

MEETING EXPECTATIONS AND BUILDING A BRIGHTER FUTURE FOR AUDITING IN SOUTH AFRICA

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Abstract

The auditing profession in South Africa, like other countries in the English speaking world, is experiencing the effects of the so-called expectation gap. An ad-hoc committee of the South African Institute of Chartered Accountants (SAICA) investigated the expectation gap with regard to the auditing profession in South Africa and published a Discussion Paper (DP12) that contains a strategy to deal with the problems of the expectation gap.

In this paper the contents of DP12 is examined and subjected to analysis. We have not adopted an approach of evaluating and considering all recommendations and arguments in DP12 because a wider, more fundamental approach was followed. The process that the Expectation Gap Ad-Hoc Committee followed is also examined and evaluated.

Key Words

Expectation gap

Accountability

Capping of auditors' liabilities

Self regulation

Auditors' independence

The role of the auditor

Other services by auditors

1. BACKGROUND

The auditing profession is experiencing a self-recognised crisis.

In the mouthpiece of the profession, *Accountancy SA* (July 1993) an editorial titled "*Profession in crisis?*" states that: "*It is clear that the services which the accountancy profession is offering, are not satisfactory and are not meeting users' needs.*". The editorial concludes: "*...if (these) strategies do not succeed,*

we could experience the downfall of the accountancy profession in this country." (Accountancy SA, July 1993:3). The November/December 1993 editorial affirms that: "*The audit function is felt to have become irrelevant.*" (Accountancy SA, November/December 1993:3). And: "*The Institute has recognised the signs of the crisis of public confidence facing the auditing sector of the profession.*" (Accountancy SA July 1993:3).

The President of the South African Institute of Chartered Accountants (SAICA), in an editorial in *Accountancy SA* (October 1993) adds to the above: "*There has been a concern over a number of years that the reputation of the profession, both locally and internationally, has been deteriorating*". (Accountancy SA October 1993:2).

The January 1994 issue of *Accountancy SA* features a red rose on its cover, symbolising the audit function. The Editorial is headed "*Our proud record*" and reads: "*...let us pause to pat ourselves on the back for all the things we have done right;*" (Accountancy SA January 1994:3).

The most recent statement on this aspect comes from the Chief Executive of SAICA. In the Business Day of Thursday June 9 (Klein 1994:19) he is quoted as having said that "*...accountants and auditors have lost their credibility...*"

Research conducted during 1992 and 1993 at the University of Pretoria (Gloeck 1993) provided evidence that South African **auditors enjoyed considerable esteem in the financial community and amongst financially knowledgeable persons**. "*These groups are satisfied with the technical knowledge and competence of members of the auditing profession.*" (Gloeck & De Jager 1993: 48). Other positive aspects identified, were that financially knowledgeable persons in South Africa, unlike their overseas counterparts, "*have a relatively high knowledge of the auditing profession.*" (Gloeck & De Jager 1993:36).

The Gloeck-study showed that only one out of every ten persons has an outright unfavourable opinion of auditors. This compares favourably with the opinions the respondents have of lawyers, for example: one out of every five persons has an outright unfavourable opinion of lawyers (Gloeck 1993:210).

"*87% of respondents suppose that auditors after qualifying manage to keep themselves reasonably well informed of developments in their field of knowledge, and that only 8% suppose that this is not the case, is an indication of a relatively high degree of user satisfaction.*" (Gloeck & De Jager 1993:42).

Another decisive aspect highlighted by the Gloeck-study, was the rating auditors received with regard to **professionalism**. Here, together with medical

practitioners, auditors were ranked at the pinnacle of the hierarchy of professions. They were ranked above accountants, engineers and lawyers.

Excluding shareholders in private companies, 76% of financially knowledgeable persons do not subscribe to the proposition that an audit is of little value to the company (Gloeck 1993:341).

The Gloeck-study did, however, identify four very specific shortcomings, relating to the perceived lack of independence of auditors; the uncertainties with regard to the role of the auditor; problems with the audit of small owner-managed companies and a lack of openness, transparency and accountability with regard to the processes in the system of audit self regulation (Gloeck & De Jager 1993:48-3).

A rather sceptical attitude amongst members as to how the Institute is addressing serious challenges, was also identified. According to the research, 64% of auditors were of the opinion that the controlling bodies **did not do enough to address the problem of the expectation gap** (Gloeck 1993:441).

It is against the above background and overseas developments that an ad-hoc committee of SAICA investigated the so-called expectation gap with regard to the auditing profession in South Africa and published a paper that contains a strategy to deal with the problems of the expectation gap (SAICA 1994a: hereafter referred to as DP12).

In this paper the contents of the Discussion Paper (DP12) issued by the Expectation Gap Ad-Hoc Committee of SAICA is examined and subjected to analysis. We have not adopted an approach of evaluating and considering all recommendations and arguments in DP12 because a wider, more fundamental approach was followed. The process that the Expectation Gap Ad-Hoc Committee followed is also examined and evaluated.

The objective of this paper is fourfold: to respond to the call for comment by the Expectation Gap Ad-Hoc Committee; to provide users of auditing services and the profession's own members with a different viewpoint; to supply additional information and recommendations, and finally to stimulate debate.

Without debate and involvement, the relevant parties will not adopt ownership of forthcoming changes in the auditing profession. In the absence of transparency and openness, suspicion will prevail. Without hearing "the other side", we cannot move forward with confidence.

It is imperative that the positive spirit of contribution and synthesis that was

instituted in the concluding remarks of the Gloeck/De Jager-study be endorsed by all parties:

"We trust that useful information has been supplied which will enable all members of the auditing profession and users of auditing services to work together in arriving at decisions which will ensure that the expectation gap is narrowed, but even more: that auditing will continue to hold its rightful place in the community and for the benefit of the community."

(Gloeck & De Jager 1993:53).

Auditing fulfils an important function of social control. The ultimate aim should always be to strive to fulfil socially accepted objectives and to be fully accountable in this regard.

2. SHORTCOMINGS IN THE METHODOLOGY AND PRESENTATION

A **report** a committee issues after investigating certain aspects, is the main medium by which the particular body gives **account** of its work, the process followed, et cetera. DP12 is therefore the medium through which the Expectation Gap Ad-Hoc Committee gives account of its workings. It is in this regard that DP12 shows shortcomings as will be shown in this paper.

The researchers acknowledge that DP12 is qualified. We refer to the following:

"The document has been kept as short as possible and, therefore, not all opinions or suggestions may have been fully motivated."

(DP12 para.09).

and

"In this paper, the key issues are identified. Some are debated in some depth with some suggested solutions being given..." "The document has been kept as short as possible and, therefore, not all opinions or suggestions have been fully motivated."

(DP12 para.09).

No justification or criteria are, however, given for dealing with one matter in detail and virtually ignoring another.

References to published and other material consulted is inadequately accounted for in DP12, thus depriving the reader of the tools to independently verify statements quoted or referred to. The conclusions that the Expectation Gap Ad-Hoc Committee come to, can therefore not always be substantiated or confirmed by independent reference to the relevant sources.

Many statements are verbatim quotations from other published documents without indicating their source. To substantiate this by means of one example, the reader is referred to paragraphs .14, .15, .22, .23, .24, .25, .26, .28, .29, .48, .60, .67, .68, .69, .98 of DP12 and pages 7, 11, 12, 23, 24, 27 and 28 of the Scottish document (ICAS 1993).

