

A public interest perspective of the auditing standard setting process in South Africa

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"The essence of a profession is found in the grant by society of a special franchise in return for which the profession accepts responsibilities to provide a degree of regulation and enforcement... thereby relieving society of the burden of providing that control by other means"

(Mautz 1988)

ABSTRACT

The auditing profession has been criticised that auditing standards favour the self-interests of a limited number of members or certain constituencies of society and not society at large. As auditing is a means of social accountability, all social constituencies have a legitimate interest in defining what is termed as generally accepted auditing standards. The state would undertake the regulatory function of auditing standard setting itself, were it not for the processes administered and managed by the self-regulating bodies. Auditing standards are therefore supplementary to legislation and can be described as quasi-legislatory. This paper examines the auditing standard setting process in South Africa and points to certain shortcomings which challenge the regulators' claims of legitimacy.

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Key words: audit, standard setting, self-regulation, public interest, role of the auditor; auditor's duties.

OUTLINE

This paper is structured in three parts. Firstly I argue the importance of auditing standard setting, its influence on social relations and furthermore its importance in legitimising the professionalisation of auditors. On these grounds I justify scholarly research of this phenomenon.

The second part of my paper focuses on the normative qualities of acceptable standard setting practices. These qualities are then juxtaposed upon the auditing standard setting practices in South Africa. I complete my paper by offering constructive direction which could lead towards greater endorsement of the standard setting process from a public interest

perspective.

THE ROLE OF AUDITING STANDARDS IN SOCIETY

The work of an auditor influences many constituencies (Hines 1989, Sikka 1992, Mitchell *et. al.* 1993, SAICA 1995c, Harding & McKinnon 1997). Audited information, in contrast to unaudited information, has a major legitimizing influence on social communications and the discharge of corporate and social responsibilities. The audit function plays a particularly important role where stewards of capital, labour and corporate wealth discharge their responsibility by reporting on certain aspects determined and defined by social arrangements, often enshrined in statute (Loots

1989 & 1994). The audit function therefore contributes considerably towards legitimizing the account given by corporate stewards.

Seen in the broader context of the function of financial statements to report to society on the employment of resources, wealth distribution and discharge of social responsibilities, the audit function also fulfils a role as society's watchdog.

Accounting and auditing practices, as experienced through the application of professional standards, directly affect the public and society. Depending on accounting practices applied, companies report either profits or losses and thus pay more or less tax. These figures are also used to determine payouts to shareholders, bonuses to the workforce and are used as the basis for negotiating wage increases. It is the auditor's function to add credibility to the figures and amongst others, to report if auditees do not adhere to accounting practices. This makes us aware of the prominent influence the auditor has on accountability relations affecting income distribution and resource allocation. Influencing powers, such as those found in the setting of accounting standards, normally reside with the State or other legislating bodies (Peasnell 1982, Laughlin & Puxty 1983, Dearing 1988, Hines 1989: 81).

South Africans make extensive use of auditing services and distinguish themselves as having an above average knowledge of certain auditing related products.

In 1993 a study conducted amongst 12,000 of South Africa's financially knowledgeable persons showed that 73% of the respondents (4,500) indicated that they have used the services of audit firms (Gloeck 1993: 207). 81% use financial statements in making an investment decision (Gloeck 1993: 216); 80% study the financial statements of companies when they receive them (Gloeck 1993: 219). 71% read the auditor's report when they study the financial statements of companies (Gloeck 1993: 221). Comparative figures (with regard to those who read the auditor's report) in similar studies are England 84% and Ireland 55% (Gloeck 1993: 222).

South Africa's financially knowledgeable persons display a relatively educated understanding of the audit report itself: 98.6% indicate knowledge of the difference between a qualified and an unqualified audit opinion. A similar study in England found only 68%

understand this difference (Gloeck 1993: 224).

These findings support the supposition that the audit report plays an important part in investors' decisions in South Africa and that the products of auditing labour influence our society and the South African public in general.

The products of accounting labour, or more specifically, *auditing* labour, in turn, are shaped by the standards which have to be applied during an audit.

These standards are considered crucial as they represent a formal, published record of how the work of an auditor should be conducted. In the absence of contrary information, the public and users of auditing services in general, accept that audit work is done according to the standards and pronouncements published by professional bodies.

