

Seeking a brighter future for auditing in South Africa

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“The auditing industry has abused its monopoly of the external audit function. It should now beware of its friends who believe in unfettered markets. In the face of its manifest failures, it will not be long before the New Right is suggesting that external audits should be open to business other than just the accountancy firms. Accounting firms have entered the consultancy arena to compete against established firms, it would be argued: let these firms in turn compete on the auditors' territory.”

“There are already calls for the abolition of external audits. Such calls are likely to get louder. The unelected leaders of the profession are more concerned with empire building than with the long-term needs of society. If auditing is to have any social value then far reaching reforms must be instituted.”

(Mitchell, Sikka, Puxty; 1993)

ABSTRACT

This is a Position Paper on structural reforms in the South African audit industry. This Paper is presented at a time where the existing legislation regarding the auditing industry is being reviewed by a committee consisting of South Africa's Public Protector and a retired judge with a view to producing a Bill to be tabled for approval in Parliament. The authors hereby heed calls made by the drafters of the new statutory framework to present suggestions regarding the transformation of the audit industry in South Africa and addressing existing shortcomings. The authors propose the formation of a new body (or the transformation of the existing Public Accountants' and Auditors' Board) to perform additional functions which would strengthen the statutory framework within which auditors operate. The proposals also discuss and address social priorities and imbalances in South Africa.

Key words:

accountability of auditors, audit malpractices, audit regulators, auditor appointment, auditor independence, auditor liability, auditor rating system, auditor remuneration, community service, self-regulation, Public Accountants' and Auditors' Board, public interest, Regulator of Assurance Providers

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- *auditing and accounting practitioners;*

- former and current office bearers of accounting institutes;
- other concerned citizens who, on reading our earlier reports and articles have taken the trouble to either write to us or otherwise personally contact us.

The authors' premise:

The authors of this Position Paper believe that auditing is a cornerstone of accountability. Auditing, as described in hundreds of textbooks, is an important function of social control.

Current practices, outdated legislation, a hostile environment and ineffective regulation have devalued the external audit function to such an extent that the concept of statutory prescribed external audits is facing the real threat of extinction.

*Our proposals in this Position Paper aim to address these fundamental shortcomings as we **seek a brighter future for auditing in South Africa.***

Personal views:

The opinions expressed in this research report are those of the authors and are not necessarily shared by the institutions with which they are associated or the committees on which they serve.

The state of auditing in South Africa

Statutory regulation of the South African auditing profession is contained in *The Public Accountants' and Auditors' Act* (No. 80 of 1991). This Act replaced the Public Accountants' and Auditors' Act, No 51 of 1951. Although certain differences between the two Acts are identifiable, these are mainly found in the increased limitation of auditors' liability in the 1991 Act (Section 20). The duties and responsibilities of auditors, however, have been fundamentally unchanged since 1951.

The auditor in South Africa operates in an environment which is not conducive to enhancing his independence. For example, the *Public Accountants' and Auditors' Act* (Section 20(3)) allows an auditor to make closing entries or assist with adjusting entries or frame the balance sheet and other auditee accounts, without even reporting his/her own involvement to the stakeholders (e.g. shareholders). The *Public Accountants' and Auditors' Act* does not prohibit the auditor from providing other services to the auditee. The Act neither regulates, nor provides a mechanism for the setting of auditing standards. Existing South African auditing standards formulated and published by a voluntary association of accountants, the South African Institute of Chartered Accountants (SAICA), merely mention auditor independence (SAICA 1996a: para.04).

Whereas in 1989 more specific guidance was given auditors in a separate statement on *independence* (SAICA 1989) this statement has become a victim of the so-called "Harmonisation Process" carried out by the SAICA in the late nineteen nineties. Furthermore research has provided evidence that existing the South African auditing standards were formulated through a process which is exclusive and lacks credibility (Gloeck, 1998: 9-21).

The aim of this Paper is not to discuss at length the problems facing South Africa's auditing industry. The reader is referred to a range of publications by the authors published over a six-year period (see "References").

The audit industry is in a self-diagnosed state of crisis. We suffice with the following quotes:

According to the Chief Executive of the largest accounting institute in South Africa, the South African Institute of Chartered Accountants (SAICA), "accountants and auditors *have lost all credibility* (Klein 1994: 19)" (Our accentuation).

The Commission of Enquiry into the Affairs of the Masterbond Group of Companies and Investor Protection (Nel 1997) has described South African auditors as "dishonest and inefficient" (Nel: 1997: 9, 45, 49, 50). The four volume *Nel Commission Report* has provided ample evidence to support claims that virtually

all major South African audit firms were involved in disreputable actions, which included: "signing of false certificates, signing unqualified reports relating to blatantly false financial statements, changing accounting policies to convert loss situations into profit situations without proper disclosure, backdating audit reports and assisting in misleading the Receiver of Revenue" (Nel 1997: 50-52).

Research by independent institutions shows that auditors do not adequately adhere to auditing standards (refer to the *Facts on Audit Firms in the Republic of South Africa* series of research reports). The Practice Review Programme which the SAICA is running on behalf of the statutory regulator, the PAAB, supports this. According to the Practice Review Reports "the level of satisfactory reviews has stabilised around 67%" (SAICA 1996b). Yet during the past decade, as far as could be established, no auditor has been barred from practice for not adhering to auditing standards. The South African Institute of Chartered Accountants in its submission to the Nel Commission identifies shortcomings related to the disciplinary processes such as the slowness of the processes, its non-transparency, and exclusivity (SAICA 1998a Section L: 3).

The South African Institute of Chartered Accountants, the body which arrogated the auditing standard-setting function in South Africa, does not support independent research and according to the SAICA's Chief Executive, they only welcome research which is in line with the strategy of the Institute (SAICA 1996). Enquiries at the PAAB and the SAICA revealed that neither body is directly funding or supporting independent academic research programmes, apart from nominal grants to individuals to further their personal studies (masters or doctoral degrees).

