Can firms cope with the pressure?

Fee pressure is an ongoing concern for firms during this global economic downturn. As the pressure from clients intensifies, the ***International Accounting Bulletin*** asks a panel of experts whether lower audit fees are affecting audit quality and how sustainable current fee levels are

Heavy fee pressure is an issue that had a material impact upon the profitability of firms surveyed in this year's *International Accounting Bulletin* (*IAB*) world survey.

The service line that suffered most from fee pressure was audit, which experienced cuts of 40 percent and above at some firms, according to global accounting leaders.

Last month, a panel of experts at the *IAB*'s network definition debate in London discussed the viability of audit fee cuts in the current climate. To begin the debate, experts were asked whether fee pressure is having an impact upon audit quality.

Paul Ginman: "There is too much regulation for firms to cut quality"

Paul Ginman, COO and technical director, Baker Tilly International: The question is how long fee pressure will continue.

If it continues longer term the threat to audit quality exists. However, I don't think any firm in any jurisdiction can afford to continue cutting prices and in the process jeopardise its business by lowering its standards on quality. There is simply too much regulation these days for firms to be able to cut quality. But clearly firms are prepared to take on audits for a lower return than they were previously.

Now, whether that is eating into profit margin I don't know, but you only need to see that firms are taking a 40 percent reduction in audit fees to see it is an issue. But like I said, in any leading market, whether it is the UK or the US, I don't think anyone is taking short cuts on quality; I don't think they can afford to as this is too short-term a view.

Arvind Hickman, editor, *IAB*: How long can these fee cuts be sustained?

Paul Ginman: It depends how deep their pockets are and what other types of work they are picking up to replace the lost income.

If you have staff that are not working at capacity and you are prepared to invest in them for the long-term for when the economy picks up, then it is worth going out and doing an audit for a marginal return – but that has to be a short-term strategy. I expect we will begin to see an increase in fee levels in 2011.

Nigel Hodges, executive director, Nexia International: I think we are seeing something which has not happened here for 20 years. The Big Four used to have consultancy arms that used to attack the audit market.

For the mid-tier firms it was very difficult as [the Big Four] were offering giveaway prices for audit in return for consultancy. That had stopped, except for Deloitte, when they all got rid of their consultancy practices, so it was a different marketplace. But now they are back in that market there is a huge pressure coming from the major four down into the mid-tier market. What they are doing is buying up turnover.

Arvind Hickman: David, you are more hands on in these issues – what are your thoughts?

David Isherwood, director of audit and advisory, BDO UK: There is certainly fee pressure, but like Paul said, the professionals doing this operate in regulated markets and therefore it does not follow that this will affect audit quality. With regard to non-audit services, the Financial Reporting Council and the Treasury Select Committee brought this up before Christmas and told the Audit Practices Board to look at it. You have to separate perceptions from evidence. I have not seen any evidence of non-audit fees affecting audit quality – there are some stakeholders that have the perception that this is the case, but it is just a small proportion of them who are saying this.

Arvind Hickman: David, from what you are seeing, are you concerned by the level of fees and how it will affect audit quality in the long-term, or is this just a short-term correction?

David Isherwood: Everyone is looking at their costs, aren't they? The economy has had a terrible time over the last 18 months. We are quite happy with our financial performance and we have seen in your survey that the sector has actually weathered it quite well compared to other sectors out there.

Should [fee pressure of this magnitude] continue, then the business model will have to be looked at, but if there is this cautious recovery that everyone is talking about then in the long-term, as the competitive market returns, audit fees will come back to a profitable level. ■

ANALYSIS

Accounting network leadership balance to shift East?

Asian firms will provide greater leadership and influence within global networks and associations as organisations invest heavily in fast-growing Asian economies, according accounting network leaders.

Asia-Pacific was widely reported as the fastest-growing region for most networks and associations surveyed in this year's *International Accounting Bulletin* world survey.

Economic expansion has fuelled strong demand across the region and this has led to significant investment in recent years from the Big Four and mid-tier, in particularly in China and India.

For example, Ernst & Young (E&Y) reported more than 40 percent growth in China and in the past four years, has pumped $100 million into emerging economies, many of which are in the Asia-Pacific region.

This publication has been tracking the mid-tier's highly-publicised push into China by partnering with large domestic firms, such as BDO International's affiliation with Shu Lun Pan.

The Big Four, Grant Thornton, RSM International, Crowe Horwath International and Kreston International have all developed their Chinese representation in the past two years and most of these organisations are also expanding rapidly in India and South East Asia.