In addition, it is submitted that some of the statements made in DP12, referring to other studies conducted in this country and overseas, are made out of context. Examples that substantiate our assertion are set out under the heading "Distortion of Facts".

During 1992 and 1993 the opinions of 16 000 financially knowledgeable persons in South Africa were sought with regard to issues concerning the auditing profession in this country. This research report was published in 1993.

Although the existence of this most recent and comprehensive research is acknowledged in DP12 (para.05 & .85) an analysis of the document confirms that the information and empirical evidence has not been incorporated into the recommendations and the proposed *modus operandi* to address the expectation gap.

No reason is given by the Expectation Gap Ad-Hoc Committee for this approach.

Our investigation of the process followed by the Expectation Gap Ad-Hoc Committee as well as an analysis of DP12 revealed no evidence that small practitioners, sole practitioners, academics, regulators, users of financial statements and users of auditing services have been involved in the initial process. It therefore seems that DP12 is the product of seven members of the mainly big auditing firms in South Africa.

Until a document, representative of the views of the majority of members and users groups, has been approved and published, **the expectation gap is likely to exist on a scale that is unacceptable** to auditors and users of auditing services alike.

DP12 addresses a wide range of topics that affect a vast audience of interested parties. Users of financial statements typically include shareholders, employees, lenders, financiers, analysts, investors, creditors, trade unions, academics, policy makers and government. Preparers of financial statements include directors, chairpersons, management of companies, auditors, accountants and supportive personnel.

One could therefore have expected that, from the outset, the process of "*meeting the needs of (these) users*" would have been an open one, facilitating inputs, opinions and ideas from all parties concerned. In addition, the exact terms of reference of the Expectation Ad-Hoc Committee were not published or communicated to members either at the Committee's inception, or as part of DP12.

A one-day conference has been organised by SAICA to "...*deliberate on the latest proposals on financial reporting...*" (SAICA 1994b:1). The brochure inviting participants to the conference advertises limited seating availability and that members have to pay R 750.00 to attend. Non(SAICA)-members are even further discouraged from attending - they have to pay R 850.00. The brochure promises that the one-day conference will provide "*the latest information*" on developments concerning the issues addressed in DP12.

We submit that members and users should not be required to pay for receiving the "*latest information*" regarding developments that relate to an issue of strategic nature. Less so during a period in which interested parties have been invited to contribute and comment on the relevant matters.

One of the authors addressed an enquiry to SAICA to determine what other opportunities **the Institute** has provided or is planning to provide in order to discuss DP12. SAICA responded: "*As regards opportunities to discuss DP12, the Institute will not be arranging any formal discussion groups.*" (SAICA 1994c. Letter dated 20 May 1994, signed by the Operations Director who replied on behalf of the Chief Executive).

Note: A day before this paper was finalised (15 June 1994), brochures of a second one-day conference was received by mail. The title of the conference is "Great Expectations". Various topics addressed in DP12 are discussed during the conference by individuals and a panel. The same **exclusivity** of the first conference applies.

It is submitted that such conferences are not the most suitable vehicles of **consultation** because insufficient opportunity is created for attendants to express their views and only limited numbers can attend.

We also believe that since the auditing profession has traditionally adopted an approach based on the gathering and evaluation of evidence, accompanied by proper documentation and accounting of such evidence, there is no reason for the Expectation Ad-Hoc Committee to deviate from such an approach. Auditors have always listened - the word "auditing" is in fact derived from the Latin word "Audire" meaning "to hear, to listen".

In some instances isolated statements are made by the Expectation Ad-Hoc Committee. In paragraph .36 of DP12 it is stated that:

"The auditing arm of the profession in South Africa, in its endeavour to play a justifiable and indispensable role in the business world, must continually adapt and develop its functions with due consideration and understanding of the perceptions and requirements of user groups." (Our emphasis).

Although it is not indicated as such, this is a verbatim quote from the Gloeck & De Jager study (Gloeck & De Jager 1993:8).

In the context of DP12 it is an isolated statement which is, for example, not followed by an explanation of how the Expectation Ad-Hoc Committee went about determining what the perceptions of user groups are. It seems that no additional empirical data was collected and existing empirical evidence with regard to the South African situation was not incorporated.

For many years SAICA has followed a certain methodology in obtaining comments and inputs from interested parties. A document is published and interested parties are invited to comment thereon. This methodology has yielded disappointing results.

During the past years three important documents were issued by SAICA for comment. All three topics are of a fundamental nature. They were to be issued as statements on generally accepted auditing standards. The following number of comments were received by the technical department of SAICA:

- Special Reports 18 comments;
(SAICA November 1986:ED 69)
- The Auditor's Report on Annual Financial Statements 22 comments;
(SAICA October 1989:ED 78)
- The Auditor's Responsibility to Detect and Report 17 comments.
on Unlawful Acts, Other Irregularities and Errors
(SAICA April 1990a:ED 80)

(The information was obtained from the Director of Auditing: SAICA on request).

To put the response rate in clearer perspective, it should be noted that in 1991 the total membership of SAICA was **13 510** (SAICA 1992b:3).

In 1993 Gloeck & De Jager commented on the process of issuing documents for comment as follows:

"The process in South Africa was further abbreviated in 1993 by the Institute's decision that members will no longer receive as a matter of course documents published for comment, but that only interested members who specifically request the South African Institute of Chartered Accountants to place their names on the mailing list concerned, would receive such documents."

(Gloeck & De Jager 1993:27).

(Also refer to *Accountancy SA* January 1993:27).

SAICA has therefore acknowledged that the process of issuing a document and inviting "interested parties to comment", is not the way to go. Yet the Expectation Gap Ad-Hoc Committee, in publishing DP12, has persisted with the same methodology.

Only through real openness, accountability and the involvement of interested parties throughout the entire preparatory process can a document be regarded as truly representative and then generally accepted.

The approach followed by the Expectation Ad-Hoc Committee in submitting DP12 for comment is therefore not considered to be constructive.

To be fully accountable, we plea that the Expectation Ad-Hoc Committee:

- will follow an open door approach;
- gives written account of all the comments received;
- provides more inclusive and open opportunities for all interested parties to meet with Committee members in order to clarify certain positions;
- to make publicly known what criteria were used for accepting or rejecting comments and suggestions made by "interested parties".

SAICA should on its part:

- recompose the Expectation Ad-Hoc Committee so it be representative of the heterogenous nature of the profession and users of auditing services: no single group within the profession and no single consumer group may be in a majority and thus in a position to control the agenda and outcome;

- make minutes of the Expectation Ad-Hoc Committee's meetings available to all members of the profession as well as the public.

This is not only necessary because all members of the profession, and users in a more indirect way, will be expected to pay for the "action plan" that the Expectation Gap Ad-Hoc Committee will draw up, but also because **auditing is not just another commercial activity. Auditing is a cornerstone of corporate governance.**

3. THE TITLE OF DP12

It is submitted that the title of DP12 "*Meeting the financial reporting needs of users of financial statements*" is not apposite. This becomes apparent when examining the subheadings used in DP12:

Subheading 2: Redefining the financial reporting needs of users of financial statements

The term financial statements is not defined as referring to major limited liability companies. In the absence of such a qualification, all recommendations would apply to all financial statements.