Companies Act contraventions which have been reported to the Public Accountants' and Auditors' Board and the South African Institute of Chartered Accountants have been played down and seemingly ignored (Gloeck 1997f).

The Public Accountants' and Auditors' Board is staffed by a handful of technical personnel and operates its Education, Investigation and Disciplinary Committees through voluntary auditors who give of their free time to preside over the acceptability of the actions of their professional colleagues (PAAB 1998).

In terms of auditing standards set and published by the South African Institute of Chartered Accountants, auditors have a minimal responsibility to detect fraud (SAICA 1997). According to the Nel Commission Report, the current requirements whereby auditors have to report material irregularities are inadequate and also not adhered to by the auditors (Nel 1997: 51 & 69).

Under the current system, auditors apparently find it difficult, almost impossible, to carry out their duties. Testifying before the Commission of Inquiry into the affairs of the Masterbond Group and investor protection in South Africa, the Chief Executive of the South African Institute of Chartered Accountants told the Commission that auditors of small and big practices are receiving death threats from their clients who say "if you don't do it this way, here's my .45 on the desk" (Nel 1998: 11921).

The South African audit industry is facing a crisis of great proportions. Recommendations made in this Position Paper must be seen against the background of this crisis.

The industry's own reform initiatives

In 1992 PAAB initiated a project styled the Future of Accounting Education in South Africa (FAESA). (PAAB 1995: 1). Although the objective of the project was stated as focusing on the educational aspects (hence its title), its recommendations centred around a four-tiered structure according to which all accountants and auditors in South Africa should be classified and categorised (PAAB 1994). The Central Working Committee of the FAESA project recommended that a Representative Council of Accountants be formed to regulate both the educational matters as well as the registration of holders of qualifications at each tier (PAAB: 1994: 125-155)

The PAAB subsequently formed what it called an *Interim* Representative Council (IRC) (of Accountants) on 25 January 1995 (PAAB 1995: 1). Over a three-year period, this body met at various occasions and formed various subcommittees. The deliberations of the IRC and the specially appointed Drafting Committee in 1995 (PAAB 1996 [Memorandum to the Proposed Accountancy Profession Act]) culminated in the publication of what was termed the "*Draft New Proposed Accountancy Profession Act*". (PAAB 1996). Although it is

generally accepted that the work of accountants and auditors greatly influences the public, the "proposed" Act was drafted through a process to which the public had no access, was not informed about and where the public and the users of accounting and auditing service in particular, had no representation. Neither the Department of Finance nor the Department of Trade & Industry (responsible for administering the *Public Accountants' and Auditors' Act* and the *Companies Act* respectively) were involved in or knew about the process.

A detailed analysis of the *Draft New Proposed Accountancy Profession Act* (PAAB 1996) revealed that no attempt had been made to address the various shortcomings of the current system of audit self-regulation (Gloeck & De Jager 1997b). The existing *Public Accountants and Auditors Act, (the Act promulgated in 1951)* with the exception of a few amendments, was included *unchanged* as a Schedule to the proposed *Draft Registered Accountancy Profession Bill*.

On 5 June 1997, the then Deputy Minister of Finance signalled in Parliament her dissatisfaction with legislative proposals designed to regulate the accounting and auditing profession (Ensor 1997: 2).

The Finance Ministry subsequently appointed a Commission co-chaired by South Africa's Public Protector, Advocate S.A.M. Baqwa SC, and former Chief Justice, Judge M.M. Corbett (this Commission has also been referred to as the National Consultative Forum (NCF) (PAAB 1997). Interested parties were invited to make their views known by giving written submissions to the Committee or addressing the forum held on 19 November 1998 (Sunday Times Business Times: 1998: 19).

Although a letter signed by the joint chairpersons, dated 19 July 1999 (NCF: 1999) envisaged the publication and circulation of a Draft Bill for comment by stakeholders, this had not materialised in November 1999 when *The Southern African Journal of Accountability and Auditing Research* went to press.

This Position Paper must be seen against the background of the above developments. It is a product of circumstances. It was formulated and published amidst calls to provide new ideas and structures which would ensure that the South African audit industry serves the interests of the South African public and users of auditing

services in particular. The Paper was forwarded to various role-players, including the NCF, the Nel Commission and various senior public office bearers and elected representatives.

Calls for a new dispensation

This Position Paper is the result of more than a decade's extensive research by the authors on the so-called audit expectation gap, self-regulation, auditing standard-setting and accountancy and auditing education.

The opinions published are supported by volumes of data, research material, correspondence with regulators and written exchanges with members of the profession and the public.

As already mentioned, this Paper does not give a detailed account of the problems underlying the current crisis in the audit industry. The reader is referred to various research reports and articles the authors of this report have published on this subject (consult the References at the end of this Paper).

These publications contain detailed references to international as well as local publications, articles and research reports, further elaborating on problems experienced by the accounting and auditing professions, in South Africa and overseas. Arguably most important of all, a study of our publications will provide the reader with a review of important statements made by the South African regulators.

Our detailed comments on the proposed *Draft Registered Accountancy Profession Bill* have already been published in a Research Report titled *Comments on the Proposed Accountancy Profession Act*. (Gloeck & De Jager 1997b) which have undoubtedly played a major role in shaping the process towards reform in the auditing industry.

Our Position Paper addresses the problems experienced in the South African accounting and auditing profession and proposes reforms which will directly address these problems.