Although network and association leaders realise the importance of investment in the Far East, this is not always reflected within governance boards and leadership teams at all global accountancy organisations, which are traditionally dominated by Europeans and Americans.

Jean Stephens, RSM International

At PricewaterhouseCoopers, 17 percent of the network's global board is based in Asia, Grant Thornton International's board of governors has 20 percent Asia-Pacific representation and KPMG has 21 percent. E&Y has area managing partners for its three Asia-Pacific regions but no global managing partners within the region.

It is important to consider that although Asia-Pacific is a hot region of activity and investment, relatively it still produces far less revenue than Europe and the US and in most countries is less developed in technical expertise.

RSM International chief executive Jean Stephens believes strong representation in the Asia-Pacific is now critical for networks and this will eventually be reflected in global leadership teams.

"Like the US, if you are not strong in the Asia-Pacific region right now it's a challenge in terms of international clients – there's a lot of activity there," she said.

"We have a board that's representative of our membership so as the members grow it has to be reflected on the governance as that is how a network model works. We can't dictate to firms what they do. They need to be represented well in governance and that is important from a building perspective."

Kreston International executive director Jon Lisby agreed that the balance of boards will shift East.

Baker Tilly International chief operating officer Paul Ginman said that although leadership influence may be increasing in the East, the profession is still developing.

"They are still in the learning phase and require input on the implementation of international audit and accounting standards. They are absorbing this information rapidly and building a profession around it," he said. ■

INSIGHT

Financial crisis causing firms to consolidate

The economic downturn has led to consolidation among accounting firms, according to network and association leaders.

Baker Tilly International chief operating officer Paul Ginman told a round table discussion in London last month that consolidation presented accounting networks with a new set of challenges on how to balance geographical membership.

"We are witnessing increased levels of consolidation in the profession. Individual firms are assessing their own situation and, depending on their position, selling or acquiring," he said.

"Networks have to consider the implications of that on their membership – ultimately they could end up with stronger or weaker coverage.

"Consolidation is an opportunity for firms and I suspect most accounting firms in the Western world are talking to someone else."

James Mendelssohn, the chief executive of multi-disciplinary association MSI global Alliance, added: "I think running a network or association you are always aware of the firms that are good – you know, it is the nature of the beast.

"The current climate is forcing people to think more carefully and look at things more closely than in good times."

UHY International executive director James Vrac paints a different picture.

Vrac says UHY International member firms are less interested in mergers and acquisitions and more looking at leveraging network resources and working together to gain an advantage across service lines.

"We are not seeing firms talking about mergers and acquisitions so much, as they are talking about expanding service lines as a strategy for dealing with precarious financial conditions," he said.

In Asia, however, this is less so. Vrac said: "I think that in some parts of Asia the regulatory environment is a little less onerous than in developed economies, so they perhaps have more flexibility and entrepreneurial spirit to start engaging with firms they want to affiliate with or network with locally as a form of protection." ■

To be or not to be?

Globalisation and the threat of vicarious liability are driving some accountancy groups to reconsider their international structural model. Experts from networks and associations debate the pros and cons of their structural strategies, the legal implications and what the future may hold

Over the past few years, global mid-tier accountancy groups have been monitoring the debate over whether to position their organisations as closely integrated networks or much looser associations of independent firms.

The implications of both models are significant. Networks are perceived to offer a more seamless and consistent cross-border audit service but run a higher risk of vicarious liability – the spread of liability to a third party, often a global administration body that is deemed to have control or the ability to control the violator's actions.

Associations offer firms in different countries independence and lower vicarious liability risk but can be viewed as providing a less consistent service, which is important when pitching for some multinational companies.

Although most associations and networks have a clear definition strategy, there are some that are either fence sitting or have different models in different jurisdictions.

As the incidence of vicarious liability suits increases, the *International Accounting Bulletin* held a round table debate on the network definition issue with a panel of experts from networks and associations in London on 28 January 2010.

The aim of the discussion was to bust some of the myths that surround the debate, as well as get a better understanding of both models and their implications.

The discussion begins with a short synopsis on the network definition issue by Institute of Chartered Accountants of England and Wales (ICAEW) head of integrity and market Tony Bromell. The ICAEW recently produced a report for the Federation of European Accountants (Fédération des Experts Comptables Européens – FEE) on the definition of networks in an EU context.

