

Regulation of the auditing profession

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ABSTRACT

The way in which the auditing profession is regulated is one of the factors adding value to, or undermining the value of the audit function. This article identifies the factors that are important to a regulatory system and evaluates the self-regulating structure of the auditing profession in terms of those factors.

It appears that those elements that are important to a regulatory system are not adequately addressed by the auditing profession's current regulations. The fundamental reason for this can be traced back to the composition and financing of the regulator.

Key words

Regulation, self-regulation, public interest, public confidence, assurance

In this article the following abbreviations are used:

Companies Act	Companies Act, Act no 61 of 1973 (as amended)
PAAB	Public Accountants' and Auditors' Board
SAICA	South African Institute of Chartered Accountants
Act	Public Accountants' and Auditors' Act (Act no 80 of 1991 (as amended))

1 INTRODUCTION

Worldwide, and particularly since the Enron collapse, there is growing criticism of, and confusion and dissatisfaction over, the auditing profession. The main criticism of and accusations against the profession are that it does not act in the public interest, but rather in its own interests only (Mays 1995:58-59, Sikka & Willmott 1995, Gray & Manson 2000:567).

Worldwide, corporate collapses have brought about severe pressures on the auditing profession. The resulting crisis in the auditing profession is that the public have lost much of their confidence in the profession. The value of the external audit function has declined to such an extent that it risks extinction (Gloeck & De Jager 1998:iv). The causes of these corporate failures are complex and the shortcomings revealed by these failures highlight, amongst other things, the regulatory structure of the auditing profession. A number of authors have confirmed that ineffective regulation is one of the key factors detracting from the value of the audit function, thereby undermining public confidence in the profession as a whole (Land 1995, Gloeck & De Jager 1998, Gray & Manson 2000, Irish Government Publications 2000). Land (1995:92) summarised it as follows:

"From the profession's point of view, what lies at the heart of public criticism is the issue of regulation."

The purpose of this article is to evaluate the self-regulating structure of the auditing profession in terms of the factors that are important to any effective and credible regulatory system.

In the first section regulation is defined, the factors giving rise to the demand for regulation are described, and the factors important to a regulatory system are identified. In the following section the role of regulation of the auditing profession is described. In the final section, the extent to which regulation of the auditing profession addresses those factors that are important to a regulatory system are discussed.

2 DEFINITION OF REGULATION

This section endeavours to identify from the literature the key elements of regulation, before defining the concept of *regulation*.

Observation 1

The following definitions are found in dictionaries:

Regulate:

"control by rule; control, monitor, govern, run, operate, administer, handle, guide, steer, conduct, direct, oversee, manage" (The Oxford Dictionary and Thesaurus 1993) "control by rule, subject to restrictions; moderate, adapt to requirements" (The Concise Oxford Dictionary 1987) "to bring into

conformity with a rule, principle, or usage" (Collins Concise Dictionary 1989)

Regulation:

"regulating or being regulated; prescribed rule, authoritative direction" (The Concise Oxford Dictionary 1987)

"the act or process of regulating; ... a rule, principle, or condition that governs procedure or behaviour" (Collins Concise Dictionary 1989)

From these definitions it appears that the concept of regulation may take on various shades of meanings. However, at its core regulation seems to be of a directional nature - from controlling or regulating authority to the individual or group who performs the task in conformity to the directives of the regulator.

Deduction 1: Regulation is directional.

Observation 2

In all industrialised societies there is tension between two systems by which the economy is controlled (Ogus 1994:1). These are:

- The *market system* which allows individuals to create their own wealth. The judicial system underpins all of its aspects, mainly through private law.
- The *collective system* where government promotes actions which would otherwise (so it is said) not have taken place. The object is to rectify perceived shortcomings in the market system in order to meet collective or public objectives - which is regulation.

Government is therefore responsible for regulation, and regulation must be conducted in such a way that public objectives are met.

This is supported by the Review Group on Auditing in Ireland which describes the primary objective of regulation in any economic system as follows (Irish Government Publications 2000:107):

"to provide, for reasons of public interest, a counterweight for free market forces and to counteract market failure. If allowed to operate unchecked, these forces may merely serve to benefit individuals in society to the disadvantage of society as a whole" [emphasis added].

It is further supported by Mitnick's (1980:7) definition of regulation: "regulation is the public administrative policing of a private activity with respect to a rule in the public interest" [emphasis added].

Deduction 2: Regulation must take place in the public interest.

Observation 3

In a collective system the role of government is to create an environment for sustained and orderly economic growth through fiscal, monetary and regulatory policies (Simon 1981:13). Government's main objective in regulating the global financial

system is to create financial and economic stability (Page 1987:298).

It is government's responsibility to evaluate whether public services are rendered in the most appropriate, economic, efficient and effective ways (Pauw, Woods, Van der Linde, Fourie & Visser 2002:48). Government should therefore ensure that the provision of auditing services, as one of the public services provided, should be rendered in the most appropriate, economic, efficient and effective way.