By proposing to include the existing *Public Accountants' and Auditors' Act*, which is with few exceptions based on the Act promulgated in 1951, *unchanged* as a Schedule to the proposed *Draft Registered Accountancy Profession Bill*, the self-regulators have forfeited

any claims to being earnest in addressing the problems of auditing in South Africa and finding solutions which bear in mind the needs of users and the public interest.

This Position Paper has to be read in conjunction with our report: *Comments on the Draft New Proposed Accountancy Profession Act*, where we have expanded on the background of certain changes.

1 Audit and accountancy - two sides of the same coin?

Accounting and auditing are two different functions within the broader accountability framework:

- the auditor reports on the work of the accountants;
- the audit function is superimposed upon the accounting function;
- the accountant works under supervision and reports to management;
- the auditor works independently and reports to the shareholders.

Taking into account the above fundamental differences, auditors cannot be accommodated in a structure which is basically controlled by accountants.

Although it is not known exactly how many accountants are working in our country, unpublished and informal estimates have stated that every one chartered accountant is supported by ten accountants (there are 17,000 chartered accountants in South Africa (SAICA 1998b)). To this figure we must add those accountants who are working independently as well as public sector accountants. A figure of not less than 300,000 accountants is arrived at. Depending on how broad the definition of an accountant is, this figure could increase substantially.

Other than accountants, all auditors have to be registered with the Public Accountants' and Auditors' Board, and according to their latest information, there are 4,339 persons registered with them (PAAB 1999b). Not all of these registrants are actually practising as auditors. It therefore seems that the ratio of auditors to accountants could be close to 1:100. This figure alone shows that any structure which controls and regulates the audit function on the basis of representation of accountants and auditors, is

effectively a statutory backing for the marginalisation of auditors.

Since 1951, South Africa has had a *separate act for auditors*. Although this Act (*Public Accountants' and Auditors' Act*) has not kept up with the changes which were particularly prominent with regard to the following aspects, the challenge does not lie in classifying all accountants in tiers and keeping the existing *Public Accountants' and Auditors' Act* unchanged (as proposed in the *Draft Registered Accountancy Profession Bill*) but rather in reforming the existing legislation to meet the challenges and onslaught made by commercially driven motives and the defence of sectional interests:

- the defiant increase in the provision of non-audit services to audit clients;
- the changes in the composition and structures of major audit firms;
- the public's expectations;
- changing morality and ethical climate;
- emergence of other accounting institutes;
- the emergence of principles which underlie democratic societies, such as the protection of the public interest, transparency and accountability.

To suggest that we now move to a dispensation where accountants and auditors are ruled under one act (as suggested in the proposed *Draft Registered Accountancy Profession Bill*), amounts to breaking down the structures of accountability and good governance rather than strengthening them.

Since the provisions concerning the external audit function, as contained in the proposed *Draft Registered Accountancy Profession Bill*, are in essence still based on the first Auditors' Act of 1951, the Act (*Public Accountants' and Auditors' Act, No 80 of 1991*) itself now requires a fundamental review.

This review must be done on the basis of an independent enquiry into all aspects of auditing.

Taking the South African situation into account, the Report of the Commission of Inquiry into the affairs of the Masterbond Group and investor protection in South Africa could be extended to make provision for recommendations.

Matters which need to be examined, are:

- the general adequacy and appropriateness

- of auditing standards;
- the audit standard-setting process;
- the auditor's role with regard to fraud, and the auditor's reporting responsibilities;
- the appropriateness of the current examination as a means of judging whether or not candidates are suitable to act as auditors;
- the auditor's duties with regard to going concern matters;
- transparency of the audit process and the public's right to certain information;
- regulation of auditors, registration, quality control, liability of auditors, auditor punishment.

A later section will deal with these audit related matters in more detail and suggest reforms in this regard.

2 Should all accountants register?

Accountants fall into two main groups.

Group A Those employed in the financial departments of various organisations

It is inappropriate to try and regulate the accountants in Group A. They are employed on the basis of their academic qualifications, work experience and possibly their professional membership. They enter into employment contracts with their respective employers and if they do not meet the expectations of their employers, their services can be terminated, they can be given other assignments, retrained, et cetera.

Group B Those offering accounting and related services to the public

These accountants offer a service in the same manner as hairdressers, draughtsmen, garden maintenance services, painters, security specialists or butchers. Their services often include tax advice, sale and installation of computer equipment, advice on the safeguarding of assets and other related services.

The public chooses these service providers on the basis of the following criteria:

- qualifications;
- experience / reputation;
- membership of certain associations.

Before a member of the public trusts an accountant to provide accounting services to him/herself, the accountant can be asked to provide that member with information to facilitate an informed decision. If the information is not presented, the member of the public can take his/her business elsewhere.

There is no doubt that the public needs to be protected from malicious, negligent and unlawful actions by all of the above mentioned service providers. This protection is basically contained in our common law.

If a butcher sells poisoned or infected meat to the public, lives can be at risk. That is why a meat inspector has to stamp the meat fit for consumption. We rely on these blue stamps as they convey assurance that the meat is fit for consumption. That is why the meat inspector has to register and work according to very definite rules and regulations and needs to be properly qualified. He is there by law and neither can he be dismissed by the butcher, nor can we take our business elsewhere if he does not do his job properly.

Where appropriate, financial information is checked by an auditor who issues a report, which conveys assurances to the user that the financial information is "fit for consumption". Therefore those issuing certificates or reports which convey assurances, need to be regulated.

Accountants, however, need not be regulated in the same sense. If all accountants have to register, do *you* have to register if you "write up" the books of your own business, fill in your own tax return or if you do the same for your parents or sister? Arriving at a definition of *accounting services* alone

could prove to be very difficult.

It therefore does not make sense to regulate all accountants.

It makes even less sense to attempt to classify accountants in various mutually exclusive categories (or even "tiers") and then attach certain powers of self-regulation to each tier, or to include the independent auditor in one or more of these tiers.