Synopsis by Tony Bromell: I am here to mention some work we did with FEE, which is

NETWORK DEFINITION ROUND TABLE

Attendees, in alphabetical order

- **Tony Bromell**, Institute of Chartered Accountants in England and Wales head of integrity and markets, technical strategy department
- **Carolyn Canham**, *The Accountant*, editor
- **Paul Ginman**, Baker Tilly International COO and technical director
- **Arvind Hickman**, *International Accounting Bulletin*, editor
- **Nigel Hodges**, former Nexia International, executive director *(Nigel's personal views do not represent those of Nexia International)*
- **Jane Howard**, Reynolds Porter Chamberlain, partner
- **David Isherwood**, BDO UK, director of audit advisory
- **Nick Jeffrey**, Grant Thornton International, a director within global public policy team
- **Jon Lisby**, Kreston International, executive director
- **Angela Lynch**, PKF International, senior manager
- **James Mendelssohn**, MSI Global Alliance, chief executive
- **Nicholas Moody**, *International Accounting Bulletin*, senior reporter
- **Jean Stephens**, RSM International, chief executive
- **James Vrac**, UHY International, executive director

the European Federation of Accountants. They published something two years ago called *Transnational Organisations and Practices within the Accountancy Profession* – Euro-speak for networks and associations.

The rationale behind it was that the European Commission is talking about a single market but we don't have very many single market European audit firms, so we looked at how firms were made up. The clear message was that it was very fragmented, largely driven by legal and cultural differences, such as different liability and tax regimes.

The most common structure appeared to be a network actually comprising a series of smaller individual national firms with a separate firm co-ordinating the whole. There were a small number of genuine pan-European firms but that has expanded with the Big Four in the last couple of years. There were an even smaller number of traditional business type international firms with a main partnership, having subsidiaries working in different places. So why is there no greater movement? It is all down to the legal and cultural differences.

The EU market wants gradual harmonisation but it will be a very long time before we have identical or near identical legal regimes. One reasonably positive aspect was an update on network firm definitions. Some years ago, the International Federation of Accountants (IFAC) ethics standards board agreed to adopt an identical network definition to that of the EU Commission. This is now in the EU's Eighth Directive, so people are starting from the position where the two main drivers have the same definition.

Looking across countries, they were not identical but they were gradually moving in that direction. If you look at, for example, the UK Audit Practice Board's definition, it doesn't use quite the same wording. Effectively, though, it means the same thing. The only real guidance on all this is a few paragraphs on in the IFAC Code itself, about two pages worth that says this is meant to be a principles-based definition, with all the rights and wrongs that brings.

What it comes down to is if you operate as one entity or nearly as one, or appear to operate as one, then you should be treated as a network. If you can exert significant influence, which is less than control but more than a recommendation, then you are a network. It is what the Americans call the duck test – if it quacks like a duck, walks like a duck and looks like a duck, it is a duck, regardless of its precise legal form. Clearly, that does require judgement and it causes some issues. Some of the very large firms are networks, no questions asked. Some of the looser cross-referral associations are clearly just that: associations. However, there are a number in the middle which could go either way.

There are consequences in terms of potential liability, I don't think any claims have succeeded yet in making one part of a network liable for another part with a separate legal identity. However, lawyers will keep trying. Other relevant issues include independence rules, transparency requirements on disclosure and audit registration transparency. So, it does matter.

Jon Lisby, Kreston International, executive director: The bigger point, which is a slight challenge, is that it is not actually Kreston that decides if it is a network or an association, it is the regulator who decides.

So even though we have a single definition globally, if you take Europe, there are 25 to 27 regulators and the regulator in Germany will form different views from those in France and the UK. So, while James says 'I am an association', he will find the French regulator will refer to him as a network. He will treat your member as a network.

James Mendelssohn, MSI Global Alliance, chief executive: We have had issues with a small number of European regulators saying to our member firms, 'you are not an association'.

Jon Lisby: And most regulators, because they are regulators and want to regulate something, will do what they can to argue that you are not an association but a network so they can regulate it.

The second issue in your opening remarks, you mention that 'I am interested in networks, therefore, I am interested in litigation' – as if networks equals risk of litigation.

I would argue that almost the same degree of risk is attracted to an association that carries a directory and does everything apart from say it is a network. The risks can be applied to associations as equally as they can to networks.

Nigel Hodges, Nexia International, executive director: Our legal advisers say the same thing about China, America, Germany and England. We have had leading lawyers in every one of those countries say that there is no more litigation danger [between a network and association].

Jon Lisby: The US attorney will not be put off by the fact that you have said 'we are an association'.

James Mendelssohn: There is also the perception of member firms and clients of member firms that there is a risk.

