The Impotence of Australia's Accounting Regulators

Janek Ratnatunga[1]

Introduction

The Australian arm of one of the world's biggest and most prestigious accounting firms, *KPMG*, has been fined A$613,000 by the US accounting watchdog, the *Public Company Accounting Oversight Board (PCAOB)*, after a review found widespread cheating by staff on training tests over a four-year period.[2]

As an ex-KPMG Chartered Accountant myself, I was shocked for two reasons: (1) that an independent body was actually checking on what a Big-4 auditor was doing, and (2) that they were fined, rather than being given a slap across the wrist.

I was *not* shocked, however, about the endemic culture within KPMG that led to the fine.

The PCAOB report revealed that more than 1,100 staff –including 250 auditors – about 12 per cent of KPMG's Australian staff members – shared answers to pass mandatory training courses on professional independence, auditing and accounting, including tests to maintain accounting licences.

The PCAOB noted that it took into account KPMG Australia's *"extraordinary cooperation in the matter, including self-reporting, substantial assistance, and personnel and policy actions".* Regardless of KPMG's cooperation, however, the PCAOB did not hold back:

"From at least 2016 until early 2020, KPMG Australia violated PCAOB rules and quality control standards related to integrity and personnel management by failing to establish appropriate policies and procedures for administering and monitoring training tests, including tests designed to help the firm's audit professionals satisfy the requirements for maintaining their accounting licenses."[3]

Why is a USA watchdog fining Australian auditors? What is Australia's own watchdogs, *the Australian Securities and Investments Commission (ASIC)* and the *Financial Reporting Council ('FRC')* doing about such a cowboy culture? And why is the *Chartered Accountants of Australia and New Zealand (CA ANZ)* – the professional body to which a majority of KPMG auditors belong – keeping silent?

From Self-Regulation to Statutory Regulation in the USA

The accounting profession in the United States has now shifted from self-regulation by peer review to statutory regulation by the *Public Company Accounting Oversight Board (PCAOB*).

The main reason for the U.S. policy on oversight changing over the years – from a fairly hands-off approach to a negotiated oversight of self-regulation by the profession, and now to a statutory-

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[1] Institute of Certified Management Accountants.

[2] Sarah Danckert (2021), "US Watchdog fines KPMG Australia", *The Age*, September 16, p.26.

[3] Consultancy.com.au (2021), "KPMG hit with big fine from US watchdog for exam cheating", 16 September. https://www.consultancy.com.au/news/3983/kpmg-hit-with-big-fine-from-us-watchdog-for-exam-cheating

based oversight that is independent of the profession – is mainly due to the *Enron* and *WorldCom* accounting and auditing scandals in the early 21st Century.

Following these scandals, a *Senate Banking Committee* was set-up in the USA to evaluate the effectiveness of the profession's self-regulatory framework, which included the peer review system and the *Public Oversight Board (POB)* – a forerunner to the PCAOB. The *Senate Banking Committee* found that the peer review system had never resulted in an adverse or qualified report on a major accounting firm in its 25 years of existence![4]

Even after *Enron* revealed its accounting errors, its auditor *Arthur Andersen* received a clean bill of health from the peer review system. How could this be? The answer was obvious, peer reviews were *"mutual back scratching"* exercises. Audit firms choose their own reviewers, who were likely to be connected through prior relationships and tended to receive 'friendly' reviews. This led to the inescapable conclusion that independent standards-setting and independent oversight, while perhaps not guarantees of reliable financial reporting and auditing, are indispensable elements of a strong financial reporting and auditing system.[5]

The result was the US Congress's passage of the *Sarbanes-Oxley Act of 2002* by a near unanimous vote, which rejected self-regulation of the Auditing Profession and required instead independent oversight and standards-setting.

In addition to examining the profession's self-regulatory system, the USA *Senate Banking Committee* also examined the effectiveness of accounting and auditing standards-setters. Among other things, the Committee focused on whether private standards-setters' funding mechanisms fostered inherent biases.

