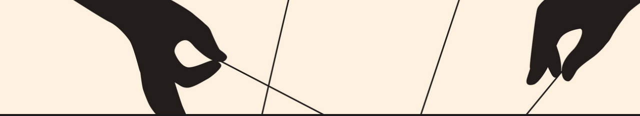
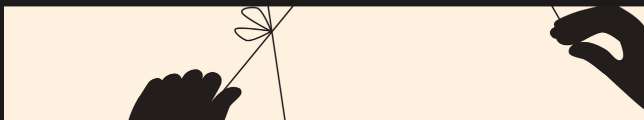
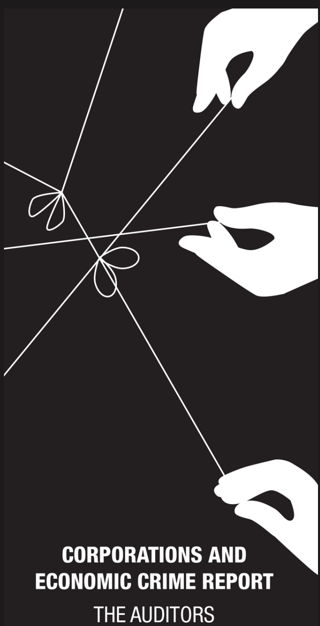


the corporations and economic crime report

volume 2: the auditors





The **Corporations and Economic Crime Report (CECR)** explores the most egregious cases of economic crimes and corruption by private financial institutions, from apartheid to the present day. We aim to highlight the key themes that link corporate criminality across these periods of time, focusing on the failure of state institutions and regulators to ensure accountability for corporations that profit from injustice.

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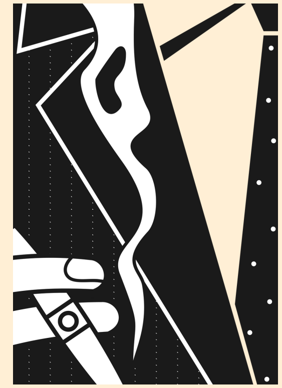
The 'Big Four' audit firms - PwC, Deloitte, KPMG and EY - have been described as a powerful cartel. 96% of all companies listed on the JSE are audited by one of the Big Four. As a result, these firms have enjoyed mega profits and have grown to become some of the biggest in the world.

auditors

The Big Four are mostly known for providing auditing services. South Africa's Independent Regulatory Board for Auditors (IRBA), which regulates the auditing industry, separates auditors' services into three categories:

1. **internal auditors** who build, review and monitor financial controls and policies within companies or organisations. Internal audit services may or may not be outsourced to a Big Four firm.
2. **external auditors** are responsible for reviewing a company's financial statements; and signing off on whether these statements fairly reflect the company's financial reality.
3. **forensic auditors** are brought in when an external audit is deemed unsatisfactory. The main role of forensic auditors is to investigate irregularities and alleged fraud, and to determine whether audit systems have failed and if laws and regulations have been breached.

consultants?



Despite being known as audit firms, the core business of the Big Four has increasingly moved towards "professional services"- their role as consultants and tax advisors has cemented their standing in the global economy. At the same time though, there has been a notable decline in the quality of audits the Big Four performs.

With consultancy fees now making up around two-thirds of their income, these firms face an "independence conundrum". That is, they need to prevent the commercially lucrative consultancy services they offer from compromising the integrity of their auditing work. Evidence shows they are not achieving this.

the audit rap sheet

The Big Four audit and consult for the biggest corporations, and are advisers to governments internationally. Yet in South African and across the world, the Big Four are implicated in scandals linked **to audit failures and allegations of corrupt consulting deals** involving state entities. Despite this, they face little or no accountability. These scandals and the lack of consequences emphasise that industry reform is necessary.

pwc

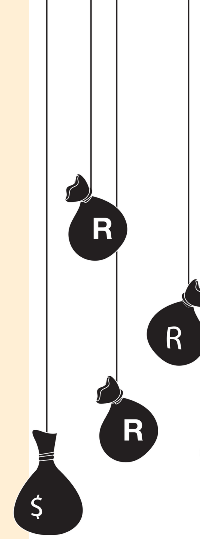
- Failed to identify major misstatements while working as the external auditors at South African Airways (SAA). Its partner, Nkonki, earned R19 million for work at SAA, but was fined only R200 000 for failing to disclose SAA's non-compliance with legislation.
- Acted as auditor and consultants for Sonangol, the Angolan government-owned oil company used by Isabel dos Santos to steal billions from Angolan citizens through a network of 400 shell companies.
- Was fined $225 million in 2017 for failing to flag overstated profit of $5.8 billion at US firm Tyco. This fraud ultimately cost investors an estimated $10 billion.
- Negotiated more than 500 deals with tax authorities in Luxembourg which allowed multinational companies to pay tax at a rate below 1%. In 2014, the International Consortium of Investigative Journalists (ICIJ) exposed this scheme as part of an investigation, the Lux-Leaks.

Deloitte.