The Companies Act (1973 as amended) defines the term "**annual** financial statements" (Section 286). DP12 does not, however, refer to **annual** financial statements. The recommendations are therefore made in respect of all financial statements drawn up by public companies, private companies, small owner-managed companies, close corporations, partnerships, informal businesses and other institutions and concerns.

This clearly was not the intention and underscores the argument that the chosen title is inappropriate.

Subheading 3: The auditor's role in financial reporting

If this heading is read in conjunction with the comprehensive title of the document, this paragraph should address the manner in which the auditor's report should be drafted to "*meet the reporting needs of users*"

Neither discussions nor recommendations are, however, made

with regard to the format or wording of the audit report.

Subheading 5: Mitigating the effects of litigation

This chapter contains a strong plea to cap auditors' liability.

Clearly this subject falls beyond the scope of the needs of **users of financial statements**. Although the theme is not necessarily excluded from the more encompassing subject of the expectation gap, the inappropriateness of the chosen comprehensive title is hereby, once again, illustrated.

4. SHORTCOMINGS IN THE SYSTEM OF SELF REGULATION

DP12 fails to address the shortcomings of the system of self regulation. This is in spite of the fact that the profession's controlling bodies have jointly recognised the possibility of a change to the current system:

"Self regulation is a privilege which is often taken for granted. However, there have recently been indications that there is a tendency for a greater degree of supervision and control to be exercised by Government over self regulatory bodies such as ours. In some overseas countries the right to self regulate has already been lost. If the governing bodies of the profession do not monitor and enforce the rules and standards they lay down, the profession incurs the risk of losing important privileges, including self regulation."

(SAICA & PAAB 1 April 1993:1).

From the undermentioned it can be deduced that problems are being experienced with the Institute's disciplinary arrangements. The following extract of an article published in *The Argus* of 15 January 1994 gives account of an experience of a user of auditing services.

"Penalties imposed by the Institute of Chartered Accountants on accountants guilty of misconduct are confidential, the Institute said this week."

Legal and ethical director Jan Dijkman said the Institute would not reveal the penalties imposed on a Cape Town accountant found guilty of improper conduct.

'We regard this as a private matter', said Mr Dijkman.

Cape Town businessman Steve Nelson complained to the Institute about the conduct of his chartered accountant in February last year. In November the Institute sent Mr Nelson a letter explaining the investigations committee had considered the accountant's case and he had been found guilty of improper conduct and sentenced to an 'appropriate penalty'.

This information, the Institute said, was 'confidential'.

Mr Nelson does not agree. He told Weekend Argus he thought the enquiry should have been more open.

'I still don't know what charges were lodged by the Institute, nor what penalty was imposed when the accountant was found guilty. I don't know what arguments he brought up in his own defence and I was not given a chance to refute them if necessary'.

'It seems strange that chartered accountants in whom the public has placed its faith do not have a disciplinary system open to public scrutiny'.

(Dasnois 15 January 1994).

A similar complaint was made by a member of the auditing profession. A former professor of Auditing at the University of the Witwatersrand wrote to the Institute:

"I spent ten years trying to convince students of the Department of Accounting at Wits that the concept of professional ethics was the cornerstone of the profession. In general I think that the students accepted the need for professional ethics, but were unconvinced that ethics were maintained in SA. On this latest evidence, I can only conclude that the students were right to be cynical.

A reasonable paraphrase of the PAAB disciplinary committee finding is that provided you say 'sorry' long enough and hard enough it is OK to steal from trust funds and to lie to your partners to do so. The sentence meted out is a disgrace. If this is how the profession demonstrates its adherence to the professional ethics, it has lost the right to self regulation." (Our emphasis).

(Dilton-Hill 1994:34).

The above examples provide evidence that problems are being experienced with the current system.

The challenges to the system of self regulation are real and made in earnest.

Anyone failing to follow a scientific and well researched approach, is playing into the hands of the supporters of the abolition of the system of self regulation.

In this regard the statements of a present British member of Parliament come to mind:

"Whichever party wins the next election, accountancy is the next profession in the firing line...accountancy can no longer be allowed to get away with that cosy system of mafia policing itself which is the basis of self regulation.

The complete disregard for democracy, accountability, auditing standards and discipline has clearly demonstrated that the profession has not operated in the "public interest" and indeed cannot."

(Mitchell 1990:21-22).

The subject of how to deal with shortcomings in the system of self regulation is, however, not addressed in DPI2.

The Expectation Gap Ad-Hoc Committee could have sought guidance on how to strengthen the disciplinary system by referring to developments in other countries. The Commission of Inquiry into the Expectations of Users of Financial Statements in Ireland, for example, recommended the following:

*"We recommend that the Investigation and Disciplinary Committees should each have an independent chairman from outside the accountancy profession. We recommend further that **not more than half** of the other members of the Committees should be members of the Institute...*

We recommend also that the Investigation and Disciplinary Committees should report annually to the Minister for Industry and Commerce..."

(ICAI 1992:103).

5. RESTORING AUDITORS' INDEPENDENCE

In 1993 empirical evidence (Gloeck & De Jager: 1993) revealed that the majority of users of auditing services and financially knowledgeable persons in South Africa believed that auditors were not adhering to the following general accepted auditing standard:

"In all matters relating to the assignment, an independent mental attitude must be maintained by the auditor."

(SAICA 1986a).

The study concluded that:

"The profession ought to be concerned about the perception that financially knowledgeable persons have of the auditor's independence. Almost 60% of them are of the opinion that the auditor is strongly influenced by management of the company which he/she audits. Amongst stockbrokers 70% are of this opinion."

(Gloeck & De Jager 1993:39).

Even the overseas accounting press has taken note of the South African crisis surrounding auditors' lack of independence. *The Accountant* in the United Kingdom reports:

"From an accounting perspective, the Masterbond fiasco has added fuel to the already strong debate around auditing standards and accountability. Understandably, the collapse of companies which have been given unqualified audit reports has led to friction between the auditing profession and users of financial statements."

A major factor here is the perceived lack of independence of auditors when it comes to major clients." (Our emphasis).(Allen 1994:6).

Intensive public relation exercises aimed at reversing the perception of a lack of independence by auditors can be equated to the increase in advertising for a product which is being challenged by a new, superior product. It is only a matter of time before the "superior" product will prevail. Only careful scientific analysis of the deficiencies, combined with the actual changes to the old product will offer a long term solution.

It is necessary to reflect, at this stage, on the words of the great accounting philosopher Flint (Flint 1988:62):

"Society for its part has an interest in ensuing that auditors' reputations for independence is protected, otherwise the social benefit of the service will be lost. Society and auditors have, therefore, a common interest in excluding from employment as auditors, persons who do not accept the discipline of the constraints imposed by the concept of independence."

Specific aspects that have a negative effect on auditors' independence were identified in the Gloeck-study. Empirical evidence, albeit based on auditors' perceptions, suggested that the following factors are having the most negative effect on auditors' independence:

- financial dependence on a particular client;
- the provision of other services;
- pressure on audit fees;
- competition amongst audit firms;
- long standing auditor:client relationships (Gloeck 1993:436-437).

Recommendations in DP12 with regard to the provision of other services to audit clients, "opinion shopping", "lowballing", limiting total fee income derived from any one client and capping the auditors' liability, however, do not address the more fundamental aspects of independence.