The era of classifying people belongs to the past. Concepts such as mobility and accessibility only come to life if there are barriers and categories. We would rather see a society without such artificial barriers.

3 Protecting the public - the case for guarded designations

The public chooses accountants on the basis of qualifications, experience and also professional membership as indicated by various designations. We believe that the public needs some form of protection against persons presenting themselves falsely as members of certain accounting institutes.

At present, the professional designation of only one voluntary accounting association, namely the South African Institute of Chartered Accountants, enjoys statutory protection through the *Chartered Accountants Designation (Private) Act, 67 of 1993* (CA Act 1993).

Unlike the position in the United Kingdom, where chartered bodies have to adhere to the principles and standards of the *Royal Charter*, the privileges of the *Chartered Accountants Designation (Private) Act, 67 of 1993* are bestowed upon the South African Institute of Chartered Accountants without specific conditions or subject to the adherence to any fundamental criteria. It is generally accepted that this unique privilege has given the South African Institute of Chartered Accountants a competitive advantage and enabled it to present its membership status as having statutory recognition of being exclusive and distinguished. The *Chartered Accountants Designation (Private) Act* has also contributed considerably to the elitist image of the South African Institute of Chartered Accountants.

However, it seems as if the main purpose of the Act is to protect the public against persons who fraudulently present themselves as being members of the South African Institute of Chartered Accountants, whilst they are not in fact members.

This protection should, however, apply equally to all professional accounting bodies and institutes.

In its current form, through protection of only one particular designation of the members of a certain voluntary association, the Act does create the (not necessarily correct) impression that this particular designation is the only *real* accountancy designation.

We therefore propose that the *Chartered Accountants Designation (Private) Act, 67 of 1993* be amended (expanded) to include protection of the designations of other professional accounting institutes. The Act could be renamed the *Professional Accounting Institutes Designation (Private) Act*.

The new Act would not challenge existing rights, but merely correct historical imbalances.

4 Consultation amongst accounting institutes

For purposes of discussing matters of mutual interest to accountants, an *Accountants Consultative Forum (ACF)* should be founded. Various initiatives which have already been taken by certain institutes in this regard can be expanded upon.

The ACF would be a forum to discuss matters which affect accountants, and representatives from the various accounting institutes as well as accountants not affiliated to such institutes, would meet on a *round-table* basis, with no body presiding over another one on the basis of a larger member body, technical proficiency in a certain field or other criteria.

The ACF would meet once or twice a year and there would be an open agenda to discuss what the relevant institutes consider to be matters of mutual interest. Participation would be on a voluntary basis.

On the above basis the ACF would contribute towards addressing accounting related problems

and the ACF would be sensitive to voices from the public identifying matters of concern.

An example of such accounting related matters could be problems the various bodies may experience with the application of certain practices prescribed as generally accepted accounting practice. The ACF could formulate its concerns and suggestions for improvement and forward these to a representative accounting standard-setting body for consideration.

5 The Assurance Act

We propose the development of an act to be known as the *Assurance Act* to regulate persons offering attestation services which provide assurances to the public.

The provision of assurances is a matter of national concern and the Department of Finance should therefore administer the Act at national level.

The *Assurance Act* will regulate any report which conveys *assurances* to the public. Various processes provide varying levels of assurances, for example:

- The highest level of assurance is conveyed through an audit and the resultant audit report;
- a review engagement provides a lower level of assurance than an audit;
- as do agreements procedures to perform agreed upon procedures.

All persons who wish to provide assurance services have to register in terms of the *Assurance Act*.

Under the *Assurance Act* a body known as the Regulator of Assurance Providers (RAP) is established.

Although certain detail aspects will have to be finalised through a process of consultation, the Regulator of Assurance Providers will perform the following functions and operate as set out on the following pages.

5.1 Structural changes

5.1.1 Chapter X of the *Companies Act* will be amended to require each *public* company to obtain an audit report from

the Regulator of Assurance Providers (RAP audit certificate) which forms part of the annual financial statements of the company.

5.1.2 All companies (private or public) within a *group* structure where the holding company is a public company, also require a RAP audit certificate.

5.1.3 Private companies which do not have a holding company, are not required by statute to obtain an audit certificate.

5.1.4 Any company, firm or organisation can however decide to require an audit or other form of assurance service. This service is then obtained directly from a person registered under the *Assurance Act* to provide such service.

5.1.5 An investigation is to be undertaken to determine the needs of the public for various assurance services. The adequacy of existing requirements for close corporations, trusts and other organisations is to be investigated.

The RAP audit certificate requirement and its possible application to listed entities and other statutory bodies must also be examined. We suggest that these bodies also be subjected to the RAP audit certificate requirement.

5.2 Composition of the Regulator of Assurance Providers

5.2.1 RAP will have a *Policy Council* made up of representatives from various stakeholders, users of auditing services, government, the state and public representatives.

The following bodies will be represented on the Policy Council:

- Users of auditing services / public (largest group);
- State Departments (Finance, Trade & Industry, et cetera);
- Government;
- Regulators such as the Commissioner for Inland Revenue, the Registrar of Companies, the Financial Services Board, the Master of the Supreme Court and

- other regulating bodies;
- Members of academia;
- Universities, technikons and other educational institutions;
- Organised business;
- Shareholders' associations and related organisations;
- The Johannesburg Stock Exchange;
- Various Business Chambers;
- Accounting and auditing institutes;
- The Reserve Bank;
- Associations of Bankers/Lenders;
- Investment and fund managers;
- Financial and investment analysts (including journalists);
- Institutional investors;
- Consumer groups;
- Labour;
- Auditors (representation from this group should not exceed 5%);
- Other stakeholders.