Although the *Companies Act* (Companies Act 1973) requires every company to appoint an auditor (Section 269 & 270) and requires the auditor to issue an audit report which has to be published as part of the annual financial statements (Section 286 & 301), the *Companies Act* does not prescribe the *standards* which auditors have to comply with in conducting their audit. The *Public Accountants' and Auditors' Act* (PAAB 1997) regulates the work of an auditor, yet it does not refer to auditing standards which auditors have to adhere to. The delineation of what constitutes admissible and acceptable performance when exercising the audit function, is captured in pronouncements of a voluntary association of accountants: the South African Institute of Chartered Accountants (SAICA).

The claimed authority of auditing statements published by the SAICA extends beyond the sphere of the private sector auditor. Through the inclusion of a so-called "public sector perspective" (normally a short paragraph at the end of the statement), the SAICA claims that their statements also describe the auditing standards applicable in the public sector (SAICA 1995h). The SAICA even publishes specific statements applicable to the audits in the public sector as carried out by the Office of the South African Auditor-General and performance auditing (SAICA 1993a & 1993b).

This leads us to conclude that the SAICA is exercising powers normally confined to the State and other legislative bodies and that statements on auditing standards published by the SAICA

are supplementary to legislation and can be described as *quasi-legislatory*.

The development of auditing regulations through the publication of documents titled "generally accepted auditing standards" therefore provides a critical and highly relevant domain for theorization, analysis, research and debate (Abdel-khalik 1983).

As auditing and accounting standard setting activities have intensified over the last years, researchers and affected parties have increasingly engaged in this debate to influence the processes defining acceptable performance in audit work (Robson 1993, Risse 1995: 830; Harding & McKinnon 1997). In addition to this, there has been a noticeable change in the relationship between suppliers of services and the users thereof. Users have become better educated, more socially confident, aware of their rights as consumers and therefore they are more likely to complain when services are not meeting expected criteria (also refer to Colquhoun 1994: 75).

The investment public in South Africa has experienced an increasing number of institutional failures and there is also evidence of an audit expectation gap in South Africa (refer to Gloeck 1993 and Gloeck & De Jager 1993).

Although not all institutional failures can be attributed to audit failures, in some way or another, users of auditing services have expressed their dissatisfaction with the role that the auditors have played (refer to studies by Hunger 1981, Macdonald 1988, Steen 1989, Porter 1990, ICAI 1991, ACCA 1992, ICAEW 1992). Particular reference is made to the auditor's duty to detect fraud, to report on irregularities and to issue warnings where the going concern principle is compromised. If auditors, however, claim to be complying with auditing standards, there is a real danger that existing auditing standards may institutionalise audit failures.

The latter threat alone provides adequate reason to research, analyse and criticise the process which is presented as constructing socially acceptable pronouncements relating to the audit function (Hornigren 1973, Peasnell 1982).

REQUIREMENTS OF ACCEPTABLE STANDARD SETTING

The construction of auditing regulations is an area of emerging concern (Robson 1993: 1). In view of the aspects discussed in the foregoing section, it should be generally accepted that 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 continuous, visible, open and democratic negotiations and renegotiations between interested parties and those affected by the products of auditing labour. These social constituencies have a legitimate interest in defining the ultimate product as embracing socially accepted auditing objectives and standards (Hornigren 1973, Mitchell, *et. al.* 1993, Puxty 1990: 340).

When balancing the competing demands of those engaged in the standard setting functions, the standard setters (in the South African context a voluntary association of accountants) will be mindful of their own positions and their members' interests. This is why the system should provide for effective procedures, to balance undue influence by those who have a financial interest in the standard setting, since the outcome of the process directly affects aspects such as the nature and extent of audit work carried out (also refer to Peasnell 1982, Laughlin & Puxty 1983, Sutton 1984, Sikka 1992: 377-382, Robson 1993, McCandless 1994, Stevens 1997, Zaid 1997).

