Practice Note

The Silence of the Auditors

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In my last CEO message, I gave recent examples of iconic companies running amok, paying scant attention to ethics and values but being rewarded with higher share values. There was Volkswagen ignoring the toxic pollution caused by their diesel engines; HSBC involved in money laundering of Mexican drug cartels; Facebook breaking all privacy legislations, and almost all the Australian banks involved in large scale corrupt practices.

Businesses Behaving Badly

Since writing that message, in Australia there appeared to be, one could only describe as a "corporate crime wave". There was an outbreak business lawlessness including wage theft, mistreatment of franchisees, abuse of workers on temporary visas, and much more[2].

Mr. Rod Sims, the chairman of the Australian Competition and Consumer Commission, in the 2018 Giblin Lecture he gave on Friday, July 13, gave us an extraordinary list of the commission's enforcement activity, just in the month of April this year.

Ford was ordered to pay $10 million in penalties after it admitted that it had engaged in unconscionable conduct in the way it dealt with complaints about *PowerShift* transmission cars, sometimes telling customers that shuddering was the result of the customer's driving style despite knowing the problems with these cars.

Telstra was ordered to pay penalties of $10 million in relation to its third-party billing service known as "premium direct billing" under which it exposed thousands of its own mobile phone customers to unauthorised charges.

Thermomix paid penalties of more than $4.5 million for making false or misleading representations to certain customers through its silence about a safety issue affecting one of its products which the company knew about from a point in time.

Flight Centre was ordered to pay $12.5 million in penalties for attempting to induce three international airlines to enter into price-fixing agreements.

K-Line, a Japanese shipping company, pleaded guilty to criminal cartel conduct concerning the international shipping of cars, trucks and busses to Australia.

Woolworths had proceedings instituted against it alleging that the environmental representations made about some of its Homebrand picnic products were false, misleading and deceptive.

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[1] First Published: Ratnatunga, Janek, (2018), "The Silence of the Auditors", *On Target,* ICMA Australia Newsletter, 22(4), July-August, pp.3-6.

[2] Ross Gittins (2018), "Businesses Behaving Badly". The Age, Business, July 18, page 18.

Mr. Sims went on to say that earlier this year, the Federal Court found that the food manufacturer **Heinz** had made misleading claims that its Little Kids Shredz products were beneficial for young children, when they contained about two-thirds sugar.

Nurofen packaging of four or their pain products claimed that each was specifically formulated to treat a particular type of pain when, in fact, each product contained the same active ingredient and was no more effective at treating that type of pain than any of the others.

Hotel giant **Meriton** was caught taking deliberate steps to prevent guests it suspected would give an unfavourable review from receiving TripAdvisor's "review express" prompt email, including by inserting additional letters into guests' email addresses. The court found this to be a deliberate strategy by Meriton to minimise the number of negative reviews its guests posted on TripAdvisor.

Optus Internet recently admitted to making misleading representations to about 14,000 customers about their transition to the national broadband network, including stating that their services would be disconnected if they didn't move to the NBN, when under its contracts it could not force disconnection within the timeframe claimed.

Pental has admitted that it made misleading claims about its White King "flushable" cleaning wipes, saying they would disintegrate in the sewerage system when flushed, just like toilet paper, when our wastewater authorities are having big problems because the wipes can cause blockages in their systems.

The Silence of the Auditors

Against the backdrop, one needs to question why the auditors have remained silent. Most of the above companies and financial institutions have received unqualified audit opinions.

Auditors collected large amounts in audit and non-audit fees. The unethical behaviour of large companies and the impact of such on the value of share, raise questions about the value of company audits, auditor independence and quality of audit work, economic incentives for good audits and the knowledge base of auditors.

The external audit is supposed to be a 'trust' mechanism installed to persuade the public that capitalist corporations and management are not corrupt and that companies and their directors are made accountable. In an uncertain world, corporate audits are expected to produce comfort by reassuring the stakeholders that there has been an external and objective check on the way in which the financial statements have been prepared and presented, and it is an essential part of the checks and balances required. Accountants, as auditors, have cemented their status and privileges on the basis of claims that their expertise enables them to mediate uncertainty and construct independent, objective, true, and fair accounts of corporate affairs. This expertise, it is claimed, enables markets, investors, employees, citizens, and the state to limit and manage risks.

Such claims of expertise are, however, frequently exposed as being inadequate by unexpected corporate collapses, frauds, and failures; and more recently, by systemic unethical and corrupt practices by corporations that the public would have trusted in the past, even without a re-assurance of an external audit.