From the above it seems that the Expectation Gap Ad-Hoc Committee is marginalising the independence issue.

Due to the importance of auditors' independence, we therefore suggest that an independent Commission be appointed by Government to investigate the fundamental aspects of auditors' independence.

6. REDEFINING THE ROLE OF THE AUDITOR

Numerous evidence can be found in South Africa that suggests that the public as well as members of the profession are confused and unsatisfied as to the role that auditors should play (refer to Basson 1993; Burger Oos Kaap 1994; Cameron & Dasnois 1994; Cape Times 1993; Cokayne 1993; Dasnois 1994; Finance Week 1993a; Finance Week 1993b; Finance Week 1994; Hadland 1993; Ireton 1993; Leuvennink 1994; Mathews 1993; Sake-Beeld 1993; Sake-Beeld 1994; Sake-Burger 1994; Sherrocks 1994; Sherrocks 1993; The Star 1994; Uys 1994a; van Wyk 1994; von Keyserlingk 1994a; von Keyserlingk 1994b; von Keyserlingk 1994c; von Keyserlingk 1993; West 1994a; West 1994b and Wilmot 1993).

It is submitted that the latter references provide sufficient evidence that support the supposition that all these parties should be heard and their views and expectations be incorporated and as far as possible accommodated in the role and objective that auditors have to fulfil. It is not a case of the auditors being misunderstood - it is the fact that the role of the auditor has to be determined by transparent and visible bargaining and negotiation amongst the various stakeholders:

"...audits are a means of social accountability and other social constituencies have a legitimate interest in defining their purpose."
(Mitchell et al. 1993:26).

In DP12 the Expectation Ad-Hoc Committee redefines the objective of an audit. The redefinition is introduced by the following statement:

"The auditing ...profession in South Africa, in its endeavour to play a justifiable and indispensable role in the business world, must continually adapt and develop its functions with due consideration and understanding of the perceptions and requirements of user groups."
(DP12 para.36 / Gloeck & De Jager 1993:8).

It is, however, not clear what steps were taken by the Expectation Ad-Hoc Committee to consult with user groups in order to take their views into consideration and understand their "requirements".

The Expectation Ad-Hoc Committee redefines the objective of an audit but does not refer to the resulting necessary changes to the audit report, which would have to incorporate and address the redefined objective.

Reform concerning the role of the auditor must be effected within the broader framework of corporate governance, and take into account the needs and expectations of users of auditing services, members of the profession, as well as the specific circumstances prevailing in our country.

A redefinition of the role of the auditor is of little or no value if no general consensus is reached between the various stakeholders on the interpretation of fundamental elements of such a definition. The different interpretations that are currently attached by various parties to the concept of auditors' independence is a prime example.

In a democratic society the redefinition of the aims and objectives of an audit, which by its very nature is a means of social accountability, should be the product of visible and open negotiations between interested parties. The presentation of a "new" definition without first seeking inputs from those parties, including the profession's own members, does not seem to be a constructive approach.

7. DISTORTION OF FACTS

It is not possible to deliberate on every statement made by the Expectation Gap Ad-Hoc Committee in DP12 nor to indicate the underlying inadequacies with

regard to every reference used.

As DP12 claims to take into account the empirical evidence available in South Africa in one instance, it would be appropriate to use this instance to substantiate our statements regarding DP12's underlying inadequacies. The aspect referred to, discusses the provision of other services by auditors to the companies they audit.

We have already referred to the limited number of references used by the Expectation Gap Ad-Hoc Committee to compile DP12.

In addition to this, the Expectation Gap Ad-Hoc Committee has made important quotations out of context.

We endeavour to substantiate this charge by means of the following examples:

DP12: *"The Cadbury Committee expressed the view that any potential gains in objectivity would be unlikely to outweigh the disadvantages of prohibiting auditors from also providing management consulting services."* (DP12 para.83).

Cadbury: The Expectation Gap Ad-Hoc Committee fails to complete the above quote which adds: *"It (the Cadbury Committee) does, however, strongly support full disclosure of fees paid to audit firms for non-audit work."* In addition, it is recommended that audit committees should specifically review the non-audit fees paid to the auditor both in relation to their significance to the auditor and in relation to the company's total expenditure on consultancy.

Furthermore, it is crucial to take into account that the provision of other services as discussed in the Cadbury Report is not comparable to the South African situation. The Cadbury Committee contains a **package of recommendations** which as a unit strives to achieve greater objectivity and independence. Many of the Cadbury Committee's recommendations are not part of the Expectation Gap Ad-Hoc Committee's plan. Examples of this are:

- Cadbury endorses a periodic rotation of audit partners (Cadbury 1992:39).
- Cadbury recommends the formation of an audit committee for every listed company (Cadbury 1992:38).

- Cadbury takes into account the workings and established activities of the audit regulatory system as exercised by the Joint Monitoring Unit and its regular reports to the Department of Trade and Industries in the United Kingdom (Cadbury 1992:37).
- Cadbury takes into account the steps that have been taken over a period of three years, to strengthen the audit system through the establishment of a new regulatory framework in the United Kingdom (Cadbury 1992:37).
- And probably the most crucial of all recommendations is the introduction of a *Code of Best Practice* (Cadbury 1992:58-60) that parties concerned with corporate governance would comply with.

Since DP12 contains none of the above recommendations, we are critical of the unconditional approval by the Expectation Gap Ad-Hoc Committee that auditors may provide other services to the companies they audit.

DP12 does not give account of the relevant decisions that have been taken by the Institute. With regard to the first point above (the rotation of audit partners) it has been decided not to adopt Cadbury proposals, and instead: "*The Committee was of the view that audit firms would manage their partner/client relationships in the best interest of all parties and that guidance on this issue would not be appropriate*". (Our emphasis). (Accountancy SA 1994:28).

A study of DP12 did not yield specific comments as to why a particular recommendation of Cadbury is adopted whilst another one is rejected.

DP12: The Expectation Gap Ad-Hoc Committee does not refer to the Scottish document with regard to the provision of other services.

ICAS: **(The Institute of Chartered Accountants of Scotland)**

The Scottish document does, however contain the following proposals:

- The establishment of an independent Audit Review Panel

(ICAS 1993:47) - its members consisting of persons completely unattached to the company that is being audited.

- *"The panel would have the responsibility for supervision of the (audit) process on behalf of the primary stakeholders..."* (ICAS 1993:48).
- *"...the Panel would take responsibility for agreeing (to) the process for the appointment of the external assessors (auditors)..."* (ICAS 1993:48).
- *"We propose that the directors should be required to obtain permission of their company's Audit Review Panel before employing their companies firm of external assessors (auditors) to carry out consultancy services."* (ICAS 1993: 51).

Once again, **the concession to perform other services is made against the background of a completely different monitoring system** that would ensure that transgressions with regard to the provision of other services are prevented and accounted for.

DP12: The Expectation Gap Ad-Hoc Committee does not refer to the APB document with regard to the provision of other services.

APB: **(The Auditing Practices Board of the Institute of Chartered Accountants of England & Wales)**

The Auditing Practices Board does refer to the provision of other services. In much the same way as Cadbury, the threats that the provision of other services hold, are identified and cautioned against. Examples of measures that would safeguard the auditor's independence as pointed out by the Auditing Practices Board, are:

- direct involvement by shareholders in the decision to obtain other services from the audit firm, *"for example by shareholder representatives having oversight of such matters on their behalf"* (APB 1992:11).
- *"strong control and tight procedures within the audit firm, involving requirements for consultation"* (APB 1992:11).