More particularly, such processes should be characterised by:

- Involvement of all players in auditing policy debates.
- Formal representation of all constituencies affected.
- Enshrined representation by democratically chosen representatives, specifically those advocating the public interest.
- *Elected* rather than selected members of the technical and decision making committees.
- Decision making based on stated norms, which enjoy general consensus and which are acceptable to the parties

- involved.
- Application of democratic principles and procedures such as voting procedures, open agendas, free access, the right to speak freely and the right to be heard, etcetera.
- Total transparency or “full sunshine” in all matters.
- Acceptance of a principle that sectional interests will be subordinated to the public interest.
- Acceptance of the fact that accounting and auditing are at least equally distinctive principles of social, political and economic organisation as they are technical practices.
- Auditing standards can therefore not be narrowly defined as internal technical documents providing guidance to audit practitioners (Sutton 1984). Auditing standards and public interest notions cannot be separated.
- Due process followed at all stages of the standard setting process, particularly in dealing with comments. Procedural aspects and criteria applied in dealing with comments and inputs to be formulated and published.
- The publishing of results of the standard setting process with regard to each professional pronouncement (the reader is referred to an enlightening discussion by Laughlin & Puxty (1983) on this subject).
- Thorough documentation and recording of all steps followed, influences, etcetera, with public access to these recordings.
- Empowerment of parties and interest groups historically excluded from the processes.
- Visible support, both financially and by stated intent of research processes aimed at studying, analysing and refining the standard setting process.
- Visible support and encouragement to persuade roleplayers and individuals to

take part in the process.

(also refer to Dearing 1988, Anonymous 1995, Cockburn 1995: 27-28, Craig 1997: 46-50).

To sum up, in democratic societies, social policies should develop in open, transparent, accountable and democratic ways (Mitchell 1995: 76).

CURRENT STANDARD SETTING PRACTICES IN SOUTH AFRICA

The observation of current practices of constructing auditing regulations and publishing them as documents of “generally accepted” auditing standards in South Africa, over a ten-year period formed part of the research methodology. Information pertaining to the procedures followed, official viewpoints, policies and practices relating to the auditing standard setting process, was obtained by studying available minutes, through research efforts directed at obtaining more details of standard setting practices, through enquiries and correspondence with the standard setting bodies, subcommittees and various office bearers of the SAICA. In this period, the author also served a term as member of the Auditing Standards Committee (ASC) of the SAICA and was part of a research team at the University of Pretoria.

Direct communications with the auditing standard setter was necessitated by the fact that no authoritative document is published which captures all elements of the auditing standard setting process. Other relevant documents are not publicly available and could only be accessed after letters of request to various office bearers and the secretariat of the SAICA. In numerous instances such letters had to be duplicated or readdressed to persons who were more sympathetic to the notion that information relating to a function which affects the public interest should be easily accessible and available for research purposes. Research efforts were further frustrated as official policies were subjected to personal interpretation by office bearers which prevented easy access to information pertaining to the standard setting process. Eventually, enquiries elicited a disappointing response.

In a letter from the SAICA's President (SAICA 1997c), the research team was told: “The Executive Committee believes that it is

unreasonable to expect the secretariat to deal with the volume of letters, faxes and other correspondence received from yourselves on a regular basis. The Institute ... simply does not have the staff or the infrastructure to handle enquiries of the complexity and in the volume that you as members expect. Accordingly, the Executive Committee has decided that in future the secretariat should take note of the content of your letters and, where appropriate, forward your views to the committees or interest groups concerned for noting. The secretariat has been instructed not to reply to your correspondence, other than in circumstances that it considers exceptional.”

Nevertheless, research is a resourceful activity which is not easily silenced or subdued. In searching for the truth, a number of shortcomings relating to the auditing standard setting process in South Africa were identified (refer to SAICA 1995a, SAICA 1995b, SAICA 1995d, SAICA 1995e, SAICA 1995g, SAICA 1997e):

- The standard setting process is secret: the ASC and other SAICA committees influencing the agendas of the ASC meet behind closed doors.
- Minutes of meetings of standard setting bodies and their committees such as the ASC are not freely available. Members of the public are not allowed to have sight of the minutes. Those SAICA members privileged to receive minutes, have to sign secrecy declarations before minutes are made available. As these bodies are pivotal in the standard setting process, approving the publishing of exposure drafts and approving the final standard setting documents, these restrictions prevent persons from following the auditing standard setting process, from analysing and evaluating its legitimacy and from formulating on-going meaningful comments. Meaningful comments regarding the proposed documents can only be forthcoming through a process of interaction and communication with all affected parties.
- Agendas of the ASC meetings are not available to non-committee members.
- Members of the ASC are *selected* rather than *elected*.