- Failed to report suspicious activities, as well as fraud, at both Steinhoff (a retail holding company) and Tongaat Hulett (an agri-processing business for mainly sugar and maize). The Steinhoff fraud resulted in an overnight loss of R120 billion, to the detriment of 948 pension funds. The Government Employees Pension Fund alone lost more than R21 billion. Tongaat's "accounting irregularities" meant that the company's assets were overstated by R10 billion.
- Failed in its 2014 audit of African Bank. Deloitte missed red flags in the overstated future cash flow predictions for the bank and ignored red flags raised in its own internal reports.
- Earned R207 million for an Eskom tender based on an irregular contract. In March 2020, Deloitte agreed to pay back R150 million, which allowed them to keep over R57 million earned between April 2016 and September 2017.
- Encouraged investors to use Mauritius to escape taxes, allowing for wealthy clients to reduce their taxes at the expense of African states, which rely on taxes for social spending. Details of this emerged in 2013 when an internal Deloitte document was leaked to the public.

EY

- For three years EY (formerly known as Ernst and Young) failed to confirm the existence of $2 billion in the financial records of German payments processing firm Wirecard. EY had audited the company for close to ten years. In June 2020 Wirecard collapsed when it was found that the $2 billion simply did not exist.
- Paid $123 million to US regulators in 2013 after admitting that, between 1999 and 2004, its senior partners had been involved in developing, marketing and defending avoidance schemes to dodge taxes worth $2 billion.



- Acted as auditors and consultants for Lehman Brothers, but did not raise red flags over questionable accounting practices at the bank and ignored a whistle-blower's report. This fraud led to Lehman's collapse in 2008, an event viewed as one of the major onsets of the Great Recession.
- Ordered by a UK court to pay $11 million to Amjad Rihan, a former EY partner, in April 2020. Rihan was forced to resign after exposing money-laundering and compliance failures by EY client, Kaloti, the largest gold refinery in the United Arab Emirates.

KPMG

- Auditor Sipho Malaba failed to raise red flags in VBS Mutual Bank's statements and provided a falsified regulatory audit opinion to cover up the fraud. VBS's failure had catastrophic consequences for its poorest depositors, stokvels, and municipalities.
- In 2015 produced the erroneous and fictitious "rogue unit report" for the South African Revenue Services (SARS). This report was used to fire over 50 senior SARS officials and it was a contributory factor in diminishing SARS' capacity.
- Audited and provided tax-advisory services to Linkway Trading, a Gupta shell company. Linkway was used to launder money from the Estina Dairy Farm. KPMG earned R40 million rand for its work.
- Was fined $456 million (nearly R10 billion) in 2005 for "tax-shelter fraud". Between 1996 and 2003 it concocted transactions for wealthy individuals and filed false and fraudulent tax returns that claimed phoney tax-breaks. The scheme cost the US public $11 billion (over R200 billion).

In certain cases, the Big Four have together been implicated in a single scandal. Each of the Big Four acted as external auditors for Danske Bank at some point between 2010 and 2014. This was the period during which the bank was used to **launder 200 billion euros for organised criminals and authoritarian governments in Eastern Europe. They all gave unqualified audits.**

why should you care?

Open Secrets believes that auditing is a social utility because it is meant to root out accounting abuses to protect the public.

Audit firms claim that an "expectations gap" exists because the public expects more than auditors can deliver. We reject this argument. The "expectations gap" is effectively the auditors' failure to deliver on legitimate expectations to assure corporate financial integrity - the crux of their job. There is therefore not an "expectations gap," but an accountability gap.

Auditing reform requires vigorous engagement by civil society and activists. We hope that this edition of the CECR series makes a small contribution to this.

what can be done?

1. separate auditing from consulting

South African authorities should follow the lead of regulators in the US and the UK and force firms to split up their auditing and consulting arms. The "independence conundrum" facing the Big Four is a crucial problem and arises from conflicts of interest created by providing services that are fundamentally incompatible.

2. power to the regulators and transparency of the Big Four

As regulator, the IRBA must be granted greater powers of investigation and sanction. But it must also commit to improving its own transparency and information-sharing, including naming individual auditors and their firms found to have engaged in misconduct.

3. a greater role for the auditor general

As an independent Chapter 9 institution with the necessary skills, the Auditor General (AG) is well placed to take greater responsibility for the audit function at public entities. Further, where an independent forensic investigation is required, the AG should set the mandate and scope of that investigation in the event a private audit firm needs to be contracted to assist.

4. prepare for the push-back

As public discussions on these and other possible reforms take shape, it is important to anticipate and prepare for the Big Four to push back. These firms resist reforms that demand greater scrutiny and accountability.

5. don't trust henhouse security to foxes

The recent painful experience of the 2008 financial crisis should remind us not to rely on the financial sector to address its own problems: 'Recall how eagerly we accepted the help of bankers in 2008. No surprise, they bailed themselves out, first and foremost. If we are going to reform auditing, then there's one lesson to learn from the financial crisis: Don't trust the auditors to do it.' (Karthik Ramana)

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+27 72 565 0173