Thus government is responsible for regulation. "Regulation, in the broadest sense, is *the* essential function of government" (Hartle 1979:1). This is endorsed by the following:

"Regulation ... is any constraint imposed upon the normal freedom of individuals by the legitimate activity of government" (Brown-John 1981:7).

"Regulation represents attempts by the state to alter the administrative and legal framework that governs market transactions" (Spulber 1989:xvi).

According to Ogus (1994:2) regulation usually has the following characteristics:

- There is control by a superior - a hierarchic function. Individuals are forced by government to act in a specific way under threat of punitive measures if they do not comply.
- It is usually government (or its agents) who have to enforce the rules by which regulation will take place - rules which cannot be repealed by mutual agreement between the parties.
- Government plays a crucial role in formulating and applying the rules according to which regulation takes place - it is therefore typically centralised.

Regulation need not necessarily be exercised by government itself. Government may delegate this responsibility to one of its public agencies. (In the case of the auditing profession regulation takes place through a self-regulating structure.) This is supported by the following opinion by Pegrum (1965:39): "Public regulation ... refers to those controls which are embodied in the laws of the land and which are administered by designated governmental agencies".

This view is also supported by Selznick (1985). According to Selznick (1985:363) the basic meaning of regulation refers to "sustained and focused control exercised by a public agency over activities that are valued by a community" [emphasis added]. That the activities are "valued by a community" supports Deduction 2.

Important structural matters are considered in the decision to delegate some of the regulatory activities to responsible agencies. Horizontal (the amount of authority delegated to an agency other than government) and vertical (the amount of control exercised over such an agency) considerations are relevant when authority is delegated. "The location of responsibility for directing and controlling economic

activity is the core of the problem of the relation of the state to economic life" (Pegrum 1965:4).

If it is decided to delegate regulatory activities, important decisions have to be taken, such as who the agents should be and which responsibilities are to be delegated. Government, as representative of the public interest, is responsible for ensuring that its agents act according to the agreement. Mitnick (1980:326) puts it as follows: "The representatives determining the preferences of their constituents, given a distribution and intensity of those preferences; the constituents face the problem of holding their agent-representatives accountable to their preferences".

Mitnick (1980:9) further mentions that regulation should be exercised by an entity which is not involved in the activities to be regulated: "regulation is a process consisting of the intentional restriction of a subject's choice of activity, by an entity not directly party to or involved in that activity" [emphasis added].

Deduction 3: Regulation must be exercised by an independent party (government or its agencies).

Observation 4

Regulation is used to control human activities or behaviour (Bernstein 1955:271). Needham (1983 in Schultz & Alexandroff 1985:3) supports this in his statement that regulation endeavours to limit human behaviour.

According to Baldwin and Cave (1999:2) the word *regulation* can be used in the following senses:

- *As a specific set of rules* - where regulation consists of issuing a binding set of rules to be applied by a specific body.
- *As an intentional influence from government* - where regulation takes place in a wider context which includes all government activities aimed at influencing industrial or social activities.
- *As all forms of social control or influence* - where all mechanisms that influence activities, either by government or through other sources (communities), are regarded as regulation, regardless of whether regulation takes place intentionally or incidentally.

Regulation can be used to indicate a range of forms of behavioural or social control.

Pegrum (1965:39) defines social control as the range of mechanisms, either statutory or otherwise, through which society achieves compliance with generally accepted standards.

Deduction 4: Actions or conduct are controlled.

Observation 5

Regulation by government can be divided into two categories (Ogus 1994:4-5 & 9, Summers 2002). These are

- *Social regulation* which consists of creating laws and rules aimed at, for example, protecting the

health and safety of a citizen or worker, or achieving environmental or aesthetic objectives, or protecting consumers.

- *Economic regulation* takes place when government intervenes and directly prescribes economic aspects such as prices, conditions for participation, quality of services, yields, and the like. Economic regulation often refers to control over access by individual firms to certain industries and the pegging of prices to be charged. In some cases it also includes specifying the quality of services to be offered by the firm (Litan & Nordhaus 1983 in Schultz & Alexandroff 1985:3).

Economic regulation is applicable mainly to industries with monopolistic tendencies. The main function of economic regulation is to create a substitute for competition by controlling prices and quality. Economic regulation is usually imposed on an industry to industry basis.

By creating a substitute for competition, the probability increases that public objectives will be met.

A third category of regulation may also be distinguished which includes both social and economic regulation (Economic Council of Canada 1981:7). It consists of the imposition of certain measures to achieve economic and social objectives.

Deduction 5: Regulation serves as a substitute for competition (in the case of an industry with monopolistic tendencies).

Observation 6

According to Spulber (1989:2) regulation is essentially "... a process of coalition formation and bargaining involving consumers, firms and regulatory agencies". Thus the regulatory process involves several entities. "Regulation exists to affect the relationships in and results of private markets" (Trebilcock, Waverman & Pichard 1978 in Schultz & Alexandroff 1985:3).