Question to Jon Lisby: Kreston International recently made the decision to move towards a network model. What are the main drivers for this decisions?

Round the table (left to right): Tony Bromell of the ICAEW, RSM's Jean Stephens, IAB's *Arvind Hickman and Jane Howard of RPC*

Jon Lisby: Our key driver, which we have been debating over the past three or four years, is how can we compete more successfully in the marketplace of the branded mid-tier group?

On regular occasions we are up against BDO, Grant Thornton and RSM. We found that we do not have the credentials that apply to network firms in terms of globally co-ordinated quality reviews and greater use of shared branding, which means you are less likely to win. We are driven by commercial desire.

David Isherwood, BDO UK, director of audit advisory: I think professional firms really designed those structures to fit the client's needs. If your clients demand the same audit methodology, quality control procedures, the same training throughout the world then you effectively fall into making a network firm structure.

If you are not careful you can talk about the tail wagging the dog here. You don't decide to become a network and then find your clients. What you do is design a business fit for your purpose. Our clients want consistently high quality products all the time throughout the world and the way to do that is as a network firm.

Now the risks and the liabilities need to be managed, but where we manage those is not deciding if we are a network or association, it is by doing high quality work all the time and at the end of the day that is the best way to protect yourself against any claims.

Jon Lisby: Reading [BDO International chief executive Jeremy Newman's] tablets of stone, BDO are trying to challenge the Big Four and groups like Kreston want to challenge the BDOs and Grant Thorntons. For us, our reason for moving to network status is commercially that point.

The marketplace assumes that to handle international work you should have those processes in place that apply to networks. It is unlikely an association would be able to handle international work in exactly the same manner.

Question from Arvind Hickman, *International Accounting Bulletin*, editor: Is this a perception or is this reality?

Jon Lisby: Now we have made the step, it is a reality.

Nigel Hodges: But does the client care? I do not think they do. They do not know what it is, they are not interested. But it may be sold by the media and others and I think as you were saying if one was up against another then it could be a marketing message but I do not think it is. If the client likes you, if you talk sense, they will come to you.

Getting his point across: Jon Lisby, executive director of Kreston International

Jon Lisby: I would agree with that if it is a managed international business. If you are talking about presenting to an audit committee, the chances of an association like Kreston competing against BDO is quite slim at audit committee level.

James Mendelssohn: I think that is the critical point, you talk about international and there is a huge range of client situations at international level. For truly global multinationals, it has to be a network with international standards. There are also lots of good young smaller entrepreneurial businesses who want to do a bilateral deal in another country, which is a totally different kettle of fish, and that is very important.

If you are a good entrepreneur in the UK, with a good business and you want to do something overseas for the first time, you will buy by relationship. In this case, I think it is easier to buy from the association route because within a smaller, more personal organisation of firms who know each other, it is easier to sell a relationship than in a network for firms. It is just horses for courses.

Jean Stephens: It's the client who dictates ultimately.

Paul Ginman, Baker Tilly International, COO and technical director: If I put myself in the shoes of an audit partner, if I'm introducing my client to someone overseas, I want them to be looked after to the same quality and standard as I provide them with.

That is key to the relationship, whether you are part of a network or an association – the badging is irrelevant. Ensuring the same quality of service is easier if you have within your organisational structures that tick boxes on what the quality of that service will be. That may be a quality assurance process, international audit methodologies, or international training programmes and so on.

Question to Jane Howard, Reynolds Porter Chamberlain, partner: You provide legal advice to networks on vicarious liability. What trends have you noticed in the past year in terms of vicarious liability and its threat to global organisations?

Jane Howard: The trend in the current economic climate is that there has been an increase in the number of claims involving both international umbrella organisations and other member firms within the same network as the firm whose work has been called into question. Plaintiffs are trying to reach through the umbrella organisations with a view to accessing professional indemnity pots held by other member firms, whether or not they are actually involved with the work in issue.

Claims are an inevitable fact of professional life. Have we seen as much as we would expect? Well, I think that in line with

expectations about increases in domestic litigation there probably hasn't been a tsunami of claims. That said, the number of claims involving international networks has been much greater in the past two or three years. Prior to that there was Parmalat of course, which went on for a number of years and has only recently settled. As someone who speaks on this topic on a regular basis, my client list has expanded fairly rapidly in the last year or so.

We have picked up a lot of advisory work in the wake of cases such as Banco Espirito Santo vs BDO (where it was suggested that the constitutional documentation put in place at network level could provide evidence of control). The Securities Acts are being well used in the US but have come under greater scrutiny. There is much debate over whether culpable participation (or the potential to control) must be shown as the basis for liability under those statutes.