- Members of the ASC serve in their personal capacities and therefore do not represent any particular constituency or interest group.
- Members of the ASC have to sign secrecy declarations not to pass any information about committee proceedings to anyone, not even members of the SAICA.
- The ASC has neither public representatives nor representatives from major interest groups affected by auditing regulations in its ranks.
- Comments relating to the discussion documents published by the ASC must be made in writing. The ASC does not provide for forums such as public hearings or open sessions. This effectively restricts contributions and dissuades many commentators, as written comments require substantial time investments and a considerable measure of skill to formulate certain perspectives relating to the standard setting process.
- Officially the only way to influence the standard setting process, is through the submission of comments which are reviewed and evaluated by the ASC and working parties. The process of evaluating these comments seems highly subjective:
 - Criteria used to evaluate the responses are not known.
 - Comments are not weighted according to their source, completeness, etc.
 - The counting of “votes” “for” and “against” has been found flawed (for a detailed account of such miscounting the reader is referred to Gloeck & De Jager 1994 & 1995).
 - Normative decision making is not applied (the reader is referred to a discussion by Laughlin & Puxty 1983).

Individual preferences and individual interpretations therefore become pivotal and disproportionately weighted and it is highly probable that a committee under a different chairperson, let alone a

committee with different members, would come to different conclusions and therefore produce a different recommendation and differently worded pronouncement. Such a situation is highly undesirable.

The process of standard setting by the accounting bodies has been criticised for its propensity to grant greater legitimacy to the rationalizations of certain groupings and the resultant agendas reflecting only issues consistent with such rationality (Selto & Grove 1982 & 1983, Booth & Cocks 1990, Sikka 1992, Zaid 1997). Any "conflict" that might arise is preempted and possible objections are influenced through the publication of selected information which only accommodates competing options based on that rationality. Any "debate" is therefore limited as well as superficial, since the outcome has been prescribed as one of the "acceptable" options within this rationality.

The unavailability of minutes and agendas inhibits research on the validity of such claims in the South African context. But the existence of such dominant modes in the auditing standard setting process in South Africa is in some way supported by the fact that the SAICA pre-standards documents (exposure drafts) elicit very little comment and therefore give rise to speculation that role players have found alternative ways of influencing the standard setting process.

The number of comments received per auditing exposure draft has declined from an average of 20 for the period 1986 to 1994, to less than 10 in the period 1994 to 1995. A further deterioration has been observed with regard to the recent draft auditing statements which were issued as part of the so-called Harmonisation and Improvement Project. Five "batches" of documents containing a number of proposed standard documents have been issued (SAICA 1995f, SAICA 1996a, SAICA 1996b, SAICA 1997a & SAICA 1997d) (Batch 1 consisting of 8 statements: 15 comments; Batch 2 consisting of 5 statements: 9 comments; Batch 3 consisting of 4 statements: 10 comments; Batch 4 consisting of 5 statements: 12 comments). This constitutes a significant degeneration of the auditing standard setting process. The previous exposure draft on the audit report in 1989 (SAICA 1989) elicited 22 comments, whilst only 9 comments were received on the latest version of the audit report (SAICA 1997b) included in

Batch 4.

Furthermore, the pertinence of some comments received can be questioned, as they are in some cases curt, often amounting to little more than an acknowledgement of having read or received the document.

In spite of various recommendations and inputs as to how the response rate could be improved and the process be made more *inclusive*, the SAICA has maintained its exclusive approach.

It is acknowledged that a limited measure of reform has been introduced to the auditing standard setting process with the publication of the Exposure Draft *ED115* "Preface to South African auditing standards and related services" (SAICA 1997e). This document is, however, only a consultative document issued for comment.

Other notable aspects affecting the auditing standard setting process, and which contribute towards exposing the process to criticism and which undermine the credibility of the auditing standards, is the marginalisation and lack of support for certain constituencies who actively participate in the standard setting processes.