Spulber (1989:39) defines the regulatory process as follows: "The regulatory process is a game defined by the set of consumers and firms in the regulated market, consumer preferences and firm technologies, available strategies, and the set of rules".

According to Fainson (1940 in Mitnick 1980:8) regulation should be seen in a wider context than only the parties directly involved; it should be seen in the context of the environment in which it is being applied. "Regulation is therefore the resultant of the actions of regulator and regulatee constrained by, and in interaction with, their environment".

Neither is regulation a static process; it is generally a continuing process or relationship (Mitnick 1980:6). Mitnick (1980:8) refers to regulation as a dynamic and infinite process - a process of adaptation of interests, both public and private, the outcomes of which cannot be determined in advance. Schultz and Alexandroff (1985:5) refer to regulation as a dynamic and versatile instrument of control. Regulation is therefore

generally accepted as a dynamic process in which changing circumstances and needs must continually be investigated and evaluated.

Regulation is used to influence actions and according to Baldwin and Cave (1999:96) the regulatory processes consist of the promulgation of appropriate regulatory legislation, the formulation of regulatory rules, and the monitoring of and adherence to the rules by those being regulated. The regulatory process therefore consists of several phases.

Deduction 6: Regulation is a dynamic process.

Observation 7

According to Mitnick (1980:2) "regulation ... is an interference of some sort in the activity subject to regulation - it is to be governed, altered, controlled, guided, regulated in some way. Interference involves a diversion from what otherwise would occur, a blocking off, restriction, or alteration in the alternatives open to the subject".

One of the aspects of the regulatory process is the formulation of rules or regulations. According to Spulber (1989:37) regulations are "... general rules or specific actions imposed by administrative agencies that interfere directly with the market allocation mechanism or indirectly by altering consumer and firm demand and supply decisions".

According to Mitnick (1980:8-9) regulation can be seen as a process consisting of the following:

- "*Prohibitive policing*:
as saying no; as guarding against deviation from regulatory goals and derived rules. Regulating as controlling, influencing, persuading, advocating, advising."
- "*Mediating*:
as filter, buffer or modifier between public and private and perhaps protecting each; as mutual control process, where regulatee and regulator try to control one another; regulating as process of exchange through a mediating body."
- "*Promoting*:
as saying yes; as creating and fostering."

In a regulatory process, the functions mentioned do not necessarily function independently (Schultz & Alexandroff 1985:7).

As is shown by the above, regulation can be negative and prohibitive or positive and prescriptive. Negative regulation is the restriction of certain actions and the prevention of certain undesirable activities. Positive regulation authorises or facilitates certain actions.

Regulation also contains an element of coercion - one party forces something on another party. "Regulation involves the ... direct and coercive use of power over citizens" (Lowi 1979 in Schultz & Alexandroff 1985:3). This is supported by Cushman's (1941:3) definition of regulation: "A commission is regulatory when it exercises governmental control or discipline over

private conduct or property interests. This control may take different forms and use different methods, but there is always present an element of coercion".

Brown-John (1981:55) emphasises this with the following definition of regulation: "Regulation is legitimate coercive intervention in the daily affairs of individuals in the public interest".

An important aspect then is that the regulator must have the necessary powers to enforce regulatory standards on the parties being regulated.

Deduction 7: Regulation contains an element of coercion.

Observation 8

Despite all the research, it is amazing that there is so little consensus on the definition of the concept (Schultz & Alexandroff 1985:14).

From the features of regulation described in the literature, the following core elements of regulation can be identified:

Firstly, *public interest*. According to Deduction 2, regulation must take place in the public interest. Deduction 1 states that regulation should be directional. The inference may be drawn that the effect of regulation should be directed away from own interest and towards public interest. According to Deduction 5, regulation is a substitute for competition. By creating a substitute for competition, the probability increases that public objectives will be met.

Secondly, *independence*. According to Deduction 3, regulation should be conducted by an independent party.

Thirdly, *actions*. According to Deduction 4, actions or conduct are regulated. The inference is that the regulation of actions or conduct will be such that public objectives will be met.

Fourthly, *dynamic process*. According to Deduction 6, regulation is a dynamic process.

Fifthly, *coercion*. According to Deduction 7, regulation contains an element of coercion. The definition of regulation includes formulation (e.g. the formulation of rules) and control (e.g. monitoring compliance with the rules).

Considering these core aspects, *regulation* can be defined as follows:

Regulation is a dynamic process whereby, through actual or implied coercion, an independent party brings about actions in another party, all in the public interest.

The emphasis on public interest is important because in the auditing profession it is chiefly the emphasis on own interest which is causing the crisis.