A few years ago, we felt reasonably comfortable that evidence of actual control was needed. However, that and other cases threw that into doubt and everyone was driven to look more closely at their member firms' agreements and the language used in them.

The plaintiff lawyers, inventive as they are, appeared to have worked through that documentation in the BDO case picking out certain phrases as evidence of an alleged control relationship. It became a forensic language exercise.

It was a big relief all round when the jury took less than an hour at the full trial to decide that BDO International was not responsible for the work done by its US member firm.

Sub-prime and the exposure of massive fraud led to further litigation involving international networks. It is interesting to see that in the New Century vs KPMG case, the argument was that since the international body had represented that it would carry out quality control, the fact that a loss had been suffered must have meant there had been a failure to supervise the member in question. In essence, it was said that the umbrella organisation had promised to police the member firms and, as something had gone wrong they failed to deliver on that promise. This was a relatively new and novel way of putting the case against the global organisation.

Question from Arvind Hickman: What are the lessons to learn from these major lawsuits?

Jane Howard: That they are hard to extract oneself from at the pre-trial stage. This means that, even where they lack merit (as they so often do), they can be expensive to defend and reputationally damaging along the way.

Ultimately, no-one has succeeded in finding that the umbrella organisation (or another member firm not involved in the work in question) has been responsible for the work of the primary auditor. It is therefore rather depressing that the courts have shown themselves reluctant to throw these cases out at an early stage.

As the Parmalat case showed, one is often involved in these cases for the long-haul. That said, it was good news for networks to see Grant Thornton and Deloitte extract themselves in a relatively painless way from that litigation.

Nigel Hodges: Probably cheaper than having a lawyer for next five years.

Jane Howard: It was probably in their irrecoverable costs that they were going to pay their American attorneys to take it to trial. No one wants to pay out, but what they did pay out was very small compared to what they might have done.

Question from Arvind Hickman: Is that a bad message to send out to the profession – that you are better off to settle rather than run the reputational risks?

Jane Howard: That is always a difficult judgment call that applies in all litigation. If you get a good settlement, that is good evidence you have done a good job on persuading the other side that they were not going to win otherwise why would the plaintiffs accepted modest terms from a solvent defendant?

It is always difficult when you have plaintiffs that are individuals (or represent individuals), such as pension funds, where there is inevitably some political pressure at play. Few judges like to leave plaintiffs without a remedy. One will so often see Judgments carefully crafted to come to a 'just' result irrespective of the law.

That said, Judge Lewis Kaplan, who has heard a lot of these cases before the New York Court, has always woven into his Judgment some quite disparaging comments about the way the plaintiffs' lawyers have put their cases forward.

Nigel Hodges: Jane, You were talking about the tsunami of litigation and we talk about that in term of economic cycles – so will there be a litigation lag?

This is the year that companies might really struggle, if they managed to survive the first cold winter, great, but the second cold winter might get them. Do you see litigation coming?

Jane Howard: Yes, as you say there is often a litigation lag. It is slower in coming than during the previous recession. Many organisations may well feel they have better things to spend money on than litigation. Where we have seen an upturn is in the area of liti-

Speaking (left to right): MSI's James Mendelssohn, TA's *Carolyn Canham, Nigel Hodges of Nexia and Baker Tilly's Paul Ginman*

gation arising from failed transactions. Also, recessions tend to uncover fraud, which is often at the heart of the very largest claims.

I dare say we can expect to see a few more claims of this sort coming through against networks and associations.

Whilst that litigation is primarily directed against the primary fraudsters, auditors are not too far down the hierarchy of potential 'deep pocket' defendants.

There are probably a number of cases where perhaps the auditors are sitting in the wings knowing that if there is a short fall in what can be recovered from those more obviously responsible for what has happened, they may be called upon.

Quite often, as time passes, we are approached by lawyers acting for the Claimant requesting that our clients enter into 'stand still' agreements, effectively stopping time running out for a claim against the auditors pending the outcome of the primary case being known. Given the scale of some of this litigation, this is perhaps inevitable. Auditors are often accused of failing to spot "red flags" that ought to have alerted them to the problems at an early stage.

Plenty to say: Nick Jeffrey of Grant Thornton International

Question from Nicholas Moody, *International Accounting Bulletin*, senior reporter: You are talking about an increase in litigation; can you quantify that in any way?

