG was recently found to have advised on dubious tax-shelter schemes, the US authorities did not press charges, to avoid endangering the entire network. Audit firms advocate a cap on their liability, but that would raise difficult questions of fairness vis-à-vis other market participants. In the short term, the only available device is ruthless self-discipline within the audit firms to maintain audit quality and punish misbehaviour, but despite the constant efforts of the big four, there can be no absolute guarantee that malpractice is never going to happen.

Mazars’ initiative, for all its shortcomings, raises crucial questions. What degree of financial transparency should the largest audit networks provide on their own operations? Are they integrated organisations, or loose alliances of national entities? What is their liability in the event of misbehaviour? Does the present structure of the audit market ensure the indispensable quality of audits? These questions, however unappealing to the layman, are crucial to maintain the public’s trust in financial reporting.

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