3 FACTORS GIVING RISE TO THE DEMAND FOR REGULATION

From the literature it appears that there are a number of factors giving rise to the demand for regulation. In the auditing profession the following five factors are the main reasons for the demand for regulation:

- **Monopolies**

The first factor identified is *monopolies* (Pegrum 1965:36-39, Mitnick 1980:289, Breyer 1982:15 & 30-31, Kay & Vickers 1990:227, Ogus 1994:5 & 30-33, Majone 1996:28, Baldwin & Cave 1999:9-11). A monopoly exists where one supplier has complete or a dominant control over the supply of a commodity to the entire industry or to society (Pegrum 1965:36).

There is no competition and consequently the supplier determines the price and quality of the product. The following features can be observed where there is a monopoly (Baldwin & Cave 1999:9-10):

- A single supplier serves the entire, or almost the entire, consumer community.
- The product supplied is unique: there is no substitute that consumers (customers) can turn to.
- There are preconditions that have to be met before access may be gained.

In order to promote their own interests and so to maximise their income, monopolistic suppliers limit their output and increase prices. The consequences of a monopoly are therefore that supply is limited, prices are increased and a disproportionate percentage of the income of consumers (customers) flows to the suppliers (Baldwin & Cave 1999:10). Competition and regulation are often seen as interchangeable - "Competition where possible, regulation where necessary" (Kay & Vickers 1990:224). The objective of regulation is, therefore, to counteract the tendency to increase prices and limit supply. Or as Pegrum (1965:39) puts it: To combat the abuse of monopolistic powers. It is generally accepted that certain industries that do not have adequate competition should be regulated by government in order to protect the public interest (Phillips 1969:3).

An audit may be conducted only by a *Registered Accountant and Auditor*. The Act stipulates the following:

- All persons conducting the external audit function must be registered with the PAAB (section 14).
- Requirements (including qualifications and practical experience) which have to be met before a person may be registered with the PAAB (section 15).

- Only persons registered with the PAAB may use the designation *Registered Accountant and Auditor* (section 15).

Consequently, Registered Accountants and Auditors are the only persons who may perform the audit function for society. There are no substitutes to whom society can turn and there are requirements to be complied with before anyone may perform the audit function.

The auditing profession therefore has no competition in the execution of the audit function in society (i.e. it has a monopoly). The auditing profession acts as agent for society and consequently society depends upon the competence and proper conduct of the persons performing the audit services. The auditing profession should act in the interests of society in order to protect their interests. For instance, society may suffer damages as a result of negligence, fraud or incompetence on the part of auditors during the execution of an audit. A monopolistic situation may lead to conflict between own and public interests in respect of the price and quality of services provided. In the event of a monopoly, regulation should be imposed to protect the interests of society (public interest) because there is no competition to bridle the excesses.

- **Insufficient information**

The second factor is the *insufficiency of information* (Mitnick 1980:295 & 309, Breyer 1982:26-28, Spulber 1989:62-65, Kay & Vickers 1990:228-230, Ogus 1994:4 & 38-41, Majone 1996:29, Baldwin & Cave 1999:12, Gray & Manson 2000:74).

Society has a need for credible and accessible information. This is supported by the following quotation from the Economic Council of Canada (1981:114):

"The efficient functioning of a capital market, for example, depends on the existence of a vast and constantly updated array of trustworthy information. Bilateral market transactions alone cannot always be counted on to serve the interests of shareholders or consumers."

Proper competition can occur only if consumers are sufficiently informed to be able to evaluate different products and their quality (Baldwin & Cave 1999:12). According to Kay and Vickers (1990:236) this is especially a problem where users or consumers are still uninformed even after receiving the service or product concerned.

Often there is insufficient information available because it costs money to provide the information and the provider of the information is not reimbursed by the users of that information. So there is no incentive to provide the information,

while the information provided may also be incorrect (Baldwin & Cave 1999:12).

The following three mechanisms may redress the insufficiency of information (Kay & Vickers 1990:236-237):

- *Reputation* - which is a market mechanism. If consumers themselves cannot evaluate the quality of a product, they prefer to support suppliers with a reputation for high quality products and services.

Reputation is important where future purchases are influenced by the quality of the product or service now being bought. The supplier should therefore be aware of the way his current actions may influence future business.

The factors that influence the effectiveness of reputation as a market mechanism include the rate at which information spreads, the exchange of information among consumers and the extent to which the supplier's business is affected by the erosion of a reputation (Kay & Vickers 1990:237).

- *Licensing* - which is a regulatory mechanism. Through licensing the regulatory structure prescribes minimum standards: if products and services do not meet the minimum standards, they may not be offered.

As a regulatory mechanism, licensing is effective where there are slight differences in consumers' preferences and/or where there is a general demand for high quality services.

- *Certification* - which is also a regulatory mechanism. Certification occurs where the regulatory structure provides consumers with information about the qualifications and competence of suppliers. Consumers may then decide, for instance, whether they want to make use of cheaper services.

The objective of regulation is to protect consumers against both the provision and consequences of inadequate information by making the information more accessible, accurate and affordable (Baldwin & Cave 1999:12).