Upon consideration, Senate Banking Committee Chairman Paul Sarbanes assessed the risk of undue influence over standards-setting as follows:

". . . the current arrangements of the standard setting bodies, both FASB and the international standards-setters … are funded by basically going around with a tin cup. So, you go to the very people who are going to be most intimately affected by the standards, you ask them for money to support the operation, and if they don't like what they think the standard setting body is going to do, they're obviously either unwilling or reluctant to give money.[6]

Chairman Sarbanes went on to propose an independent funding source for both the new oversight board, as well establishing auditing and related professional practice standards applicable to public companies, and any accounting standards-setters.

The U.S. experience teaches the auditing profession many lessons, some of which are:

- that rigorous auditor oversight is critical to maintaining an environment in which auditors can stand up to clients and enforce comparability in financial reporting.

- To gain public confidence, oversight must be independent of the profession, both in fact and appearance.

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[4] Charles D. Niemeier (2007), "Independent Oversight of the Auditing Profession: Lessons from U.S. History', *German Public Auditors Congress of 2007*, Berlin, Germany, Nov 8. https://pcaobus.org/news-events/speeches/speech-detail/independent-oversight-of-the-auditing-profession-lessons-from-u-s-history_32

[5] Ibid.

[6] Spiegel, P. and Peel, M. (2002), "Enron Considered Influencing Accounting Body", *Financial Times*, Feb. 13, p. 13.

- U.S. efforts at more modest oversight did not fail for lack of highly competent practicing auditors – they failed because they used highly competent practicing auditors.

- This is not to say that expertise in auditing should not play a role in oversight, but it must be expertise that is independent of the profession itself.

There was a lot more in the Sarbanes-Oxley Act in addition to oversight measures that is the focus of this article. For example, the auditor independence requirement where an auditor could not also provide consulting to that client, and the requirement of a personal sign-off on the Accounts by the CEO and CFO.

Unfortunately, these lessons have had little or no impact in the regulation of accounting standard setters and auditors in Australia.

The Parliamentary Inquiry in Australia: Much Ado About Nothing

On 1 August 2019, the Senate referred an inquiry into the regulation of auditing in Australia to the *Parliamentary Joint Committee on Corporations and Financial Services*. The ICMA made the first submission to the Committee (see Appendix 1) calling for an independent body for both setting accounting standards and regulating auditors. Its submission called for a complete overhaul of the system; and probably this was reason it was never contacted for a follow-up discussion!

To counter ICMA's submission, the powers that be organised a deluge of submissions from the audit firms and auditor friendly academics – ensuring that the flaws in accounting standards of not recognising intangible assets in the balance sheets was never discussed. It may seem that the non-recognition of intangible assets in the accounting standards is not relevant to the argument in this article, i.e. that we need more independent oversight of auditors.

However, what are the auditors auditing and certifying? They are certifying that the financial statements are "true and fair" *according to* the accounting standards. Thus, flaws in prevailing accounting standards issued by IFRS should be first step in any investigation of the accounting profession. After all, what is the point of independently overseeing an auditor who is certifying fiction![7]

The report of findings and recommendations of the Parliamentary Committee was released on 11 November 2020. The recommendations of the report were *'motherhood'* statements about improving the business community's *'perception of the auditing profession'* in light of audit failures, perceived lack of visibility of accountability of auditors, and auditor independence considerations.

The report included the following recommendations:

- That the *Financial Reporting Council ('FRC')* oversees a formal review of the sufficiency and effectiveness of reporting requirements under the Australian auditing standards in relation to the prevention and detection of fraud, and management's assessment of going concern. *[The issue that the reports totally ignore self-generated intangible assets and hence do not give a true valuation of knowledge-economy companies was completely ignored in the report].*

- That the *Australian Securities and Investments Commission ('ASIC')* formally review how it publicly reports the findings of its audit inspection program, with a focus on the transparency and relative severity of identified audit deficiencies. This could include the findings being

[7] Janek Ratnatunga (2019) "Why Audit Opinions are 'Untrue' and 'Unfair'", *Journal of Applied Management Accounting Research,* 17 (2): 23-30.

presented on ASIC's website. *[I will address later why ASIC is not discipling KPMG for their latest scandal].*

- That the FRC and ASIC oversee consultation, development and introduction of defined categories and fee disclosure requirements in relation to audit and non-audit services, and a list of 'explicitly prohibited' non-audit services.

