

Audit firms' global ambitions come home to roost

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In the Parmalat fraud case, a judge serves notice that audit firms can't boast of global reach while claiming no connection to local units.

In a lawsuit over the demise of an Italian milk company, global audit firms this week were sent a serious warning that they may be on the hook for a host of local blowups they had long sought to avoid.

Though they heavily market their global reach to clients, the Big 4 and other large accounting firms have long argued in legal proceedings that their global entities are simply loose affiliations. But in a Jan. 27 ruling in a case centered on Italian shelf-stable milk maker Parmalat, Judge Lewis Kaplan of U.S. District Court for the Southern District of New York ruled in effect that they can't have it both ways.

Auditing has never been more global than it is today. That point was driven home with news coverage of the Jan. 24 arrest of two partners of Price Waterhouse India over the audit of tech outsourcer Satyam. And the prospect of rising liability is something none of the Big 4 welcomes. "All of them have structures designed to build fire walls" between local companies and the global firm, says Stanford law professor and former SEC commissioner Joseph A. Grundfest. "The question is, will the dikes hold when you have this kind of a flood?"

Links or no links

In the case involving Parmalat, Judge Kaplan held that Deloitte Touche Tomatsu, or DTT, the global network, and its former CEO, James Copeland, should remain defendants in a shareholder case seeking damages from an alleged fraud. Kaplan cited DTT's marketing practices and financial and other links between Deloitte firms in Italy and Brazil and the global firm DTT.

"The judge said you can't sell yourself and run your business like that and then say, 'no, we're just a loose affiliate under Swiss law,'" says Stuart Grant, a partner at Grant & Eisenhofer and co-lead counsel for the plaintiffs. "In essence, the parent can't hide from the misdeeds of its children."

The judge's ruling did not find that DTT is responsible, only that there is enough evidence for it to stand trial as a defendant and face a jury verdict. In response to the ruling, Deloitte issued a statement saying the firm is "disappointed in the Judge's decision, but we are confident of victory at any trial of this matter."

The firm further noted that "Deloitte Touche Tomatsu is a Swiss Verein [membership association] and provided no services of any kind to any Parmalat entity."

Cooking the books

The Parmalat scandal stretches back to the early 1990s, when the Italian dairy conglomerate launched an aggressive growth plan financed by debt. An expansion into South America went bust, and according to executive statements, the company, needing to cover both millions in losses there and the diversion of funds by the CEO and his family, began to cook the books. Management created fictitious bank accounts allegedly with the help of then-auditor Grant Thornton, according to the judge's summary of the case.

Deloitte's involvement came when Grant Thornton had to rotate off the account under an Italian law that mandates periodic changes in auditor. Deloitte failed either to discover or to report the problems. Eventually the scheme unraveled, and by Dec. 24, 2003, Parmalat was bankrupt.

The plaintiffs' lawyers have long built their case around DTT, the global affiliation, because Deloitte's Italian firm is no longer a going concern.

Financial Ties

Kaplan supported their line, noting connections between the local entities and DTT that included: quality control between the global and local Deloitte firms; financial ties and a dispute resolution process used at Parmalat that ended with a decision by the global firm, DTT. As for financial ties, DTT gets funding from local Deloitte firms. In 2001, \$80 million of its \$218 million budget came from the U.S. firm, for example.

In his ruling, Kaplan notes that "although disclaimers on DTT's website assert the legal separateness of DTT and its members, DTT's goal, as expressed by its chief executive officer, James Copeland, was for clients to 'get consistent seamless service across national boundaries.' Member firms therefore use the Deloitte name when serving international clients 'in order to project the image of a cohesive international organization.'"

Kaplan's decision isn't binding on other judges, but he is well-respected in legal circles and operates in the most closely watched district in the securities industry, Grant notes. How much sway his thinking will have and how it might affect the firms is now "the \$64,000 question," says Steven Berger, a lawyer in the New York office of Vedder Price who's not involved in the case but is watching it closely.

"Going forward either [the firms] become one organization and assume the responsibility of all of the actions in every country, or they go to the other extreme, making them looser with less control," says Berger. "Then the question is whether that will result in a diminution of quality."

The India tale

Heightening interest in this decision is its coming just as another Big 4 firm, PricewaterhouseCoopers, has become the subject of a number of lawsuits over its Indian affiliates' audits of Indian outsourcer Satyam Computer Services. The full extent of the Satyam case is still unfolding, but in a letter to the company's board, CEO B. Ramalinga Raju said that for many years he inflated the company's results. Prosecutors later claimed that the company's employee rolls were inflated to benefit Raju, a charge his lawyers denied.

Two of Price Waterhouse India's partners, S. Gopalakrishnan and Srinivas Talluri, have been held in a Hyderabad jail since Saturday. They have been suspended from their duties by the firm in order to focus on the Satyam investigation. In a statement, their firm, which is one of the largest auditors in India, said it doesn't know the basis on which they were detained and that the firm has been cooperating fully with authorities.

"We share the regulators' concern in understanding the full extent of the fraud and how it was accomplished. Like everyone else, we were shocked by the massive fraud at Satyam and by the steps undertaken to conceal it," the firm said.

But Mike Davies, the communications director at the international accounting firm PwC, who has been deployed to Mumbai to help the local firm through this crisis, sought to make clear the distinction between the global group and local affiliates.

Global? Moi?

"There isn't such a thing as a global firm," Davies says. "We are a membership organization." The individual country firms, he says, "are not collected legally in terms of ownership. Each firm is owned separately in their own country by their local partners." As to the shareholder suits filed in the U.S., including at least one naming the global firm, PwC "will be robustly defending them," says Davies.

Those and probably a few more. Shareholder lawsuits in general have been on the rise. In 2008 federal securities fraud class-action filings hit their highest level since 2004. Some 226 cases were filed on behalf of investors who have lost as much as \$856 billion, according to the Stanford Law School Securities Class Action Clearinghouse. Most of the cases involved financial firms and were filed in the Southern District of New York.

Not surprisingly, lawyers expect to file more suits in 2009. And audit firms just became a much more attractive target.

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