Business cannot function effectively if customers (consumers) cannot evaluate the quality of auditing services provided to them. Services are inherently difficult to evaluate in advance and in many instances customers have to predict the consequences or quality of the services based on intangible features such as the reputation of the auditor (supplier). Some individual auditors could gradually build a reputation for high quality service. However, other people's experience is not always a reliable yardstick and mistakes are potentially damaging and costly. Clients are totally dependent on the integrity and judgement of those rendering the services. Consequently clients need to have confidence in auditors.

Regulation must therefore be imposed in order for minimum standards to be set. The services must comply with the standards because society has a need for services to be of high quality. Regulation must also take place so that clients may obtain information on the qualifications and competence of those who are to render the service. Regulation takes place in order that society has an accepted set of minimum standards to which the accredited suppliers (auditors) are compelled to comply.

- **External factors**

The demand for regulation of the auditing profession is also caused by certain *external factors* (Mitnick 1980:289 & 312-320, Breyer 1982:23-26, Spulber 1989:46-52, Kay & Vickers 1990:226, Ogus 1994:4 & 35-38, Majone 1996:28-29, Baldwin & Cave 1999:11-12).

The price of a product often does not reflect the real cost to society of producing it; consequently it may be over-utilised (Baldwin & Cave 1999:11). For instance, there may be external factors (not directly related to the provision of the service or product) which cause the price of a product not to reflect its real cost to society.

External factors may be defined as follows:

"... a commodity bundle that is supplied by an economic agent to another economic agent in the absence of any related economic transaction between the two agents" (Spulber 1989:46).

"Externalities arise when the well-being of one economic agent (consumer or firm) is directly affected by the actions of another" (Kay & Vickers 1990:226).

The objective of regulation is to eliminate such outside influences and to protect society from the detrimental effects of external factors (Baldwin & Cave 1999:12). The supplier is forced to shoulder the full cost of production and not to burden society with part of the cost.

An audit is carried out mainly for the benefit of someone who has an interest in the company but does not have access to its accounting records or does not understand them. The direct users are those persons who cause the audit to be done, namely the owners or shareholders.

There are also indirect users of the annual financial statements, namely investors, clients, employees and creditors. The indirect users, that is to say society, may for instance suffer damages as a result of the auditors' negligence, fraud or inability during the execution of an audit. Regulation must take place because the costs and the benefits of an audit may overflow onto parties not directly involved (indirect users).

- **Anti-competitive conduct and predatory pricing**

The demand for regulation also arises from *anti-competitive conduct and predatory pricing* (Breyer 1982:31-32, Baldwin & Cave 1999:13).

Apart from a lack of competition, firms may act in a way which is not conducive to healthy competition, for instance by charging predatory prices which may have undesirable consequences. This happens when a firm charges prices lower than cost in the hope of eliminating competitors and thus gaining a dominant position. The firm's position is then used to recoup previously unrecovered costs, and future profits are increased at the expense of consumers (Baldwin & Cave 1999:13).

The objective of regulation is to maintain competition and to protect consumers against the consequences of market domination by prohibiting predatory or other forms of anti-competitive conduct (Baldwin & Cave 1999:13).

In recent years there have been growing accusations of "low balling" against the auditing profession. This occurs when an auditor tenders for auditing services at a price unrelated to the amount of work to be done (Gray & Manson 2000:569). By tendering too low, the auditor hopes to secure the appointment. The initial unrecovered costs are recouped in subsequent years at the expense of the client by increasing the prices of either auditing or non-auditing services. Regulation must take place in order to maintain competition and to protect society from the consequences of market domination.

- **Unequal bargaining power**

The fifth factor giving rise to the demand for regulation of the auditing profession is *unequal bargaining power* (Breyer 1982:32, Baldwin & Cave 1999:14).

One prerequisite for the effective and equitable allocation of resources in a community is equal bargaining power. If the bargaining power is unequal, regulation can be justified to protect certain interests.

As was shown in the discussion on monopolies, the auditing profession is the only supplier of auditing services in South Africa. The Companies Act (sections 269 & 270) requires all companies to appoint an auditor every year and that the auditor issues an audit report which must form part of the annual financial statements (sections 286 & 301).

The auditor acts as agent for the community to ensure that their interests in the accounting process are protected. The attitude and behaviour of auditors in rendering audit services have an influence on society. Apart from the inadequacy of information about the quality of the professional services being rendered, the mere provision of

information to clients is not sufficient. Knowledge is required for an informed decision to be taken because it could sometimes be a complicated decision. Clients may perhaps be unable to understand the information or be unwilling to spend the time required to understand the information provided. Clients therefore feel the need for assurance that they can rely on the quality of the auditors' services because they themselves are unable to evaluate the services, even in retrospect (Kay & Vickers 1990:230). So there must be control over the auditing profession in order to ensure that they do not act in their own interest, but in the public interest. Regulation must take place so that the community may have confidence in the competence of those rendering the services, and in the quality of the services being rendered.