- That the Corporations Act 2001 be amended so that an auditor's independence declaration is expanded to require the auditor to specifically confirm that no prohibited non-audit services have been provided.

- That the Corporations Act 2001 be amended to implement a mandatory tendering regime such that entities required to have their financial reports audited must undertake a public tender process every ten years; or explain 'why not'.

Why are ASIC and CA ANZ silent in the KPMG Scandal?

Why is it that it was the US audit watchdog the PCAOB, and not the Australian watchdogs, ASIC and FRC, that has fined KPMG Australia to the tune of $US450,000 (A$615,000), for widespread and systematic cheating on internal audit integrity exams dating back to at least 2016? And why is *CA ANZ trying* to keep a lid on this and other multiple incidents of bad ethical behaviour amongst its members?

In fact, KPMG had informed three bodies about cheating within the firm: the *PCAOB, ASIC* and the *CA ANZ.*

It was reported by *the Australian Financial Review* (AFR) that *ASIC* had in fact, assessed the material and concluded it did not have the power to sanction KPMG partners and staff over internal training misconduct. An ASIC spokesman had told the AFR that:

"ASIC has no power to intervene directly on such matters … it is of course very disappointing. The audit profession is in a position of considerable authority and trust, and it is important that the corporate and broader communities can rely with confidence on their expertise, honesty and professionalism."[8]

However, despite being first told about the matter 18 months ago, the AFR reported that CA ANZ, the main professional body that represents, trains and disciplines corporate auditors, has yet to investigate or take any disciplinary action against KPMG Australia partners or staff over the systemic exam cheating.

Typical of the glacial speed at which chartered accounting bodies worldwide move with regards to disciplinary matters involving the Big-4 professional service firms – KPMG, Deloitte, EY and PwC – it told AFR reporters that it was, *"monitoring the case".* Had the PCAOB report from the USA not been published, it is most likely that CA ANZ would be monitoring the case forever.

None of the chartered accounting professional bodies in countries that have had major scandals from just a few years ago, have disciplined their Big-4 members (or the chartered accounting partners within these firms) for professional misconduct. These major scandals include:

[8] Edmund Tadros (2021) "Accounting body in go-slow on KPMG cheating scandal" *Australian Financial Review*, Sept 17. https://www.afr.com/companies/professional-services/accounting-body-in-go-slow-on-kpmg-cheating-scandal-20210916-p58sdn

- ***Ernst & Young (E&Y):*** In September 2016, public accounting firm E&Y agreed to pay $9.3 million to settle charges against three of the firm's audit partners.

- ***KPMG:*** In 2017 KPMG's South African branch came under fire and suffered a severe reputational damage when it was accused of facilitating the Gupta family in tax evasion and corruption.

- ***Deloitte:*** In 2017 the South African accounting watchdog launched an investigation of Deloitte's audit of *Steinhoff International* after the retailer disclosed accounting irregularities that triggered a share price collapse.

- ***PricewaterhouseCoopers (PwC):*** In 2018, 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.*

This is because globally, chartered accounting professional bodies like CA ANZ that are responsible for enforcing the professional standards of its members, receive major funding from Big-4 auditing firms – and almost always have Big-4 partners on their boards. The Big-4 are also major sponsors of the *IFRS Foundation and the International Accounting Standards Board* that issues *International Financial Reporting Standards* (IFRS) – according to which 'true and fair' opinions are given. The whole process is totally incestuous.

Going back to the KPMG scandal, a spokeswoman for the CA ANZ gave the expected, and very typical, stonewalling answer to AFR reporters:

"CA ANZ administers its professional conduct oversight role with due process. As a result, we are unable to comment on the implications of the PCAOB decision for members at this time."

The reality is that most cases are swept under the table. In fact, during the *Parliamentary Joint Committee* inquiry into audit quality that was discussed earlier, a CA ANZ representative said the body had penalised just two members from a Big-4 firm during the past decade.