Jane Howard: The headline grabbing cases, whilst on the increase, are still not that numerous. Quite a few have arisen out of Sub-prime, Madoff and related scandals, but no more than 15 or 20 such claims in the last couple of years have come onto our radar. No doubt there are others that don't hit the headlines as they are not as sexy/ high value.

Question from Carolyn Canham, *The Accountant*, editor : Do you think the results of BDO case would make plaintiffs less likely to chase the international administration body? Do you think that put them off?

Jane Howard: Plaintiff lawyers are rarely put off but it will send a firm message to them that it is no longer sufficient to say 'you were on the scene' or 'you happened to be a member of the same network and, therefore, you must be vicariously liable for them'.

Hopefully, plaintiffs will be made to work much harder in the future to produce evidence of actual control if these cases are to be allowed to continue.

The depressing thing is (as the Parmalat litigation showed) that it is hard to convince a Judge to let you out of the action at an early stage unless there is absolutely no evidence of any control or involvement with the audit in question.

If there is to be a case where a number of organisations are found liable for the actions of another member firm, one would like to think that it would be in circumstances where they went way beyond normal quality control and actually directed or influenced the work in question.

Quality control, after all, is simply the organisation's way of seeking to deliver to the client what had been offered to it at the outset of the relationship – getting what it says on the can.

Question to James Mendelssohn: You have previously been outspoken on the legal threat to networks due to vicarious liability, but in the past year the major lawsuits against networks – Parmalat against Grant Thornton/Deloitte and Banco Espirito Santo against BDO – have gone in favour of the networks. Have these rulings changed your views on the perceived legal threat?

James Mendelssohn: Obviously, going back some time, the distinction between an association and a network is that the one benefit of an association is that it is less cohesive and has less liability, and clearly those two decisions have eroded that distinction, which we welcome.

I think there are plaintiff lawyers who will join anything that moves and you are still arguably less likely to be joined as an association as it is more removed. The reputational damage [due to litigation] is there if it is successful or not.

Everyone knows about Parmalat, who was involved and it was long before it settled, therefore, the damage had been done. What is also quite interesting is the number of firms I talk to who are applying for membership who raise this as a key issue.

So whether that is a misapprehension, the firms say they apply to you because you are an association. We are independent, we do not want to get linked in with dodgy firms in emerging economies, and for us that is important.

What Jane is saying is that maybe that distinction is not quite as marked in reality as it is in perception but it is certainly still in the minds of firms, particularly in the US where they are very litigation aware.

Jane Howard: James' point was well made, in that given the ambiguity of different regulators it is hard to clearly define.

James Mendelssohn: Well, we are very clear that as an association, in the IFAC definition, it says if you are a group that includes lawyers then the lawyers are part of the network. Then, when you are trying to refer work between lawyers and accountants it underlines your whole rational, so we are clear and we tell members what they can and can not do, and 98 percent of the time this works very well.

You then get an email from a country where a regulator has said to a member firm that you are a network and yet we are fairly

clear that we stick to all the rules and definitions laid down by IFAC, so it is tempting to say it is not our problem. But what we have actually got to do is to create the environment for our members to operate as an association firm.

Although those two cases help the cause, there is still a nervousness among certain firms. Reputational damage is huge and it is all very well to say you won the case seven years to eight years later, but already a huge amount of damage has been done.

Tony Bromell: Reputational damage goes with the name of the structure, of course, and a lot of networks do require a partially common name whereas an association will not use them.

Jane Howard: Don't you come under pressure from some members who say 'well don't you think it would be a good idea commercially to share a name'?

James Mendelssohn: Absolutely. There are many people who like to be part of a larger firm in an association rather than a small firm in a network. I suspect from a commercial point of view, what most associations are trying to do is to push as far as they can in terms of promotion and marketing, but still allow you to be an association.

Of course there is pressure to do more and more but you have to be careful not to overstep the mark. Our problem is that we do not know where the mark is because different regulators in different countries say totally different things even within the European Union.

Jane Howard: I have had associations come to me and say 'what can we do to not be a network, what do we have to tick'? It is very hard to give them that assurance.

James Mendelssohn: I will not say it is not our problem, but we are not going to be hit by the regulators. Nobody regulates associations; the people who get hit are firms by their local regulator.

Question from Carolyn Canham: What are the implications for individual firms when, for example, the regulator in Germany says you are a network firm?

James Mendelssohn: It is a matter for the firm or firms in Germany to demonstrate they are not a network. They either have to stop doing whatever they are doing that the local regulator deems as evidence of network status or comply with requirements of a network firm.