Most of the factors giving rise to the demand for regulation are due to deficiencies in the markets. "The justification for intervention arises out of an alleged inability of the marketplace to deal with particular structural problems" (Breyer 1982:15). Markets may cause actions which are not in the public interest. The objective of regulation is to achieve particular desired public results or consequences in circumstances where the markets would fail to achieve it (Baldwin & Cave 1999:19).

Regulation can take place in two ways, namely by regulating the structure of the industry (structural regulation) or by regulating the actions of the industry (behavioural regulation) (Kay & Vickers 1990:233). Structural regulation refers to which individuals or firms will be allowed to perform the audit function, for instance, by setting admission requirements before the designation *Registered Accountant and Auditor* may be used. Behavioural regulation covers the conduct of individuals or firms during the execution of the audit function, for example by setting ethical and auditing standards and ensuring compliance with them.

4 FACTORS IMPORTANT TO A REGULATORY SYSTEM

In the literature, a number of authors have identified factors or aspects that are important to a regulatory system. In order to evaluate regulation of the auditing profession, it is necessary to have clarity about these factors. Regulation of the profession can be measured against these.

For the purposes of this article these factors or aspects are grouped under the following headings:

- **Mandate**

The *mandate* held by the regulator is one of the factors that are important to a regulatory system (Bernstein 1955:286, Noll [ed] 1971:37-39, Breyer 1982:354-356, Baldwin & McCrudden 1987:33-35, Gray & Manson 2000:74-75, Baldwin & Cave 1999:78).

The essence of laying claim to a mandate is that the form of regulation concerned is democratically justified. If a system of regulation is authorised by government, which is the dispenser of democratic powers, then it will be respected by society (Baldwin & Cave 1999:78). The *scope* of the mandate given to the regulator is also important.

The success of regulators should be measured against the degree to which they have complied with the mandate. This may be difficult. In most cases only broad guidelines are provided in a mandate to a regulator. Application of the mandate is therefore left largely to the discretion of the regulator (Baldwin & Cave 1999:78). The regulator's mandate will be reinforced if there is a statutory requirement that it must *report* to government (see accountability).

An important aspect of the regulator's mandate is whether he has the *necessary powers* to enforce compliance.

The degree to which *rules and standards are statutorily enforceable* should also be noted. In some cases the regulatory body may be entirely responsible for the rules, in which case those rules will not be statutorily enforceable. On the other hand, a regulatory body may formulate the rules with an external party (government) approving the rules, which will make them statutorily enforceable.

- **Structure**

The *structure* of the regulator is another factor important to a regulatory system (Bernstein 1955:289-290, Breyer 1982:350-354, Baldwin & McCrudden 1987:181-184, Gray & Manson 2000:597).

As mentioned earlier, several parties are involved in the regulatory process. Regulation should be seen in a wider context than only that of the parties directly involved; it should also be seen in the context of the environment in which it takes place.

The regulator can be captured by the regulated to such an extent that the interests of these parties, rather than the public interest, is served. Mitnick (1980:40) mentions that the regulator should maintain a balance between the various conflicting interests. There must be a balance between the different interests of those that are regulated, and between the interests of the regulated and the public interest (Page 1987:321).

The structure and composition of the regulator must therefore consider *all the parties involved*. It is important that all the parties involved, especially the public interest, should have democratically elected representatives in the regulatory structure. In that way not only external opinions are taken into account, but society is assured that its interests are being taken care of and public confidence is cemented.

There must be proper *external supervision* over the regulatory process. The structure of the regulatory body must also be *evaluated* externally from time to time.

- **Competence**

Another factor of importance to a regulatory system is the *competence* of the regulator (Bernstein 1955:chapter 4, Breyer 1982:342-345, Page 1987:309, Baldwin & McCrudden 1987:48-50, Baldwin & Cave 1999:80, Gray & Manson 2000:74). Landis (1960:66 in Mitnick 1980:95) stresses the importance of competence as follows: "Good men can make poor laws workable; poor men can wreak havoc with good laws".

It is of utmost importance that the regulators can be trusted to act efficiently and in the public interest. Noll [ed] (1971:43) states the following regarding regulators: "In theory, regulatory commissions are composed of neutral, objective *experts* on the affairs of the regulated industry and on the public interest in the behaviour of the regulated" [own italics].

Some of the functions of a regulator may require expert judgement. This may be the case especially where the regulator must take a decision or pass judgement where conflicting interests are at stake. It could be difficult for society to judge whether or not the regulator's decision was fair and appropriate. It is therefore essential that there be confidence in the regulator's expertise (Baldwin & Cave 1999:80).

- **Independence**

Independence is also a key feature of a regulatory system (Bernstein 1955:chapter 5, Noll [ed] 1971:34, Baldwin & McCrudden 1987:5, Gray & Manson 2000:577 & 596).