- *"the use of review panels"* (APB 1992:11).
- *"Regulation and monitoring must address this important area"* (APB 1992:11).

DP12: *"In a survey conducted by Professor Dieter Gloeck of the School of Accountancy at the University of Pretoria on the audit expectation gap in South Africa, almost 60% of the respondents who were classified as financially knowledgeable persons maintained that the auditor is strongly influenced by the management of an organisation and therefore is not independent."* (DP12 para.85).

"In line with the results of this survey, we believe that the provision of other services would not effect independence or have an effect on auditors' objectivity." (DP12 para.85).

Gloeck & De Jager: **(The audit expectation gap in the Republic of South Africa)**

*"The following steps will need to be taken to ensure auditors' independence: (i) No 'other services' may be rendered by the auditor to **audit clients**."* (Gloeck & De Jager 1993:50).

"Most financially knowledgeable persons express a degree of confidence in the audit report. Certain factors have been identified which materially affect this confidence (negatively). The prime factor is the question of independence. The following factors have a negative effect on confidence in the audit report. The sequence in which they are listed, ranges from the most negative factor to that which has the least (yet still material) negative effect:

- (i) *the question of independence - the view that the auditor is strongly influenced by management;*
- (ii) *offering other services - the concept that the auditor is less objective when he offers other services to his audit client;"* (Gloeck & De Jager 1993:39).

"43% of them (financially knowledgeable persons) are of the opinion that fulfilling these other services has a detrimental effect on the auditor's objectivity. Only 32% are of the opinion that

fulfilling other services has no effect on the auditor's independence." (Gloeck & De Jager 1993: 38).

The Expectation Gap Ad-Hoc Committee concludes that a recommendation to the effect that auditors are allowed to provide other services to their audit client is "*in line with the results of this (the Gloeck & De Jager) survey*", whilst the Gloeck & De Jager results are distinctively the opposite.

The premise adopted in drafting the recommendations contained in DP12 falls short of discerning that recommendations made in the research papers referred to above, are based on interdependent components and detail.

If individual elements are wrenched from concepts that must be seen as holistic, recommendations are at risk of being perceived as arbitrary.

It is submitted that similar misinterpretations and incorrect conclusions with regard to the Gloeck & De Jager study are published in the May 1994 issue of *Accountancy SA*. The past President of the South African Institute of Chartered Accountants, who is also the Chairman of the Expectation Gap Ad-Hoc Committee writes as follows:

"...a recent opinion survey conducted by KPMG in the UK found that 75% of the respondents thought that it is the auditor's responsibility to detect fraud of all kinds..."

"More recently, research conducted by Professor Dieter Gloeck of the Pretoria University confirmed the same trend in South Africa in that most respondents were of the opinion that auditors had a duty to detect fraud." (Our emphasis). (Wilmot 1994:5).

The fact of the matter is that the 75% with regard to the study conducted in the United Kingdom by Market & Opinion Research International Limited on behalf of KPMG Peat Marwick McLintock (more commonly known as the Steen study) (Steen 1989:45) is correct.

The fact of the matter is also that **only 27,7%** of the respondents of the Gloeck & De Jager study were of the opinion that auditors had a duty to detect fraud (Gloeck & De Jager 1993:59). Most respondents are therefore **not** of the stated opinion.

The reader of the article in *Accountancy SA* is, however, not put in a position to independently confirm facts and/or statements, since no references have been

disclosed in the five and a half page article (Wilmot June 1994:4-11).

The reader would, for example, also have noticed that the opinion survey by KPMG in the UK which the author described as "recent" was conducted no later than 1989.

The last-named example underlines the necessity that readers of a document must be put in a position to independently verify quotations and references used in the text under consideration.

The question of detection of fraud by auditors is one of the numerous examples that confirmed the existence of meaningful, different circumstances in South Africa.

In the October 1993 editorial in *Accountancy SA* it is suggested that problems with regard to the expectation gap are similar around the world except for slight changes in emphasis (*Accountancy SA* October 1993). In contrast to this statement, the School of Accountancy (University of Pretoria) has for some time now pleaded that it should be acknowledged that South African circumstances with regard to the auditing profession differ from those in other countries and that steps taken to narrow the expectation gap should take this into account.

8. INDEPENDENCE AND THE PROVISION OF OTHER SERVICES

The Expectation Gap Ad-Hoc Committee is of the opinion that audit firms should be allowed to offer other services to their audit clients.

The Expectation Gap Ad-Hoc Committee makes the following statement:

"...we believe that the provision of other services would not effect independence or have an effect on auditors' objectivity."

The above statement is put into perspective by quoting another source:

"The auditor's independence is further compromised by the routine provision of non-auditing services. Many auditing firms act as recruitment consultants for companies, hiring the very directors who then hire the auditors. A highly undesirable situation now exists. Auditors provide all kinds of services to companies; these include, printing T-shirts, badges, laying golf courses, tax avoidance schemes, creative accounting schemes, insolvency, advising banks to put companies into receivership and preparing profit forecasts. The auditors are explicitly acting as extensions

of company personnel and finance departments. They are a party to the creation, recording and execution of transactions; and yet they claim to independently audit the resulting transactions. This is clearly impossible.

No other watchdog is ever allowed to become an extension of a company and is allowed to audit the work done by itself. External auditors should not be an exception to this rule. There must be a complete ban on the provision of non-auditing services by auditors and their associates to their audit clients."

(Mitchell *et al.*1993:15&17).

In South Africa it is also general practice that auditing firms recruit directors for client companies and screen the appointments of senior staff and directors in the financial divisions of the companies they audit. A glance through the "Appointments Section" of the Sunday newspapers substantiates the above.

Many other studies contain provisos that restrict auditors from freely providing other services. The Institute of Chartered Accountants in Ireland, for example, recommends that the chairman in his report accounts for and reports in detail on all other services that were rendered by the companies' auditors (ICAI 1992: 117).

With regard to other services, no mention is made of the fact that in many European countries (including Germany and France), auditors are not allowed to offer other services to their audit clients. Auditors of many public sector organisations in the United Kingdom are prohibited from this practice (Mitchell *et al.*1993:15).

In South Africa, the Office of the Auditor-General acts in harmony with these overseas developments. The general guidelines issued for persons conducting audits on behalf of the Auditor-General contains the following provisions:

"With a view to the maintenance of the necessary independence and objectivity it is the policy of this Office that a firm which audits an institution on behalf of the Auditor-General, will as a rule not be allowed to do consulting or other non-audit work for the same institution simultaneously." (Office of the Auditor-General 1992:52).

The Expectation Gap Ad-Hoc Committee does, however, not refer to these South African circumstances.

The Expectation Gap Ad-Hoc Committee also makes no mention of the many voices that are critical of the notion that auditors should be allowed to provide

other services to their audit clients. Once again, this includes voices from within our own country. In 1988 the then Executive President of the Johannesburg Stock Exchange condemned the provision of other services by auditors in this country as chasing after profitability rather than serving the community:

"Nog 'n saak waaroor ek besorg is, is dat die beroep in Suid-Afrika hom moet toespits op dië basiese ouditeringsfunksie waarvoor rekenmeesters unieke opleiding ontvang en kwalifikasies verwerf het. Dit ontstel my (die eertydse uitvoerende president van die Johannesburgse Effektebeurs) dat daar 'n neiging is om hierdie fokus te verwar met die lewering van 'n verskeidenheid van dienste in verwante maar dikwels ook randgebiede... Ek besef dis alles deel van die oënskynlik gesonde benutting van die bedryfseksonomie om winste te kweek, maar ek sien dit as synde die rekenmeestersfirmas eerder verdienste najaag as voortreflikheid tot voordeel van die gemeenskap." (Norton 1988:2).