Paul Ginman: Each country will be policed by the European Commission on its implementation of the Eighth Directive, but if you go outside of the EU any country can have its own network definition.
The IFAC Code is only a recommendation, it doesn't have any power. Therefore, you will always come up against the situation where someone will believe that because you have a website and a directory you are a network.

James Mendelssohn: It is such a grey area. Every case is different and it is dangerous to put too much weight into an individual case because they are all so different. Really, if it came to it, the case goes to court and someone will decide.

You can not say the Parmalat settlement is good or bad for us because there are so many discrete factors that in a short newspaper article do not get reported on.

Jean Stephens: Well, the next case will be different anyway..

Jane Howard: Kaplan described it as like the Bayeux Tapestry – do not judge it by looking at a single thread.

Question to Angela Lynch, PKF International, senior manager: How has the BDO decision impacted on the structure and operations of your network?

Angela Lynch: I think to some extent we breathed a short sigh of relief, but I am not sure it is a long-term relief. We know that litigation will probably come back, they will find different ways, and it might only be short-term good news.

I am not sure it has had much of an impact on the structure of our network.

We put effort into our language of our writing but that was probably as a result of the preliminary findings not as a result of the final findings. So there has not been a lot of action.

Nick Jeffrey, Grant Thornton International, director of global public policy team: We all still want to do international work, none of us are preparing to walk away.

It is very inconvenient bordering on threatening to the livelihood of our partners and member firms but it is not stopping us at the moment, it might change if a major firm goes down through one claim, which is not a remote possibility.

Arvind Hickman: Is that possible?

Jane Howard: It is theoretically possible.

Nick Jeffrey: One claim could sink a firm, you are then talking about clients walking away, it damages your reputation, the partners see what is going on and it reflects negatively.

Jane Howard: Look at Enron, it was not a judgement that sank [Arthur Andersen], it was the clients.

Finding time for a smile: Jon Lisby, Carolyn Canham and Angela Lynch

Taking part (left to right): David Isherwood of BDO, IAB's *Nicholas Moody, UHY International's James Vrac and Angela Lynch of PKF*

Arvind Hickman: So the reputational damage that would come from a major lawsuit is what is going to really destroy a firm.

Question from Nicholas Moody: There was a recent judgement in Hong Kong, which was a long running case for Ernst & Young, what are your views on that?

James Mendelssohn: Not big enough. It was £400 million ($630.6 million), where did I find that?

Nicholas Moody: The figures were never disclosed.

Nick Jeffrey: It wasn't a number in the public domain, but that is a number that seems unlikely at first glance that the local firm could finance on its own.

Coming back to James' point about regulators, regulators are national and I agree with that entirely, but there are increasingly international organisations of regulators both on the securities side and audit side that are co-operating and they want to know what is happening at an international level – the quality control procedures, how the accounting organisations are safeguarding quality and consistent service throughout the network.

Even the UK regulator is not just interested in the UK, they want to know about international procedures and about what is happening elsewhere.

Jean Stephens: It is the same in the US, the same questions.

Paul Ginman: The regulators are asking the member firms 'you are part of a network, explain what that means and how the quality of other network members' work is controlled so you can place reliance on the audit'.

Question to David Isherwood: A few Big Four firms have moved towards cross-border integration, such as KPMG in Europe and E&Y. Do you believe other Big Four and mid-tier networks will move to this model?

David Isherwood: There has been some movement in the way they organise themselves but there is no consistency in the way they have done this.

I think to some extent it comes back to similar arguments as made in the distinction of networks and associations. We all set ourselves up in ways to best deliver quality products to our clients all the time.

If you look at the difference between associations and networks, a lot of international corporations demand common practices, common quality control and so on throughout the world to service their needs and that drives a lot of firms to become networks.

To a certain extent, I think this is an extension of that demand – the corporate world is becoming more international and it is important to them to have people servicing their needs who control their organisations in a similar way as themselves.

To become a network firm you have to agree to common objectives with your fellow network firms but you don't have control.

Now, without a doubt our international clients are going to demand we work more closely with our international firms to produce more consistency.

How we do that will evolve and the Big Four have moved and devised different structures of their own, so there is not a single clear model.

The important question is not how I want to be legally structured, but are we are going to have to work more closely in the future?

The answer is 'yes', but how we get there isn't clear. It might depend on how laws and liabilities develop in Europe and worldwide but it is not clear, so I don't think there is currently a model of choice. But I do think we'll continue to work a lot more closely with our member firms.