Regulation must be conducted by an independent party (government or its agents) (Deduction 3 in Section 2). The independence of the regulator is especially important in cases where the public interest is being pursued. The independence of the regulator has an influence on the acceptability of the form of regulation. The regulator must not only be independent from those being regulated, but must be seen to be independent. This can only be brought about by external representation in the regulatory structure.

There is often doubt whether the regulator is really independent and acting in the broadest public interest. The regulator may be subject to influences from powerful governing parties, politicians or interest groups in the community so that regulation serves the interests of such parties or sectors rather than the interests of the broader community. The regulator may for instance be susceptible to bribes and would therefore act in his own interest or those of a section of the community.

The independence of the regulator could also be questioned if the regulated are responsible for the *financing* of the regulator. Instead, all the parties involved should be jointly responsible for the financing of the regulator.

- **Efficiency**

A fifth factor of importance to a regulatory system is the *efficiency* of the regulator (Bernstein 1955:289-290, Brown-John 1981:235, Breyer 1982:346-350, Page 1987:305-309, Baldwin & McCrudden 1987:50-54, Baldwin & Cave 1999:81-82, Irish Government Publications 2000:95).

The mandate of the regulator must be carried out in the most economical and efficient manner. However, it is difficult in many cases to measure efficiency because a mandate does not always spell out clear objectives. It is also problematic to assert that a particular method of regulation will deliver better results than alternative methods which have not yet been applied in that specific field (Baldwin & Cave 1999:81).

There may also be conflict between economic efficiency and the attainment of social objectives. Often the main objective of a regulator is more than to be merely economically efficient. It may also be required to fulfil social responsibilities (Baldwin & Cave 1999:81-82). Regulatory objectives are often "mixed and include ... varied rationales, economic and social" (Prosser in Baldwin & Cave 1999:82).

In cases where the regulator is subject to much *bureaucracy*, this may have an influence on its efficiency. The same applies where it is subject to *political influences*.

The ability of the regulator *to adapt to change* must also be considered because regulation is a dynamic process (Deduction 6 in Section 2).

The regulatory body must have the necessary *resources* to be able to fulfil its delegated tasks.

- **Accountability**

Next, *accountability* appears to be a key element in the regulatory process (Brown-John 1981:156 & 216, Breyer 1982:354-356, Page 1987:318-321, Baldwin & McCrudden 1987:35-45 & 318-321, Ogun 1994:111, Baldwin & Cave 1999:78-79 & chapter 21). The Lambert Royal Commission on Financial Management and Accountability (1979:21 in Brown-John 1981:216) defines accountability as "... the liability assumed by all those who exercise authority to account for the manner in which they have fulfilled responsibilities entrusted to them".

Regulators should give proper account of the way in which they fulfilled their mandate, in order to ensure that the public interest had been taken into account. Reporting must be done to government as representative of the public interest.

Government must see to it that the agent (regulator) acted in the way agreed upon. Government has a responsibility towards society to ensure that the agent to whom the function of regulation had been delegated is monitored.

By delegating the regulatory function to one of its agents, government cannot deny or evade its responsibility for regulation. Proper supervision and control over the agent responsible for regulation is of the utmost importance (Page 1987:318).

Three forms of accountability may be distinguished (Loughlin 1992:2-3 in Ogun 1994:111):

- *Financial accountability* - regulators must comply with certain standards regarding financial management; administrative costs must be contained and resources must not be wasted.

- *Procedural accountability* - regulators' procedures must be reasonable and impartial so as to create a suitable framework for the formulation of rules and decision making in the interests of society.

- *Substantive accountability* - the rules and decisions of regulators must be justifiable in terms of the public interest objectives of the regulatory system, both economic and social.

If the regulator is accountable to an entity other than parliament or other elected body, it could be said that accountability is owed to a non-representative body. In cases where accountability and control is exercised by the courts, for instance, their expertise in a particular field may be questioned (Baldwin & Cave 1999:78-79).

What is important in accountability is that the body being reported to must possess the necessary *resources* (time and expertise). That body is responsible for monitoring adherence in the public interest and must therefore not be subject to influences from partisan private interests.

The *degree* of accountability is another aspect to be considered, as is the magnitude of resources used in the accountability process (Baldwin & Cave 1999:79).

- **Processes and procedures**

Another factor of importance to the regulatory system is the *processes and procedures* of the regulator (Bernstein 1955:290-291, Breyer 1982:345-350, Sutton 1984:91-93, Page 1987:313 & 320-321, Baldwin & McCrudden 1987:45-48, Baldwin & Cave 1999:79, Gray & Manson 2000:597).

As a result of the specialised nature and complexity of the services provided by, for

example the auditing profession, people who are not suitably trained cannot judge the quality of those services, which means that those who provide those services must fulfil their responsibilities towards society, the client or employer. Services rendered must be of high quality. Regulation is exercised to control actions or conduct (Deduction 4 in Section 2).