An interesting case of Mr. Steve Bourke, as highlighted by AFR, is a case in point. He was a PwC partner who the corporate regulator ASIC had accused of failing to gather enough evidence while auditing the collapsed education provider Vocation, At the time of the *Parliamentary* inquiry, CA ANZ said it was *"aware of and monitoring"* the ongoing allegations against Mr Bourke – who had denied ASIC's allegations against him. According to AFR, this monitoring was dropped after Mr Bourke had voluntarily cancelled his registration with the corporate regulator as a registered company auditor. The punchline of the story reported in the AFR is that Mr Bourke, now a managing director at PwC, remains a CA ANZ member. The CA ANZ spokeswoman said *"information relating to members and investigations"* was confidential when asked about the status of the case by AFR.[9]

Independent Oversight is Needed of Professional Bodies that can Undertake Audits

CA ANZ is one of the three generalist professional accounting bodies who have members that provide public practice services in Australia; and are recognised in s88B of the *Corporations Act (Australia)* to issue a certificate under paragraphs 708(8)(c) or 761G(7)(c) after compiling or auditing a financial report in public companies. The other two are *CPA Australia* and the *Institute of Public Accountants*. All these bodies supposedly hold their members accountable to the principles set out by their '*codes of conduct and professional standards'*. However, very few cases are enforced where the rulings are reported publicly, and almost never against the member who is linked to the Big-4.

[9] Ibid

All three bodies, as well as all chartered accounting bodies globally, also belong to *the International Federation of Accountants (IFAC)*, which is a global advocacy organization mainly for the financial accounting and auditing professions. In its website it states that it supports the development, adoption, and implementation of international standards for accounting education, ethics, and the public sector as well as audit and assurance. It says that it also supports four independent standard-setting boards, which establish international standards on ethics, auditing and assurance, accounting education, and public sector accounting; and issues guidance to encourage high-quality performance by professional accountants in small and medium business accounting practices.

However, despite these lofty ideals, IFAC is *not* an accreditation organization. It is merely a lobby group. Membership of IFAC is not obtained via an accreditation process, but instead, IFAC membership is obtained via an application process that must be sponsored by at least two current IFAC member organizations. No individual members belonging to its professional bodies globally has been brought in front of it for disciplinary action.

Therefore, it is time that all three generalist professional accounting bodies in Australia come under strict independent scrutiny of their auditor training programs and professional qualifications; similar to how the *Tertiary Education Quality and Standards Agency (TEQSA)* reviews higher education degrees issued by universities. This is the only way to ensure that Australian reputation in corporate governance is maintained and capital markets are protected.

Impact on Profit vs. Reputational Damage

Some of the personnel and policy actions taken by KPMG (after the horse had bolted) in the aftermath of its exam cheating scandal included the departure of at least two partners. Dozens of employees, including 16 partners, are said to have been stripped of pay entitlements amounting to tens of thousands of dollars in penalties. In total, more than 1,130 individuals within KPMG's 6,700-strong Australian headcount have received disciplinary action over the affair – the least being verbal or written cautions for the sharing or receiving of exam answers. However, it is possible that the penalties imposed by KPMG more than covered the fine of A$ 615,000, which would have been less than one partner's salary!

This brings up an interesting management accounting conundrum. Why is the fine so low? When such low fines are imposed by regulators, coupled with the low probabilities of getting caught, the fine itself can be a revenue-generator for the company via salary savings and penalties. The real loss is *reputational damage* in the marketplace, but the Big-4 appear to shrug-off reputational damage as yesterday's news. The only reason why KPMG was targeted by PCAOB is that KPMG undertakes audits on companies listed in the USA. No sanctions have, as yet been imposed by Australia's own financial regulators.

To gain public confidence, oversight must be independent of the profession, both in fact and appearance.

As such, it really is time for a proper *Royal Commission on the Accounting and Auditing Profession* with the *Terms of Reference* starting from the questions as to why have legislation requiring a statutory audit. If there is a corporate need for an audit of past transactions, then what should be the focus: detection of fraud, valuation of the company as a going concern, or some other? This will then lead to appropriate financial reporting standards (including valuations of intangible assets); auditor training and assessment; the regulation and licensing of auditors; audit quality; independent auditor oversight; the adequacy and performance of regulatory bodies; and the ability to take disciplinary actions against auditors.