The reader is also referred to Sommerfeld, *et al.* 1987; Johnson 1988:118-121; English 1989:47-51; The Public Oversight Board of the Institute of Certified Public Accountants (Hines 1989:83); Waller 1991:55; Hudson, *et al.* 1992:22; Mitchell, *et al.* 1993:15-17 who are all providing strong and solid arguments against the provision of other services.

In 1992/93 questionnaires were sent to financially knowledgeable persons in South Africa to evaluate the perceptions that exist with regard to the auditing profession and their products. In the resulting report (Gloeck 1993), the following written remark by one of the nearly 6 000 respondents is cited as summing up the general feeling:

"The auditor may be a "watchdog rather than a bloodhound", but the profession short sells the public and shareholders, in my view, by allowing itself to become management lapdogs." (Gloeck 1993:260).

The following extract from *The Accountant* in the United Kingdom adds to the argument for banning auditors from providing other services to their audit clients -the author of the article is referring to the South African situation:

"Some members of the profession have labelled the provision of other services as "red herrings" in establishing true independence. But when seen in the context of users' confidence in the audit report, the negative effect of providing other services is alarming.

Of the respondents who said they have little or no confidence in the audit

report, 83 percent mentioned a perceived lack of auditor independence and 61 percent pointed to the negative effect associated with the provision of other services by the auditor.

In contrast, there seems to be less concern arising from doubts about the audit work itself: only 7.5 percent of respondents who lack confidence in audit reports mentioned factors like unprofessionalism, low quality audit services, unsatisfactory involvement of partners on the audit and a lack of technical competence.

The effect of the proposed ban on the profession and individual audit firms, cannot be easily determined. A survey of South Africa's top 200 listed companies revealed widespread deviation from the legal requirements on disclosing amounts paid to auditors for other services.

Section 283 of South Africa's Companies Act requires that the amount paid to auditors be broken down into three categories: audit fees, fees for specified other services and expenses. But the general trend among the top listed companies is to disclose only one amount paid to the auditor.

This lack of information on the extent to which other services are provided inhibits a proper evaluation of auditor independence and is a further reason for the report's proposal that audit firms be banned from providing other services to their clients."

(Gloeck 1994:9).

In addition to the above it can be submitted that the provision of other services by audit firms to their audit clients leads to unfair competition. The temptation to use audit as a "loss leader" increases as the lucrativeness of the other services increases. The statutory audit reservation which has been described as a monopoly (Mitchell *et al.* 1993:16) is then misused as the statutorily appointed auditor enjoys a privileged position to offer other services during his audit engagement.

For those arguing that better knowledge of the client's business due to the continuous involvement through the provision of other services will result in a beneficial reduction of audit fees, it might also be interesting to note that Simunic (Simunic 1984:699) concludes that:

"...audit fees for clients who also purchased MAS (Management Advisory Services) from their auditors are higher than those of clients who did not do so."

In South Africa, the lack of auditors' independence is critical. Based on the foregoing we repeat the call for an independent Commission to be appointed by Government to investigate the fundamental aspects of auditors' independence. Until the profession has been accountable to such a Commission, current evidence is sufficient to substantiate a ban on the provision of other services to auditors' clients.

9. THE AUDIT REPORT

The audit report is the final product of the audit process (SAICA July 1983: AU 310 & SAICA December 1990b:AU 321 Revised). Due to the current arrangements, entrenched in the Public Accountants' and Auditors' Act (PAAB 1993) and the Code of Professional Conduct (SAICA 1992a), specifically with regard to the aspect of confidentiality, the audit report is the only visible product of the audit process to the shareholder.

The wording of the audit report is set in terms of a statement on auditing standards (SAICA December 1990b:AU 321 Revised). Virtually the only variation that is found in published audit reports is in the formulation of an explanatory paragraph preceding a qualified opinion. The South African auditing profession does not have a record of issuing qualified audit reports (Editorial: Accountancy SA July 1993:3).

Therefore audit reports in South Africa look virtually alike, but for different financial year ends, signatures and dates.

In view of the above fact, it is therefore of crucial importance that the wording of the audit report carries the approval of users of auditing services, users of audit reports and more generally includes and harmonises with socially accepted audit objectives.

Also with regard to this aspect, empirical evidence of the South African situation is available. Only 44% of financially knowledgeable persons feel that the new format of the audit report is an improvement.

"Amongst directors 66% feel that the new format of the audit report is not an improvement... Shareholders also feel that it is not a change for the better. Shareholders in private companies are relatively dissatisfied with the changes."

(Gloeck & De Jager 1994:40).

The above findings are supported by the opinions of nearly 6 000 respondents.

A study of the audit reports included in the financial statements of the 200 top companies as ranked by the *Financial Mail* in 1992 (Financial Mail June 26 1992), showed that problems were experienced with the manner in which the guidelines contained in the statements on reporting standards (part of the generally accepted auditing standards) were put into practice (Gloeck & De Jager 1994:195-218).

As DP12 does not address the problems experienced with the audit report, we recommend that an independent Commission be appointed by Government to investigate how the audit report can incorporate the needs of users of auditing services; to investigate the related reporting standards and the auditing statement on reporting standards.

10. MORE ARBITRARY RECOMMENDATIONS

10.1 Limit fee income derived from one client:

The Expectation Gap Ad-Hoc Committee proposes that there should be a mandatory limit with regard to the gross fees that may be earned from one single client. In the absence of any information as to the total fee incomes by audit firms and their associates it is impossible to even comment on or assess the effect that such a constraint would have.

This aspect demonstrates that certain relevant information has not been incorporated into DP12.

- Throughout DP12 frequent reference is made to the document prepared by the Auditing Practice Board "*The Future Development of Auditing*".
- When proposing a maximum percentage of total income which an auditor may derive from one single client, a reference is suddenly made to the **Australian** document which recommends a 15% ceiling (ASCPA & ICAA 1993:122).
- "*The Future Development of Auditing*" does, however, contain the following recommendation:

"...the current requirements...placing a limit on fees earned from one company, of 10% of the auditing firm's gross fee income are sufficient...".
- "*The Future Development of Auditing*" goes on to say:

"...although the present level (10%) could, it is thought, be easily reduced." (Our emphasis).

- No mention is made of the recommendations of the Financial Reporting Commission ("*Report on the Commission of Inquiry into Expectations of Users of Financial Statements*") which recommends that: "*The Institute of Chartered Accountants in Ireland should reduce from fifteen to five the percentage of the recurring gross fees of a practice which can come from a client or group of clients.*" (Our emphasis). (ICAI: 1992:117).

10.2 Capping auditors' liability:

In the absence of public disclosure of audit firms' turnover, income, et cetera, there is no basis for evaluating the substance of the claims made that litigation is crippling the profession in South Africa.