Auditors Behaving Badly

Let alone the problems of the audit, the unethical and corrupt practices of the auditors themselves has been in news, as shown below:

Ernst & Young

In September 2016, public accounting firm Ernst & Young agreed to pay $9.3 million to settle charges against three of the firm's audit partners. The US SEC found that Gregory Bednar, a former senior partner on the engagement team for an unnamed New York-based public company, "maintained an improperly close friendship" with the company's chief financial officer, thus violating rules that ensure objectivity and impartiality during audits. Bednar reportedly spent close to $100,000 in travel and entertainment expenses between 2012-2015 while socializing with the company's chief financial officer and his family, according to the New York Law Journal. The firm was aware of the expenses but did nothing. In a separate case, former E&Y partner Pamela Hartford, who served on another audit team, had a romantic relationship with Robert Brehl—the former chief accounting officer of client Ventas, a real estate investment trust, according to the USA SEC (Farber,2016).[3]

PricewaterhouseCoopers

PwC was banned from auditing listed companies in India for two years after being accused of negligence in its audit work at the now defunct *Satyam Computer Services*. The Securities and Exchange Board of India said that Price Waterhouse chose to rely on "glaring anomalies" and huge differences in Satyam's balance confirmations during its audit work between 2001 and 2008. Although the initial ban did not include ongoing 2017/18 audits for listed companies, the date was extended into 2019, and now PwC carry on auditing its clients until 31 March, 2019.

KPMG

KPMG's South African branch has come under fire and suffered a severe reputational hit after becoming caught up in a growing corruption scandal surrounding one of the country's most powerful families, the Guptas. KPMG was accused of facilitating the Gupta family in tax evasion and corruption. The Gupta family, once called South Africa's "shadow government", is a very wealthy and politically influential family with close ties to former South African president Jacob Zuma. It is alleged that the family exerts undue influence over government policies and dictates high level governmental appointments in exchange for commercial opportunities. Note that HSBC (the bank's unethical behaviour was detailed in the May-June 2018 CEO Message) has been accused of money laundering for the Gupta family.

Following the above allegations, financial services company Sasfin and investment company Hulisani announced plans to drop KPMG because of reputational risks. Sygnia Asset Management had fired it earlier. In all six companies terminated their KPMG contracts within two months of the scandal erupting.

While the firm has denied any wrongdoing, it admitted to missing several "red flags" in relation to the Gupta family's accounts. At least eight senior KPMG South Africa officials resigned in the wake of the scandal, including CEO Trevor Hoole.

It is clear that it's not because they had a sudden change of heart that they suddenly came forward. If they were not caught there would not be this pseudo-accountability.

[3] Madeline Farber (2016), "Ernst & Young Was Just Fined $9.3 Million for Inappropriate Client Relationships', Fortune, September 20, 2016.

Deloitte

The South African accounting watchdog has launched an investigation of Deloitte's audit of *Steinhoff International* after the retailer disclosed accounting irregularities that have triggered a share price collapse. The *Independent Regulatory Board for Auditors* in South Africa is investigating audit work done by Deloitte South Africa for the South African-based retailer from 2014 to 2016. The watchdog plans to liaise with accounting regulators in Germany, where Steinhoff is listed, and the Netherlands, where the company is incorporated. Deloitte has signed off on Steinhoff's accounts for at least 18 years, according to the retailer's annual reports. The investigation is another blow for Deloitte, which admitted in September 2017 that it had suffered a cyber-attack that undermined its reputation as an expert provider of security advice.

The breach, which affected clients, also prompted an investigation of Deloitte by New York State's attorney-general, which is ongoing. Steinhoff's announcements that it had discovered "accounting irregularities" and planned to restate its 2016 financial results have caused the company's share price to plummet by more than 80 per cent. The company's former chief executive, Markus Jooste, stepped down last week and apologised in correspondence with close associates for making "some big mistakes" that have "caused financial loss to many innocent people". German prosecutors said they were investigating whether Steinhoff inflated its revenue and book value, and Steinhoff's supervisory board has commissioned PwC to carry out an independent investigation into the accounts (the same PwC mired in the Satyam scandal in India!!).

Such events fuel the suspicions that auditors lack the requisite independence, expertise and incentives to construct the promised 'true' and 'fair' account of corporate affairs. It also brings forward the question if the rules and principles of the *International Financial Reporting Standards (IFRS)*, are in-fact hopelessly outdated and cannot differentiate between ethically and unethically generated revenue and expenses of companies; or provide a "true and fair" valuation of a company that has significant intangible assets.

A Royal Commission into the Audit Profession?

These examples also bring forward a discussion on the role, value and independence of auditors. Perhaps what is needed is a *Royal Commission into Regulation, Independence, Politics, Production and Knowledge Base of Auditors*. An independent inquiry into the role of auditing, especially at financial institutions, would help to highlight the shortcomings of the current practices; why there has been a *"Silence of the Auditors",* whilst all the Banks were marched like lambs to the slaughter, to sheepishly admit their significant ethical and moral shortcomings in the Banking Royal Commission.

We have looked at unethical, and often corrupt and fraudulent behaviour of large corporations, financial institutions and even external auditors. What about the professional bodies of accountants that educate, train and certify the competency of the auditors, and provide good governance guidelines for their professional members?