No constituency is to have a majority or to dictate proceedings or to influence the agendas unduly.

The members of the Policy Council will be nominated by various constituencies and approved by the Ministry of Finance.

- 5.2.2 The Regulator of Assurance Providers will have a strong *operational* section. No practising auditor will be allowed to serve in the operations section of RAP.

The operations section will function according to the criteria laid down by the Policy Council.

5.3 Other functions

The Regulator of Assurance Providers will perform the following functions as well as any others determined by the Policy Council:

- register auditors;
- regulate other forms of assurance services;
- administer entrance requirements;
- administer an auditors' entrance examination (if considered necessary);
- administer practice certificates;
- administer trainee contracts of trainee auditors;
- administer education and training requirements;

- protect the public from persons fraudulently presenting themselves as registered auditors;
- issue audit certificates.

5.4 Operational aspects

- 5.4.1 RAP will contract with available audit firms to do audits on behalf of RAP.

As an interim arrangement we suggest that RAP will honour existing audit appointments for a period of 2-3 years, and make certain adjustments to include firms from previously disadvantaged communities (so-called emerging firms).

- 5.4.2 RAP will develop, through its representative and transparent structures, a set of criteria to apply to the contracting of audit work. The Office of the Auditor-General currently operates a similar system through its Contract Work Committee and the principles employed here can prove a useful starting point for developing suitable criteria and norms.

An acceptable system of auditor rotation could, for example, be implemented and criteria applicable to achieving national goals of empowering previously disadvantaged groups could be incorporated and *uniformly* implemented.

- 5.4.3 The contractual agreement between RAP and the audit firms will lay down conditions under which the audit firms are contracted in. This will include:

- the specific audit standards which audit firms have to adhere to;
- independence requirements;
- other auditor responsibilities;
- reporting duties;
- audit fees;
- conditions of payment.

- 5.4.4 RAP will determine criteria which auditors have to meet before being allowed to do audit work on behalf of RAP.

- 5.4.5 RAP will publish full details of its allocation of audit work and also information in respect of so-called

voluntary assurance services provided by various audit firms.

The income from all assurance services (and the apportionment to the various providers) will therefore be known. This is considered to be in the public interest.

5.5 Income for RAP

5.5.1 RAP will levy audit fees as a percentage of certain key financial indicators (refer to a more detailed discussion on this subject later in this report).

5.5.2 The total audit levy will exceed the amount paid to individual auditors, thereby allowing RAP to build up various funds.

The following funds are envisaged:

- A **General Fund** to cover RAP operating expense, including:
 - administrative expenses
 - quality review expenses
 - legal expenses
 - investigations.
- A **Litigation Fund**.
- A **Development Fund** to finance
 - bursaries
 - education
 - equity development.
- A **Research Fund** to stimulate and support independent research into auditing related problems.

5.5.3 RAP income will consist of the following main streams:

- The public company audit levy
- The levy for voluntary assurance services
- Community service development project
- Other income, such as:
 - income from re-ratings done (refer to the heading "ARAP-ratings");
 - penalties charged;
 - basic auditor levies (it is envisaged that the annual

registration fees charged to auditors will amount to approximately R200 per auditor and allow for documentation and notices distributed);

- inspection fees (fees charged to certain bodies who have obtained permission to scrutinise working papers of RAP).

5.6 Auditor independence

Auditors will only qualify to do audit work on behalf of RAP if they meet certain independence requirements:

5.6.1 The auditor must be able to declare the following:

- no work of any kind, except audit work on behalf of RAP, was performed at the auditee, by the following:
 - the auditor her/himself;
 - an immediate family member of the auditor;
 - the auditor's partner;
 - a firm/body/company in which the auditor has a financial interest or serves on the management or has any form of cooperation agreement (the above should exclude shares held in listed companies).

An Independence Oversight Committee will investigate and rule on applications for exemptions in exceptional cases where, for example, the involvement of auditors in non-audit work is considered to be in the public interest (no practising auditor will be allowed to serve on this committee).

5.6.2 After completion of the audit, before payment is made, all auditors have to declare in writing that they have not violated the independence requirements.

5.6.3 The independence requirements are part of the contractual conditions and non-adherence would be considered a breach of contract.

5.7 Contractual requirements

Other than the independence requirements, the contract between RAP and the auditors performing work on behalf of RAP would provide for the following:

- No auditor is allowed to subcontract any work assigned by RAP, except to trainee auditors or staff under the auditor's direct supervision.
- Auditors have to submit a list of trainee auditors and staff under their direct supervision.
- Auditors will have to furnish RAP with full details of all audit assignments carried out (both RAP assignments and other audit assignments).
- The standards to which auditors have to adhere (non-adherence to standards will therefore constitute breach of contract).
- Penalty clauses in the case of breach of contract.
- Other rules and regulations to be applied by the auditor.
- Format and contents of working papers.
- That all working papers are the property of RAP.

5.8 The determination and payment of audit fees

5.8.1 Audit fees are payable to RAP, thereby eliminating the undesirable practice that the audit firm which is conducting the audit, has to present an invoice to the auditee and enter into negotiations as to the payment of the account.

5.8.2 Audit fees will be charged on the basis of a ratio to certain key financial indicators (for example: turnover, assets, and income).

This will allow the auditee to budget in advance for audit fees as this will no longer be an unknown factor.

5.8.3 Audit fees will be payable monthly and not at completion of the audit, thereby providing RAP with sufficient cash flow to pay auditors who do audits on behalf of RAP.

Research conducted by the University of Pretoria over a six year period amongst South Africa's top 300

companies (representing almost half of South Africa's listed companies) (refer to the *Facts on Audit Firms in the Republic of South Africa* series of research reports) shows that there is a sufficient basis for determining audit fees as a percentage of turnover, assets or other key financial indicators. Over the period 1992-1996, the bandwidth, measuring the variance between highest and lowest ratios has narrowed considerably.