It seems that overseas scenarios are intertwined with the South African situation and the impression is generated that the cost of litigation is the greatest crippling factor for South African audit firms. This is highlighted in the following scenario sketched by the President of SAICA whilst talking on national radio in South Africa:

"The liability issue is a separate although related issue and what is happening overseas is that the auditors are regarded as having deep pockets, they are the ones who carry insurance and when there is a failure or a major fraud the directors normally flee the nest and those who are left in line are the auditors and they usually get sued for the whole of the loss albeit that they may only be responsible for a portion of the loss. And in fact to just give you some idea of how serious this has become, in the USA for example, claims against public accounting firms are in the order of thirty billion US dollars which is hundreds of times greater than their capitals and they will be wiped out if those claims came to fruition... and that's were we believe there should be some sanity brought back into this market because if this level of claims goes on there will no longer be a profession and quite frankly we anticipate that one of the major accounting firms will fail in the not too distance future."

(Radio Today: 3 May 1994).

It should also be noted that there is a distinct difference between auditors being sued due to actual negligence on their part and so-called "unjust law suits" against audit firms. The two should not be combined in the plea to cap auditors' liability. The advocates that want auditors' liabilities to be capped should present evidence (in real South African Rands) to show the extent of successful

so-called "unjust law suits". It is submitted that such cases yet have to occur in South Africa.

It should also be noted that due to the fact that auditing firms do not publish information on their business affairs, the real cost audit firms incur to insure themselves against law suits, is not publicly known.

The users of auditing services receive no guarantees from their auditors that the audit fee will not exceed a certain amount - and quite rightly so: the fee is determined by the extent and complexity of the audit work. Why should shareholders therefore agree to limit their auditor's liability? The extent of damages should be determined by the extent of the negligence on the part of the auditor and the loss he/she has caused users of his/her services.

DP12 attempts to fight "low balling" by audit firms by including a sentence in the Code of Professional Conduct outlawing such a practice (DP12 para. 108.6). It is, however, submitted that the capping of auditors' liabilities *"...would encourage some accountancy firms, which are already perceived to be aggressive 'low ballers' in the marketplace, to introduce the question of professional indemnity limits as part of their commercial negotiations for attracting new clients. Thus, rival firms' clients could be offered a considerably reduced audit fee on the basis that a low level of liability is agreed."* (Douglas 1994:70).

A notable stand with regard to the capping of auditors' liabilities, is found in an official statement from the Chartered Association of Certified Accountants (ACCA) in the United Kingdom:

"Auditors have no right to be protected from the consequences of their professional negligence... it would be inappropriate for legislation affecting all company audits to be changed in the interest of a minority of the profession, we (the ACCA) do not consider that such a cap would be in the public interest." (Our emphasis).

"...members of other professions also face loss of livelihood, if not financial ruin, if they 'get it wrong', for example doctors...The collapse of one or more of the large firms would not be anything like as damaging to the public interest as the firms' submission suggests. Competition for work would remain, and there would be no long-term effect on employment since the majority of audit and support staff would still be needed, albeit by other firms." (Speechly 1994:3).

More perspective on the topic is provided in *Accountancy Age* (Accountancy

Age, April 1994) with reference to a debate on the limiting of auditors' liability: "*One of the most significant questions from the floor in last week's debate was all the more telling because it did not get an answer. It was, to paraphrase: 'What's in it for the client?' The audit cap the big firms are looking for would be a voluntary arrangement entered into with the client. The answer is straightforward: in return for a contractual cap on liability, the auditors will cut their fees - but this is not something which can be comfortably said out loud by the big firms' spokesmen. Not all firms would be able to capitalise on this opportunity, which is why many practitioners outside the big six do not support their campaign. The move would also raise some corporate governance issues: directors could be accused of selling their shareholders' interests short in order to cut down on overheads in the short term. Given that in many cases the auditors' liability arises from failure to spot the directors' mistakes, or even dishonesty, one might well ask whether a capping agreement between auditors and directors is such a good deal for shareholders.*"

The point on the capping of auditors' liabilities is adept summarised (Mitchell *et al.* 1993:20):

"...it is a point of law that all producers of goods/services should provide goods/services which are of acceptable quality. Anyone injured has the right to go to the courts and seek redress. We can see no reason why the auditing industry should be exempt from such responsibilities."

Turning to the South African scenario it is therefore interesting to note that in *The Accountant* of October 1992, the Executive Director of SAICA, when asked whether there has been much litigation against auditors in South Africa, is quoted as saying: "*It's not nearly as serious a problem in South Africa as it is elsewhere. I think its a cultural thing. Americans are litigious people, South Africans are not.*" (Brady 1992:13).

What is important about this remark is that it clearly indicates that litigation against auditors in South Africa is not seen as a problem - the choice of the word "*elsewhere*" can in fact be interpreted as having the meaning that all other countries experience a bigger problem in this regard. Such a conclusion would be in line with the findings of the expectation gap study in South Africa (Gloeck 1993).

SAICA's Expectation Gap Ad-Hoc Committee, however, seems not to have taken the same stand as the organisation's Chief Executive. The issue of limiting auditors' liabilities is addressed in depth and made one of the main themes of DP12. This raises the question of whether the South African situation could have deteriorated so drastically within eighteen months. Whilst a study

of South African literature revealed dissatisfaction with regard to the auditor's role, insufficient evidence could be found to support such a supposition. If the Expectation Gap Ad-Hoc Committee holds such evidence, it should be published so it can be used in independent analysis.

DP12 states that recommendations have been made to the SA Law Commission to establish proportionate liability for auditors (DP12 para.100). This has, however, apparently been done without prior consultation amongst the wider member base of the profession. DP12 is therefore used as a medium to communicate a decision to its members. This raises the question whether such a request (to the SA Law Commission) will be withdrawn if comments received on DP12 indicate that members of the profession and users of auditing services do not support such a capping of liabilities.

10.3 The use of audit committees:

The question with regard to the use of audit committees is another example where the Expectation Gap Ad-Hoc Committee seemingly did not make use of empirical evidence available in South Africa. The use of audit committees was the subject of an intensive research project in 1992 at the University of the Orange Free State (Marx 1992). Reference to this study provides valuable information concerning the establishment and functions of established audit committees in South Africa.

Without reference to a particular study or document, the impression is created that the Expectation Gap Ad-Hoc Committee, speculates with regard to the deficiencies of audit committees in South Africa "*However, some concern exists that in South Africa there might be an insufficient number of competent non-executive directors to form audit committees for all listed companies*" (DP12 para.74).

In spite of the voiced concerns, the audit committee is used by the Expectation Gap Ad-Hoc Committee as a cornerstone in its strategy to address numerous problems identified.

10.4 Using the internal audit function:

The Expectation Gap Ad-Hoc Committee makes no effort to incorporate the activities of established internal audit departments into their framework of recommendations.

This matter could have been investigated by the Expectation Gap Ad-Hoc Committee because many South African companies have internal audit

departments and South Africa has its own organised internal auditing profession.

11. THE COMPULSORY AUDIT OF SMALL OWNER-MANAGED COMPANIES

As already indicated, DP12 refers to financial statements. As this term is not qualified it must therefore be seen in its broadest context. Many recommendations the Expectation Gap Ad-Hoc Committee makes, are, however, meaningful and effective if they were to be implemented in listed companies only.