Appendix 1

Submission to the Regulation of Auditing in Australia by the Institute of Certified Management Accountants (Australia)

Whilst all of the listed *Terms of Reference (TOR)*[10] would make for interesting in-depth investigation, the Institute of Certified Management Accountants, would like to raise issues pertaining to:

TOR 4- on audit quality, including valuations of intangible assets.

TOR 8- the effectiveness and appropriateness of legislation, regulation and licensing, and

TOR 10 – the adequacy and performance of regulatory, standards, disciplinary and other bodies.

In this submission we will briefly demonstrate that these three TORs are significantly interlinked and require urgent review by Parliament.

TOR 4, 8 and 10.

The audit report of financial statements uses the term 'true and fair' to express the condition that financial statements are truly prepared and fairly presented in accordance with the prescribed accounting standards. The problem is that it is the Auditors themselves who issue the accounting standards!

This is done by stacking the Boards of the Standard setting bodies by the auditors themselves, especially members of the Big-4, and thereby controlling the development, production and modification of accounting and auditing standards. Then they do an audit in accordance with the very standards that they have issued.[11]

Using a university analogy, it's like the Big-4 are setting the subject syllabus, preparing the exam paper, writing the answers to the exam, and finally giving a grade. If there is a complaint, they are the adjudicators of the quality of their own work!

It is time for an independent body, appointed by Parliament, to be responsible for setting accounting standards.

A related issue is that preparing accounts based on IFRSs results in flawed financial statements and meaningless and fictitious audit reports.

In knowledge economy companies such as Microsoft, Amazon and Google, the auditors book valuations are over 5-10 times less than market valuations. At Microsoft, this is a difference in value of US$686 Billion in 2018! Against market values, all IFRS valuations would get a fail grade, but Auditors are certifying them as 'True and Fair'.[12]

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[10] Parliament of Australia (2019), Terms of Reference of the Parliamentary Joint Committee on Corporations and Financial Services Inquiry, ttps://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/RegulationofAuditing/Terms_of_Reference

[11] Janek Ratnatunga (2018) "The Silence of the Auditors", *Journal of Applied Management Accounting Research*, 16 (1): 21-26.

[12] Janek Ratnatunga (2018) "Auditing Opinions for Sale?", *Journal of Applied Management Accounting Research*, 16 (1): 17-19.

The outdated belief that the addition of all fair value of individual assets (less liabilities) will give an accurate reflection of the state of affairs of the company is based on an outdated economic paradigm of a largely industrial economy, where tangible assets were the engines of growth. The IFRS based values are totally flawed in today's knowledge economy; as most intangible assets are left out, and an organisation's capability values completely ignored. Regardless, such an flawed valuation is not necessary as a more accurate valuation can be provided by the market at any time. Asking auditors to provide a value is a costly and, ultimately, a meaningless task.

Legislation should be passed to reduce the scope of the traditional statutory financial audit to only reporting if transactions are correctly recorded and that the financial statements are prepared and fairly presented in accordance with Generally Accepted Accounting Principles (GAAP).

TOR 12 – Any other related matter.

If the traditional statutory audit is limited in scope by Parliament, one must consider what should replace it for proper governance of organisations. It is strongly recommended that the replacement should be a statutory audit of expected future performance and how it affects current value, and not an audit of past performance and meaningless book values. Such audits are called 'Strategic Audits'.

A strategic audit is far different from the common perception of a financial audit. It is a continuous evaluation of all the strategic functions of any success-seeking firm. Numerous components (e.g. stakeholder audit, customer satisfaction audit, etc.) make up the totality of the strategic audit, although the scope of each component audit will vary depending on the organisation. Most shareholders will want strategic auditors to perform, at a minimum: (a) stakeholder audits; (b) information security audits; (c) environmental audits; (d) corporate ethics audits, and (e) leadership audits. The skill-set strategic auditors would require will be very different from those required by those who audit the past– based on flawed accounting standards.[13]

[13] Janek Ratnatunga (2020) "The Case for Statutory Cost Audits", *Journal of Applied Management Accounting Research*, 18 (2): 35-42.