For example, the audit fee for every R1,000 turnover amounted to 91c (1992); 86c (1993); 73c (1994); 81c (1995); 75c (1996). The bandwidth has narrowed from 13c in 1992 to 8c in 1993, to 7c in 1994, to 6c in 1995 and to 5c in 1996. The asset bandwidth has narrowed from 11c in 1992 to 4c in 1996.

Research has also provided data in respect of companies in certain sectors, which can be taken into account in determining the audit levy.

5.8.4 Companies can apply to RAP to be assessed according to various options available (for example: turnover, assets, sector average, et cetera.)

5.8.5 Further research based on available information will most certainly allow the development of generally accepted ratios to determine the audit levy.

5.9 The ARAP-rating system

5.9.1 In addition to the above, RAP would rate the companies (groups) according to their *audit risk and preparedness* (the ARAP rating). The ARAP-rating would be assessed after completion of each audit and the fees for the next year levied on that basis.

This will not only encourage companies to achieve a high level of audit readiness and cooperation with the auditor, but the rating will also provide additional information to the investors and shareholders. This will reinstate a desire amongst companies to cooperate with the auditor in providing necessary documents, explanations, et cetera and to operate according to principles of

good governance and accountability.

The relationship between management and staff of the auditee on the one hand and the auditor on the other, is hereby normalised by eliminating numerous adverse factors.

- 5.9.2 Companies could apply to RAP for a re-rating which will be done at an appropriate fee, according to certain predetermined criteria.

5.10 Remuneration payable to auditors

- 5.10.1 Fees will be paid to auditors on the basis of a predetermined fee structure, similar to the one already in existence with regard to audit work done by private sector auditors on behalf of the Office of the Auditor-General.

- 5.10.2 Because all auditors will operate according to the same auditing standards (which is not currently the case) this will eliminate, to a large extent, *over* and *under* auditing.

- 5.10.3 Audit firms can make submissions to RAP regarding changes in the environment which may necessitate adjustment of fees.

It has to be pointed out that this system provides an incentive to auditors to be well educated in the application of auditing standards as required by RAP, to have personnel well trained and working papers and electronic software properly adjusted to meet the audit requirements of RAP, as this will enable them to maximise their profit potential based on the fees payable by RAP for audit work.

5.11 The levy for voluntary assurance services

- 5.11.1 A private company, firm or other organisation seeking to obtain an assurance service (other than the statutory RAP audit certificate), can directly approach an assurance provider (registered with RAP).

- 5.11.2 The assurance provider, before accepting the appointment, must lodge a form containing certain information regarding the assignment with RAP. This will include an estimate of the hours to be spent on the assignment and other information which will enable RAP to assess the ability of the assurance provider to meet existing obligations in terms of possible contract work to be done on behalf of RAP.

The *Assurance Act* is to provide for an exchange of details relating to the contract work between The Regulator of Assurance Providers and the Office of the Auditor-General. The aim of this exchange is to monitor individual auditors' commitment to RAP and to the Office of the Auditor-General. As each auditor has a limited number of audit hours available, taking into account the staff under his/her supervision and time spent on training and continued professional education, effective regulation must also be aimed at preventing *overload* as this is a prime source of risk and poor quality work.

- 5.11.3 A tariff (say 10%) based on the fee charged for the assurance service is payable to RAP.

- 5.11.4 All assurance providers have to submit an annual return to RAP, giving details of the assurance services provided, details of the auditees, the firms under consideration and other details considered relevant. This information is vital to an effective regulation of the assurance industry and the development of the industry.

- 5.11.5 Any assurance services provided by an assurance provider have to be conducted in terms of the standards, regulations and rules laid down by RAP. It should be noted, however, that the private company, firm or other organisation seeking to obtain an assurance service, is free to decide on the nature (or level) of the assurance service required.

5.12 Community service of trainee auditors

5.12.1 All future trainee auditors should be required to serve an appropriate period (approximately one year) of their training contract under RAP.

This will be a prerequisite for future registration as auditor and to qualify for contract audit work from RAP.

5.12.2 The exposure to various audit and related assignments is to be seen as part of the trainee auditor's training and is a safeguard against practices whereby trainee accountants under the present system are not given auditing exposure and experience, but rather employed in specialist fields, such as computer departments, management consulting, et cetera.

5.12.3 RAP will be empowered to appoint the trainee auditors to engage in various assignments.

The following options are available:

- The trainee auditor is assigned to work on an audit which is contracted out to a private sector audit firm (it is envisaged that most trainee auditors will be engaged in this manner).
- RAP will be mindful of the trainee auditor's future engagement with a particular audit firm and this can be taken into account when assigning the trainee auditor.
- The trainee auditor is engaged to assist with routine work during quality reviews conducted by RAP.
- Specified public or state bodies can apply to RAP to provide assistance on audit related matters (for a reasonable fee). Examples would be the Office of the Registrar of Companies or the Receiver of Revenue. A maximum period which trainee auditors should spend at such engagements should be specified.
- The trainee auditor will earn a

basic salary appropriate to a person under training, but RAP will receive the income from fees generated by the trainee auditor.

5.13 Accountability of RAP

5.13.1 The Regulator of Assurance Providers will operate under the *Glass House*-principle under full sunshine (transparency and openness).

5.13.2 The Regulator of Assurance Providers will report to the Minister of Finance on information to be considered essential to the public, users of auditing services and stakeholders.

5.13.3 The Regulator of Assurance Providers will be audited by the Office of the Auditor-General (the Regulator of Assurance Providers will in turn audit the books of the Office of the Auditor-General). Regular performance audits will be conducted and the reports published.