Jane Howard: It is double-edged on the liability front. It could be used against you if you are seen to be more co-operative.

It seems to me that the future is about trying to close the gap between what the client is being promised and what you are able to deliver, and quality control is the key to that.

David Isherwood: Cut through it all, with closer co-operation, if something goes wrong it affects you in a bigger way throughout your member firms.

But actually with closer co-operation and more control, you should have less chance of getting it wrong in the first instance.

Jean Stephens: Closer co-operation – so you are dealing with bigger clients so your risk is bigger.

David Isherwood: Absolutely. Commercially that is the choice we take. It is a risk-reward choice.

Question from Carolyn Canham: We heard some suggestion recently that the middle ground would go away, that you would have one group in a loose association, others would be closely integrated global entities. Do you see this happening?

Nicholas Moody: It was Patrick De Cambourg, the Mazars president, who predicted that.

David Isherwood: Mazars is a different structure in itself.

Jean Stephens: Over what time period? Five years, 50 years?

David Isherwood: It is hard, I don't have a crystal ball, they obviously see an advantage in structuring themselves in the way that they do but we currently don't see it like that for BDO. Restructuring is not a means to an end in itself.

Jean Stephens: The clients do not care, they just care about the service. But where I do think it makes a difference is when you are in a tender and you are spending half of that process explaining why you have the different business card look.

You are spending time assuring them you can still do it, but ultimately you are wasting time and you lose a competitive edge. Over time you build a relationship and that goes away but it is there at the start.

David Isherwood: If your structure is stopping you delivering your product to the client, then you would change it. If you can see profit coming from changes then equally that might drive you to change your structure.

Jane Howard: The ones that disappear are the ones that have not been able to agree in which direction they want to go.

James Mendelssohn: That is good news for clients, isn't it? What this is doing is making firms, networks and associations have to carefully think about what market position they want. As a profession, if we get it right we can educate clients to make sure they get the right product and service.

We have lost a couple of member firms who have gone into networks because of their size, client profile or location and they need to be in a network. We have gained more firms who have come out of a network because they value independence and do not have enough international work to justify [the cost of] being in a network.

Jane Howard: One of the upsides from all the litigation is there is greater clarity about what these organisations are. I think Parmalat is a good example of firms getting that message out into the press.

Question from Arvind Hickman: In terms of clarity, there is a lot of discussion about the grey areas of the definition: what would you like there to be – a global definition?

James Mendelssohn: It is the local interpretation of the definition that for us is the problem, and that is sometimes driven by political ends rather than anything else.

Debating: Nexia International executive director Nigel Hodges

Arvind Hickman: What is the solution?

Paul Ginman: There are two different issues. Would we like a single set of clear global standards? Yes, it would make it easier in the way we operate as we could reflect the global standards in everything we do.

But does the fact that there are differences drive the way we structure ourselves? No, because as we have discussed, the way you operate is driven by what your membership requires of you.

The fact that there are grey areas in the definition means some have called themselves associations which can lead to disagreements with regulators in a specific location.

Likewise, those who say they are part of a network can get caught out if they fail to comply with the implications of this.

However, once you have positioned yourself, the fact that grey areas exist is a headache but it's accepted that there will always be grey areas whatever the rules. It doesn't matter to us now, we have chosen our camp.

Conclusion by Arvind Hickman: While the network definition may be clear at an international level, its interpretation varies from jurisdiction to jurisdiction.

This is not necessarily a major concern, but more something that firms have to live with and adapt to.

Perhaps the bigger threat is the cost of auditor's liability and reputational damage that could spread across a network of firms as opposed to an association of independent firms.

How an increase in litigation and the threat of vicarious liability pan out in the future is unclear, but so far it seems the networks have received favourable rulings in high profile vicarious liability cases such as Parmalat and Banco Espirito Santo.

This may provide some comfort, but it is important to note that every case is different and plaintiff lawyers are always testing new boundaries of the relationship, such as the potential for network administration bodies to control the actions of member firms.

Litigation is here to stay and network and association leaders will continue to follow developments in US courtrooms with great interest and a hint of anxiety.

Consequently, risk management and quality control procedures will continue to be increasingly important aspects of running accountancy organisations for years to come.

Whether a firm chooses to belong to a network or association is very much driven by client demand. Both models have their pros and cons and it is a case of horses for courses.

An interesting aside to this debate is whether networks will move to the full integration of firms into a single global entity.

A variety of models continues to provide choice in the market, which can only be a good thing for firms, networks, associations and clients alike. ■