- Research directed at measuring the compliance to auditing standards by major firms (Gloeck *et. al.* 1993), was met with public, unsubstantiated disparagement by the standard setter (refer to *Cape Argus* 1994, *Sunday Tribune* 1994, *The Citizen* 1994). This was in spite of the fact that such research has a major contribution to make towards the development of auditing and the refinement of auditing standards and procedures (for a more detailed account refer to Gloeck & De Jager 1995).
- It is also important to note that the above mentioned research identified a number of deviant practices regarding the application of reporting standards by South Africa's major auditing firms.
- Instances have been recorded where the SAICA has denied members and researchers access to comment files. This was done in spite of the fact that the exposure drafts contain a covering letter stating that all comments are on public record (unless otherwise indicated by the

commentator). It also became apparent that no explicit policy exists as to who has access to documents and comments submitted; or that existing policies are applied at the discretion of certain office bearers.

It is acknowledged that after extensive correspondence voicing disapproval of these practices, access is now granted more readily.

- Comment files are, however, only available *after* the standard setting process has been “completed”, a highly subjective criterion, as it can be easily argued that the standard setting process is never really “completed”. This consideration can be used to indefinitely deny access to comment documents.
- Conflicting instructions from the secretariat, however, state that the relevant committees will decide when to release a particular comment file. This has added an element of subjectivity which can be used to further enhance the exclusivity and secrecy of the standard setting process.
- The elitist and exclusive standard setting process is further entrenched by the levying of financial penalties for participation. In terms of the EXCO policy (SAICA 1995f), an amount of R 25.00 has to be paid for each *set of minutes* requested by a member. In order to participate meaningfully in the standard setting processes, the minutes of various standard setting bodies and their sub committees have to be obtained and studied regularly and the cost of obtaining all relevant documents therefore becomes substantial. This further discourages members and disempowers many individuals from participating and promotes both the exclusiveness of the process as well as diminishing the degree of acceptability of the final product (also refer to Sutton 1984).

Whether or not the above restricting influences and practices are introduced as part of a definite agenda, is open to speculation. The excommunications of researchers, however, clearly reveals how the current standard setters intend dealing with enquiring individuals. It is

therefore necessary to turn to office bearers' public statements for explanations of their rationale and interpretations regarding the auditing standard setting process.

In this regard the remarks by the chairperson during the proceedings at a highly publicised conference on the audit expectation gap, hosted by the standard setters, provides some insight. The fact that the speaker was the Chairperson of the ASC at the time, is of particular significance.

“...are we talking self-interest here, or are we talking some sort of fuzzy ‘We are here for the benefit of society stuff?’ I always get suspicious when people start creating these halos around ‘We are here for the good of society’. You know, I am not sure that people work like that.”

“I genuinely believe that we should be masters of our own destiny, we should be deciding what markets we want to be in, and what markets we want to provide ... I believe that we must retain control of what we do ... Perhaps if I didn't make that clear, I was certainly saying that we should be in control of what we decide we provide and not simply run after whatever the client wants...” (Harte 1994).

“Turning to the role of SAICA and PAAB ...(Public Accountants' and Auditors' Board), and this whole issue of self-interest ... I would see SAICA and the PAAB as being really representing our industry ... they represent our interests in the industry. I don't see that they should be representing the interests of society, and being on the side of society ... They're our societies, our structures. Let them work for us.” (Harte 1994).

These statements display insensitivity to the needs of users of auditing services and the public in general. They do not accommodate the public interest but instead focus on serving self-interests only (for a discussion of the dangers this view may hold, refer to Laughlin & Puxty 1983).

CONCLUSION

This discourse has identified major shortcomings in the auditing standard setting process as undertaken by the South African Institute of Chartered Accountants. These shortcomings challenge the authority and legitimacy of the published statements as being socially accepted products or termed "generally accepted".

This predicament has a profound impact on the legitimacy of the standard setting process and

negatively influences the esteem and status of the auditing profession. In the interest of the public, users of auditing services and also the auditing profession itself, serious attention has to be given to reform of the auditing standard setting process so as to more closely align it to the requirements of a democratic, inclusive and open process.

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