5.13.4 An independent ombudsman for the Regulator of Assurance Providers will be appointed by an outside body (e.g. the Finance Ministry) to investigate complaints.

5.13.5 The Regulator of Assurance Providers meets openly. Members of the public must be able to attend the meetings. Minutes of RAP and its committees must be available to the public upon payment of a small administrative fee.

5.13.6 The composition and terms of reference of all working parties must be announced, progress reports available and all agendas accessible.

5.13.7 Decisions are taken through a voting process, and the results publicly available.

5.13.8 Members of the public must be allowed to make oral presentations and submit evidence. Public hearings should be held on policy matters.

5.13.9 It should be made an offence for members of RAP to meet in private to fix the outcome of meetings or decisions. Conventions applying to all

RAP members must be determined beforehand, strictly enacted and enforced.

5.13.10 On payment of a predetermined fee, certain parties (for example shareholders of a company) will be allowed to inspect the audit working papers at the offices of RAP.

6 Advantages of the proposed structure (RAP)

6.1 Creating an environment conducive to audit

Our proposals will substantially improve the adverse conditions and hostile environment under which auditors are currently operating, since:

- Auditors (private audit firms contracted by RAP) will be able to conduct audits without fear or favour.
- They cannot be dismissed simply because their work gives the management of companies cause for concern.
- They do not have to negotiate with management regarding the setting of audit fees and beg for the payment thereof.
- RAP provides statutory protection for auditors who have acted in accordance with laid down standards and procedures.
- Interim arrangements ensure that the audit market is not unduly disturbed and that audit services are provided uninterrupted.
- RAP will set socially acceptable audit objectives and standards to meet these objectives. Audit expectations which the profession has been unable to either manage, assess or meet, will now be addressed through RAP. The auditor's nightmare of unfulfilled expectations will be substantially reduced.

6.2 Mindful of the public's interest

Audit is a means of social control. Our proposals ensure that the public interest is not marginalised or forgotten.

- The proposed system prevents corruption between management and auditor, as the motive for collusion is largely eliminated.
- Information relating to assurance services, the basis on which the audit fees are calculated and paid, the allocation of audit work to different auditors, the different companies' ARAP-ratings: this is information which is available to the public to make informed decisions.
- Confidentiality cannot be claimed if the information is in the public interest. These criteria will be applied consistently, because there are not thousands of different audit firms with separate conceptualisations as to what effects the public interest.
- RAP promises the public open, democratic practices applied consistently without undue influence and involvement of the very group which needs to be regulated.

6.3 Liability of auditors

Our proposal addresses concerns of *both* auditors and the public regarding the subject of litigation.

Auditors claim that they are currently the targets of unjustified litigation as they are seen as the only party with so-called "deep pockets". They state that they find it almost impossible to obtain professional indemnity insurance and, once found, the premiums are so excessive as to be virtually unaffordable.

The public has found that under current legislation it is virtually impossible to hold auditors liable (no Court in South Africa has ever made an allocation of damages against auditors) and even in

cases of gross negligence, auditors may prove to be men of straw, rather than to have deep pockets.

- The RAP litigation fund will ensure that where the public has been misled on the basis of an improper or false audit opinion, sufficient funds are available to pay members of the public who seek redress. Apart from the litigation fund, RAP will be able to find underwriters to its risks more readily than individual audit firms seeking to protect their own risk.
- Except in the case of appointments for voluntary assurance services, the auditors cannot be sued directly, as RAP acts as a body between the auditor and the party relying on the audit report issued by RAP.
- Where auditors are negligent it is easier to take them to task. RAP as a body with stature can hold auditors liable in terms of a contractual agreement, thereby simplifying proceedings. Contracts between RAP and the auditors will provide for penalties and damages where breach of contract is established. This will facilitate easier redress.

6.4 Respecting auditors' desire to operate in private structures

6.4.1 The current system allows audit firms to operate in partnerships irrespective of the number of partners, staff or financial measures. No statutory duty is placed on auditors to publish annual financial statements, have their own affairs subjected to audit or to provide the public with information on the profitability of the audit function which is granted to them as a statutory monopoly.

It is suggested that the auditors' desire to operate in private structures is respected, subject to the provision in the next paragraph.

Through RAP, the public will obtain certain information on the audit function,

but we propose that the awarding of contract work to auditors be made subject to the auditor submitting audited annual financial statements of his/her firm to RAP, where these can be inspected by the public.

6.5 Addressing imbalances of the past

6.5.1 The system of community service for trainee auditors contains advantages for all parties:

- Trainee auditors will acquire first hand experience of the work done by the industry's regulator. Many trainee auditors will gain audit experience which would not be acquired at audit firms where they will work later in their professional career. Engagement in departments such as the Receiver of Inland Revenue or the Office of the Registrar of Companies will provide insight into organisations which play a pivotal part in their working lives. Involvement in re-rating exercises in respect of ARAP-ratings are unique to RAP.
- The trainee auditors' experience of the way RAP functions, is invaluable to their future employers. The fact that trainee auditors will, for most of their time, assist in the performance of audits, will ensure that this valuable source of labour is still available for the conducting of audits.
- The community benefits from the trainee auditors' engagement with RAP, and assistance in other projects (for example the Office of the Registrar of Companies). Since RAP is effectively providing the public with a system whereby meaningful assurance services are given, the income generated through the compulsory RAP experience are ploughed back into related services.

6.5.2 The allocation of contract work to various auditors provides a mechanism whereby historical imbalances can be properly *managed* to improve various aspects:

- Emerging firms will receive a fair quota of audit work based on criteria acceptable to all stakeholders. Definite targets can be agreed upon, set and achieved through a managed process, overseen by a credible representative body.
- The system prevents malpractice such as emerging firms acting as audit brokers who receive an excess of audit work and then sell back this work to established firms (RAP prohibits the subcontracting of audit work; audits are awarded to auditors not to audit *firms*).