***CPA Australia*,** the country's largest accounting body had a tumultuous year in 2017, after an unprecedented member uprising over indiscriminate spending and exorbitant salaries led to the sacking of CEO Alex Malley and the entire board resigning.

The issues of what has been listed as the 'CPA Scandal" on Google, has been well documented in the financial press in Australia; and include the revelation that CEO Alex Malley's salary was $1.79 million per annum, the details of the over-the-top pay of board members, the excessive salaries of senior management, the termination payout of $4.9 million to Mr Malley, etc. These revelations outraged members, and were key factors that led to the revolt over the way the body was run.

A group of CPA Australia members then put forward 10 Resolutions at the at the accounting body's make-or-break annual general meeting in May 2018 Amongst these were resolutions to cap director pay, permit members to directly elect the board, and to have chairman Peter Wilson removed.

The CPA board and Mr Wilson opposed all 10 of the member resolutions, citing a variety of reasons including that the ideas are impractical, costly and not in the interests of the body.
Instead, the new board and chairman put forward resolutions that stem directly from the controversial independent review commissioned into the CPA late last year and subsequent (so-called) member consultation.

A key CPA member group spokesperson, Mr. Brett Stevenson, said the rejection of all the members' resolutions showed the board did not want to deal with the major governance issues at the body.

"*After all that has been exposed and reported on about the terrible leadership, at both board and management level, and resultant shenanigans at CPA Australia over the last decade, it appears we are just being taken for a ride. In more blunt terms we are just being treated with the same disdain and patronising professionalism that has gone before*," he wrote in his governance blog in May 2018.

One of the key resolutions put forward by the CPA board (as a counter to those put forward by the CPA members' group) is the creation of an "appointments council" to appoint board members. It would replace the discredited 23-person "representative council", where the board appointed 11 members to a body that in turn selected the board members. The proposed appointments council would have 13 members with the chairman, Mr Wilson, sitting in as a non-voting chairman. Each division and branch would select a member of the council, meaning that NSW and Victoria, where more than half of the 163,000-strong membership reside, would get only two representatives. Regions such as Singapore, with almost 8500 members, and Greater China, with 5800 members, would each have one representative on the appointment's council. Critics of this resolution fear it will be a back-to-the-future move that will disenfranchise the majority of members in Australia.

It was claimed in the media that CPA Australia actively harvested proxy votes from overseas members and was successful in preventing the CPA members' group from having majority acceptance for any of the resolutions that could have transformed the way the embattled accounting body is run.

This will result in a situation where the Europe divisional council, with 1750 members, will have the same voting power as the NSW council with 45,000 members and Victoria with 40,000 members. The NSW and Victoria divisions have over 50 per cent of the membership of CPA. They're only going to have two votes on this appointment's council. The other divisions and branches, which have less than 50 per cent of the members, are going to have 11 votes. This is Gerrymandering at its best, says Mr Stevenson.

The bottom line is that ordinary members of CPA cannot directly vote for their Board or President. However, it appears that such lack of governance by CPA Australia will not affect its financial viability as a majority of its professional members appear to be indifferent to the lack of good governance practices in their own body. It is hoped that ICMA members take a more active role in how their professional body is run.

It appears that not only is the need for social responsibility dead in the corporate world, but also amongst the auditors of those very corporates and also the professional financial accounting and auditing bodies that promote such governance practices.

The Role Management Accountants Can Play

It is time that management accountants further distance themselves from the financial accounting and auditing profession and ensure that they are able to be inculcate good strategic governance and strategic audit practices in the organisations that they work in.

Since businesses are behaving badly in the (legitimate) pursuit of higher profits and shareholder value, the key is for the government to legislate that companies undertake compulsory strategic audits to evaluate business practices beyond simply the financial reporting of the past. Key business practises in marketing, advertising, supply-chain, manufacturing, human resource management and information technology need be strategically audited to ensure that brand reputation and shareholder value is “future-proofed” against such rampant bad behaviour by corporates, their compliant financial auditors and the professional accounting bodies given the legislative responsibility of training such auditors.

Further, it is important for government legislation to significantly increase the cost of bad behaviour. Even though the fines and penalties listed by Mr Sims appear large, they are often easily absorbed by the sheer volume of revenue generated by such unethical actions. In other words, companies assess the profitability of law breaking by weighing the benefit to be gained against the cost of being caught multiplied by the probability of being caught. Mr. Sims said in his speech that “the penalties for misconduct, given the likelihood of detection, are comparatively weak”.

Many firms invest heavily in their brand reputation, to signal that they can be trusted. The greater the likelihood that bad behaviour will be exposed and made public, the more companies will do to guard against such behaviours that significantly diminish brand reputation.

Mr Sims is recommending to the Australian government that once bad behaviour is exposed, penalties and fines should be 10 to 20 times higher than it is today. Alongside such hefty fines, a statutory strategic audit, alongside strong whistle-blower protection, will increase the chance of bad behaviour being exposed and fined, and their executives sent to jail.

As I said in my last CEO Message, no company should be “Too Big to Jail”.