

Ethics and Professional Accountability: Structural Challenges in the Audit, Assurance and Consultancy Industry.

Submission from John Ferguson – 20th August 2023.

The biggest problem for a small retail investor in ASX listed companies is the potential for “soft” annual audits. “Soft” audits are those where the auditor avoids tough questions of company management, professional scepticism is benign and the audit is structured to provide credence to the company’s narrative of its performance.

Small retail investors place faith in the integrity of these annual audits to get a true picture of the financial state of the companies they invest in. The bulk of ASX company audits are carried out by the Big Four global professional services firms. Given the PwC revelations, a big question now hangs over the integrity of these firms and the quality of their audits. The proposal for a complete split up of companies providing audit and assurance services from those providing consultancy services is a good one, but it does not completely solve the “soft” audit problem.

ASIC Report 709 gives some idea of the quality of the auditing for ASX companies. As part of its surveillance, ASIC tested 115 key audit areas (from 35 audit files) performed by the six largest audit firms and 23% were not up to scratch. The audit firms were encouraged to carry out a root cause analysis of its audits. This form of self-regulation does not contain sufficient disincentives to stop bad behaviour from the auditing firms.

Compounding the problem is the story titled “How the Big Four ‘infiltrate’ Boards” (*Weekend Australian* 10-11 June 2023). The opening sentence says it all: “ The boards of Australia’s Top 100 companies are heavily populated by people drawn from the ranks of professional service firms, with almost 25 per cent of directors with multiple seats coming from the Big Four...”. This points to the potential for a number of conflicts of interest, particularly the way an auditor is selected.

In the absence of a “tough cop on the beat”, small retail investors need good comparative data to take to company AGMs where intelligent questions can be asked of Boards and pressure applied. ASIC could be charged to publish data like:

1. Audit and assurance fees based on market capitalisation, or sector average, are published. To provide an example here, I sampled ten companies in the ASX 150 (BHP through to CSR) comparing market capitalisation and audit fees paid in FY22. For each \$1b of market cap the average audit and assurance fee was \$227,780.
2. Information is provided about the background of the Chair of the company’s Audit and Risk committee and links to the company selected to complete the annual audit.
3. A snap-shot of Key Audit Matters is provided. Of particular interest is the amount of goodwill written down or written off in the course of the year (thereby wiping out shareholder equity in a company). For example, the data would provide an insight into shareholder value generated by business acquisitions, often encouraged by executive remuneration structures.
4. ASIC should name the companies whose audit files have been sampled for surveillance. Providing feedback to company directors where there has been an auditing deficiency, in the belief that the Board will fix things is a big ask if everything is kept confidential. Shareholders deserve this information if company Boards are to be made accountable for the choice of an auditor.

In order to illustrate my case, I submit a real case study. The company in question listed in November 2021 and has just dropped out of the ASX 200. Private equity sold into the float and continues to hold Board seats on a non-independent Board. Most of the public money went into the progressive acquisition of many businesses (some privately owned by Board members) which now carry a goodwill valuation of \$1.6b (current market cap is \$1.63b). The auditor is from PwC and the Chair of the Audit and Risk committee is ex-PwC. The audit and assurance fee for FY22 was \$2.093m, 4.75 times more than the average calculated by me above. There may be good reasons for all of the above, but questions need to be asked. The quality and impact of these questions would be bolstered by having current and authoritative comparative data available. Without the data, the questions become personal and this benefits no-one. (Disclaimer alert: I hold no shares in the company).

Thank you for the opportunity to make a submission about this important but complicated issue.