As all assurance providers have to submit details of their commitments in terms of assurance services and available hours (partners and staff under their supervision) to RAP and since RAP also obtains information from the Office of the Auditor-General, the regulator can assess all data to ensure that individual auditors are not allocated more work than they have assurance hours available. This will eradicate many malpractices which are currently at the heart of poor standards.

- 6.5.3 Various funds will provide means to effect the correction of imbalances which are particularly noticeable in areas such as:
- accounting and auditing education;
 - upliftment;
 - independent research.

6.6 Strengthening the image of audit

- 6.6.1 By removing claims that auditors are effectively *management lapdogs* because of their inclination to serve management which effectively appoints and pays the auditor, the auditors' true mission is re-established with a resultant restoration of pride and respect.

Our country needs watchdogs who are proud of their work and who enjoy support of the community they serve.

6.6.2 Due to the engagement of an acceptable regulator in setting standards and regulations, the audit will become more standardised and socially acceptable. This will strengthen the image of auditing as a necessary service.

6.6.3 Auditing standards do not need legal backing. The auditing (or assurance) standards are part of the contractual arrangement between assurance providers and RAP. Non-adherence to standards will constitute breach of contract. It will be possible to effectively enforce adherence to standards effectively.

6.6.4 Quality reviews, and other investigations are done by the regulator itself and the process is not seen by the public as an auditor self-congratulatory exercise between various auditors. The auditor will be seen to be regulated.

6.6.5 The regulator will be seen to be effective and restore confidence amongst investors.

In view of our particular history, high levels of fraud, low ethical standards and morality, we need to do more than other developed countries whose credentials are accepted unqualified. We are confident that the introduction of the Regulator of Assurance Providers will restore lost confidence in financial reporting in South Africa and lead to a reassessment of the credibility of our country's financial reporting within the international investment community.

The Regulator of Assurance Providers is the solution to *our* problems.

6.7 Eliminating current malpractices

The proposed system will minimise and in many instances eradicate current malpractice such as:

- low balling;
- under cutting;
- under auditing;
- premature signing of reports;
- audit overloads;
- audit-loss-leader strategies;

- audit spring boarding;
- free audits;
- opinion shopping.

Corrective measures which are contemplated by overseas regulators can be investigated by RAP and their suitability assessed by the inclusive and transparent processes of RAP. Recommendations can actually be implemented by RAP through the application of published agreed upon criteria. Two of the measures referred to above are: rotation of auditors and limit on work from one sector or auditee.

6.8 Restoring auditor independence

Arguably the most important benefit the proposed system provides, is that it restores the independence of the auditor:

- Cosy relationships and auditor/management interdependence developed through the provision of non-audit services, are eliminated.
- Fees charged and the payment thereof are no longer negotiating tools to force auditors into commitments.
- Auditors can no longer be dismissed because they have uncovered fraud or because their audit is becoming a threat to the dealings of management.
- The auditor is at last free to conduct the audit *without fear or favour*.

6.9 Promoting good accountability

6.9.1 The system of companies being given an ARAP-rating, will not only encourage companies to achieve a high level of audit readiness, and cooperation with the auditor, but the rating will also provide additional information to the investors and shareholders. This will reinstate a desire amongst companies to cooperate with the auditor in providing necessary documents, explanations, et cetera and to operate by applying principles of good governance and

accountability.

The relationship between management and staff of the auditee on the one hand and the auditor on the other, is hereby normalised by eliminating numerous adverse factors.

6.9.2 Criteria for awarding work to auditors will be publicly known, thereby encouraging auditors to strive towards meeting these criteria. This will provide much needed focus for auditors and result in higher standards and audit quality.

Auditors will be given an incentive to be well educated in the application of auditing standards as required by RAP, to have personnel well trained and working papers and electronic software properly adjusted to meet the audit requirements of RAP, as this will enable them to maximise their profit potential based on the fees payable by RAP for audit work.

6.9.3 The matters of reporting fraud, material irregularities, going concern problems, et cetera will be addressed, as RAP will assess needs of user groups and certain information will be routinely reported by the auditors to RAP as part of the audit documentation.

6.9.4 The proposed system is based on *preventative* regulation.

6.10 The gift of a genuine regulator

The Regulator of Assurance Providers gives the South African society the benefits derived from concepts which a democratic society cherishes:

- openness;
- transparency;
- fairness;
- credibility;
- inclusivity;
- consistency;
- representativeness;
- addressing imbalances;
- public interest orientated.

7 Reflection

It should be apparent that finer details regarding

the application of the broad principles in this Position Paper will be developed and further refined by committees, subcommittees and other structures within RAP under principles of full sunshine and inclusivity.

If the audit industry, users of audit services, academics and government make a concerted effort to resolve any practical problems which may arise from the implementation of these principles, we are convinced that these will be readily solved.

We are also confident that the audit industry will support, in principle, the proposals contained in this Position Paper, as no other proposed structures, suggestions, or institutional strategies currently on the table have addressed and eliminated so many adverse factors while remaining constantly mindful of the public interest.

Those who reject these proposals outright, may reflect on the fact that the present system, if proposed in its current form, would probably be dismissed outright.

Our Position Paper offers a workable solution to most problems which are systematically eroding the importance and acceptability of auditing. Many voices rejecting our proposals will be raised because the present system has already harmed the image of auditing to such an extent that the true value of an effective audit has already been forgotten.

As stated at the beginning of our Position Paper, we do, however, believe that auditing is the cornerstone of accountability. Our country cannot afford to be without an effective, economic and efficient audit system.

Against this background, our Position Paper seeks a brighter future for auditing in South Africa.

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