It is therefore necessary to know what recommendation SAICA has in mind with regard to the audit of small owner-managed companies, before one can meaningfully comment on the other proposals contained in DP12.

At this point, note should be taken of the comprehensive title of the document:

"Meeting the financial reporting needs of users of financial statements in South Africa."

However, DP12 does not include any recommendations with regard to the compulsory audit of small owner-managed companies. It is only mentioned that the issue will be addressed in a future Discussion Paper (DP12 para.30).

All role players in the South African economy have been called upon to help eliminate unnecessary cost and focus our country's scarce resources on addressing social imbalances and national priorities.

The following evidence was published in August 1993:

- *"In the last decade there has been a complete change of opinion with regard to the abolition of the compulsory audit of private companies. In this study 64% of respondents indicated that they did not endorse the compulsory audit of smaller owner-managed companies, while in 1981/82 75% of the respondents were still in favour thereof."*

(Gloeck & De Jager 1993:41).

- *"The abolition of the audit of small owner-managed companies is supported by more than 75% of all auditors. Those who are probably most involved with this kind of auditing: partners in small auditing firms, are the greatest advocates of changing the compulsory audit into a limited review engagement."*

(Gloeck & De Jager 1993:45).

- The audit of small owner-managed companies is a factor that significantly contributes towards the expectation gap. This became clear when analyzing the responses relating to three questions:
 - Do you agree that an audit is of little benefit to a company?
 - Do you agree that audits generally take too long to complete?
 - Do you agree that audits are generally unproductive?

Generally, the highest number of affirmative voices came from shareholders of private companies.

We submit that as the South African Institute of Chartered Accountants has postponed the matter (DP12 para.30) **the Government should, as a matter of urgency, investigate the abolition of the audit of small owner-managed companies.** SAICA must be seen as representing producers' interests and its role with regard to the recommendations should be moderate.

This is a matter which the users of auditing services will have to decide.

12. STEPS TO ENSURE ADHERENCE TO AUDITING STANDARDS

The Expectation Ad-Hoc Committee recommends that accounting standards must receive legal backing (DP12 para.18). The current application of accounting standards in South Africa is described by the Technical Director of SAICA as remorseful: *"This, combined with a lack of policing and South Africa's own brand of accounting morality - often supported by preparers and auditors alike - has led to a sorry state of affairs."* (Singer March 1994:7). Yet is it not the South African Institute of Chartered Accountants that has been in command of the process to develop and emanate accounting standards for the past 20 years?

The Companies Act has been in force since 1973, more than 20 years. The Constitution of the South African Institute of Chartered Accountants (SAICA: July 1992 Member's Handbook, Constitution:2) contains the following objective:

"To consider and pass comment on actual or impending legislation in the Republic of South Africa affecting the accountancy profession or otherwise and to apply for, petition for, or promote any Act of Parliament or other legislative enactment desirable for the betterment or enhancement of the profession of accountancy."

Why, it can be asked, has the Institute allowed the situation to develop into "a sorry state of affairs" before a petition is made for legal backing of accounting standards?

The same can be said with regard to auditing standards. Yet DP12 does not discuss the possibility or desirability of legal backing for auditing standards.

The Expectation Ad-Hoc Committee recommends that "*Those that become aware of this practice (opinion shopping) taking place should be encouraged to report it to the PAAB for investigation*" (DP12.82).

This is not a new concept as it has been tried by the profession's controlling bodies before. However, these steps were not successful:

"The Maintenance of Standards ad-hoc committee gave rise to a voluntary reporting programme by those with knowledge of sub-standard work in terms of Circular 8/89 of SAICA and Circular B1/1989 (replaced by B.1/1992) of the PAAB. The programme failed in as much as very few cases were dealt with." (Our emphasis).

(SAICA & PAAB 1 April 1994).

The above example provides further evidence that the Expectation Ad-Hoc Committee has not incorporated into their recommendations relevant and available information relating to the South African auditing profession.

The Chief Executive of South African Institute of Chartered Accountants and the Executive Director of the Public Accountants' and Auditors' Board in a joint newsletter reminded their members of the audit profession's social responsibilities:

"The attest function is reserved to our profession by statute, not because it is to the advantage of members of the profession, but for the protection of the public." (Our emphasis).

"Whilst a profession has certain rights and privileges, it also has obligations to the society which gives it those rights." (Our emphasis).
(SAICA & PAAB 1 April 1993).

DP12 should be seen and evaluated against the background of such responsibilities.

13. RECOMMENDATIONS

Although DP12 raises many questions and portrays a seemingly enigmatic situation, empirical evidence has, however, identified some very specific problems in South Africa.

- In South Africa, the lack of auditors' independence is critical. Based on the foregoing **we hereby call for an independent Commission to be appointed by Government to investigate the fundamental aspects of auditors' independence.**

Until the auditing profession has been accountable to such a Commission, current evidence is sufficient to substantiate **a ban on the provision of other services to auditors' clients.**

- Apart from the overwhelming support evidenced amongst financially knowledgeable persons and auditors alike, towards the abolition of the audit of small owner-managed companies, our country cannot afford products that are not meeting the needs of our society. As the South African Institute of Chartered Accountants has postponed the matter **the Government should, as a matter of urgency, investigate the abolition of the compulsory audit of small owner-managed companies.**
- **The role of the auditor** will have to be clarified. Since the origin and existence of auditing is based on the requirements of users of the reporting process, the role of the auditor will have to be redefined, **but with due consideration for the requirements and expectations of users.**

The process by which this is achieved should not be directly undertaken by the professional body, so that it will be acceptable to all parties. In addition, the process should take the form of an investigation, involving representatives of all stakeholders in order to give them ownership of the process.

We recommend that an independent Commission should be appointed by Government to investigate how the audit report can incorporate the needs of users of auditing services and to investigate the related reporting standards and the auditing statements on reporting standards.

- Before the "capping" of auditors' liabilities can be considered, **the audit firms seeking such a limitation of their liability should accept the principle of full disclosure of fees earned, profitability of the audit function, and the extent of their other social contributions.**

The SA Law Commission should note that the wider member base of the accountancy and auditing profession has not been consulted before recommendations to limit auditors' liabilities have been drafted and submitted to the Commission.

- The campaign of legal backing for accounting standards should persevere, but **auditing standards should also receive legal backing.**
- **There must be a drastic move to open up processes.** The workings of the professional auditing bodies must be transparent and fully accountable to its members as well as the users of auditing services. Processes through which audit policy documents are issued must be drastically adjusted to incorporate the opinions of the widest possible member base and user groups.

The Expectation Ad-Hoc Committee must, for example, be recomposed in order to be representative of the heterogenous nature of the profession and users of auditing services: no single group within the profession and no single consumer group may be in a majority and thus in a position to control the agenda and outcome.

14. CONCLUSION

With regard to DP12, it is concluded that, in the view of the shortcomings identified and examined in this paper, both with regard to the process and product, DP12 has largely failed: to meet its objective; to assist in narrowing the audit expectation gap; and to address the financial reporting needs of users of financial statements.

By not addressing certain critical aspects, the good reputation of the auditing profession is compromised and the public interest is not served.

Although shortcomings in DP12 were identified, we believe that this could herald the beginning of a meaningful, participating process that can, eventually, result in representative products that will not only narrow the audit expectation gap in South Africa, but ensure that auditing will continue to hold its rightful place as a cornerstone of corporate governance.

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