Australian Citizens Party

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MEDIA RELEASE

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Don’t wait for a 2008-style crash to reveal failings of Australian bank audits

Australians can have no confidence in the health of the major banks from the annual audits of their books.

This is the conclusion to be drawn from Digital Finance Analytics Principal Martin North’s submission to the Parliamentary inquiry into the regulation of auditing, which highlights four areas where audits fail to assess the true state of Australia’s banks.

Click here to read “DFA submission to Senate Inquiry on auditing in Australia” .

Click here to view North’s video post on the DFA YouTube Channel: “DFA Submission: Regulation Of Audit In Australia”.

North is a banking expert and analyst with decades of experience in the UK and Australia; he also worked at and resigned from major global accounting firm Arthur Andersen just before its ignominious demise from its complicity in “Enron accounting” in 2001.

The inquiry of the Parliamentary Joint Committee on Corporations and Financial Services into “Regulation of auditing in Australia” was established in August in response to a growing drumbeat of criticism of the shameless conflicts of interests that permeate the relationships between the Big Four global accounting firms KPMG, PwC, EY and Deloitte, and the bank and corporations they audit. Years of non-stop scandals involving the Big Four have led to increased scrutiny all over the world, and the growing realisation that auditors shouldn’t be able to combine auditing and consulting functions.

In the UK, the Labour Party commissioned a report in late 2018, Reforming the Auditing Industry, by an expert team led by retired accounting professor Prem Sikka, which recommended breaking up the Big Four firms into separate auditing and consulting businesses, and for a statutory (government) auditor to inspect the books of all of the banks and large corporations in the UK.

In Australia the government shielded the Big Four accounting firms from scrutiny by the banking royal commission, through the rigged terms of reference for Commissioner Hayne which dropped the requirement proposed by the Greens, and agreed to by Labor and rebel Nationals, that he should also investigate the accounting firms. However, after big four firm EY was caught in yet another scandal—failing to disclose former Treasury Secretary and NAB chairman Ken Henry’s admission to EY made during the royal commission that he knew his bank was still selling bad financial products—the government did an about-face and agreed with Labor to establish the current inquiry.

The main emphasis of the critics of the Big Four firms is the clear conflict of interest between auditing and consulting, which is very serious and must be rectified through forced separation—a kind of “Glass-Steagall” for auditing firms.

Martin North’s submission, however, has a different emphasis which is just as important: the way these conflicted auditors have failed to assess the actual solvency of the major banks, which has huge implications for the Australian financial system and economy.

The four areas where audits fail that North identifies are:

1. Financial derivatives exposure—Australian banks have some $48 trillion in combined derivatives exposure but auditors don’t examine their derivatives books to validate their claims of the risks involved, which immediate history shows us the banks always understate;
2. Internal risk models—these models allow the banks to set their own capital requirements, but they are not regularly audited and will not be proved to be accurate or otherwise until a crisis hits, which will be too late;
3. Property portfolio revaluations—the banks are able to “game” the accounting for the valuations of the properties that are the collateral for their mortgage lending, the biggest part of their business, which enables them to understate risk and hold reduced capital;
4. Household versus loan risks—bank regulator APRA assesses risks of individual loans but ignores whether households have more than one loan, which means the real risks are greater than assessed and will only be evident in a crisis.

“Remember that in 2008 several banks failed, despite having been given an unqualified audit in the months prior”, North says. “Others required substantial Government bail-out or were absorbed by other industry players. *Nothing has changed* (other than the quantum of debt and other exposures have increased substantially) *since then*.” (Emphasis added.) He endorses breaking up the audit firms, and the idea of the Commonwealth Auditor-General conducting independent audits of the banks to assess their true health. (In September former BT Australia managing director Rob Ferguson also endorsed using the Auditor-General to audit the major banks.)

The true state of the banks is the biggest issue facing the Australian economy right now. In the CEC’s view they are basket cases, with world-record exposure to the debt tied up in the housing bubble; skyrocketing derivatives, and massive short-term overseas borrowings of which more than $300 billion must be rolled over every 90 days. The banks and the broader financial system require a massive clean-out, starting with breaking up the corrupt conflicts of interest in both the banks (Glass-Steagall) and the audit firms, and a thorough independent audit of the banks to assess their real risks. The CEC has drafted legislation for Parliament for precisely this purpose.

The deadline for submissions to Parliament’s audit inquiry is 28 October. All concerned Australians should read the DFA submission and make their own submission endorsing North’s call for a serious examination of the banks.

Click here to make a submission to the Regulation of auditing inquiry by Monday 28 October .