Procedures are required to *formulate* the standards of competence and conduct, and to *monitor* the maintenance of those *standards*. "Astute enforcement can remedy design defects in regulatory mechanisms and ill-enforcement can undermine the most sophisticated designs of regulation" (Baldwin & Cave 1999:96). There must also be mechanisms to handle complaints against those who are regulated and disputes between the regulated and outsiders.

In the public interest, procedures are required to *discipline* a person who acts in an undesirable manner and, in appropriate cases, to prohibit such a person from acting again. This is important because "... failures to identify and deal with breaches of rules may reduce regulatory statutes to mere paper exercises" (Baldwin & Cave 1999:96).

The *processes and procedures* of the regulator must be *fair, accessible and open* if they are to enjoy public support (Baldwin & Cave 1999:79). In democratic dispensations all social decisions must be taken in an open, transparent and accountable manner (Mitchell 1975:76). Regulation must be conducted as openly as possible to serve as proof of fairness and effectiveness (Page 1987:320). To that end there must be provision for *external involvement* in the regulatory processes and procedures in order to enhance their credibility and validity. Decisions on regulation and the regulatory processes must provide for participation from the community, consumers and other interested parties. Differences may occur over the appropriate measure of participation by external parties. On the other hand, one should guard against a case of the more participants in the decision-making process, the less effective the process - which could lead to stagnation of the regulatory process (Baldwin & Cave 1999:79).

5 THE ROLE OF REGULATION OF THE AUDITING PROFESSION

The audit function evolved when shareholders or owners of an entity were separated from its management. Shareholders do not *trust* the management. Therefore the shareholders themselves have to investigate, or create mechanisms that they could *trust* to investigate, the management whom they had entrusted with their capital. An audit is such a mechanism by means of which shareholders can gain *assurance* that management has been suitably investigated.

By executing an audit, assurance is obtained that management is accountable for the state of the

company as described in the annual financial statements, for the benefit of society. Published annual financial statements of companies may be regarded as public property (Peasnell 1982:252). An audit therefore, is carried out in the interest of the shareholders or the community.

The role of the auditing profession can be defined in the following terms:

The role of the auditing profession is to act in a professional manner as an instrument of social control in the accounting process and to report accordingly to the community.

In the case of the auditing profession the *community* consists of clients (i.e. shareholders), governments, employers, employees, investors, the business and financial community and others who rely on the objectivity and integrity of the profession to maintain the orderly functioning of commerce (SAICA 2002, Code of Professional Conduct .07). *Public interest* is defined as the collective well-being of the *community* being served (SAICA 2002, Code of Professional Conduct .07).

On the other hand a mechanism is required which would justify confidence in auditors. An audit reduces the risk of unreliable information, but assurance is also needed that auditors and their procedures can be *trusted*. Society wants to be confident that services of the highest quality are provided and that auditors are at all times competent and independent and act professionally. Society also wants to be confident that compliance with professional standards and actions will be monitored and that transgressors will be disciplined. Power (1997:1) states the following: "Trust releases us from the need for checking". Regulation of the auditing profession is a mechanism through which society can obtain assurance that the auditing profession is being suitably controlled and therefore can be *trusted*.

From the role of the auditing profession and the factors giving rise to the demand for regulation it appears that the profession should be regulated in order to meet the needs of society and, more specifically, to justify the *trust* of the community. Ethical and auditing standards (including standards of independence and competence) must be set by the regulator and compliance therewith must be monitored and transgressors must be disciplined where necessary. The regulator must also award a suitable designation to those who qualify to act as auditors (public recognition).

Regulation of the auditing profession plays the following role (Gray & Manson 2000:74):

Provides assurance:

It provides assurance to society that the services are of a certain standard. In the absence of regulation society would not know which auditing firms could be trusted to provide the desired assurance.

Formulates admission:

It sets requirements which have to be met before a person is admitted to the profession and may use the designation *Registered Accountant and Auditor*. This prevents just anyone, irrespective of his or her competence, to pose as an auditor.

Sets standards:

Through regulation audit standards of compliance are set.

Engenders trust:

Regulation engenders trust. It provides that element of trust which is absent when dealing with an otherwise unknown person.

The auditing profession must act in the public interest and therefore regulation of the profession and enforcement of those regulations is needed in pursuance of the public interest.

6 REGULATION OF THE AUDITING PROFESSION

The auditing profession in most English-speaking countries is, or until recently has been, subject to one or other form of self-regulation (SAICA 2003). In South Africa the regulatory framework is determined by government. The framework includes the Public Accountants' and Auditors' Act and the Companies Act. These laws delegate several aspects of regulation of the auditing profession to the PAAB. Although the PAAB is a statutory body, government representatives have only non-executive status. It is thus a form of self-regulation because PAAB policies are largely determined by auditors, while government plays a limited role (SAICA 2003).

In section 4 the following aspects were identified as being important to a regulatory system *Mandate, Structure, Competence, Independence, Accountability, Efficiency, Processes and Procedures*. These aspects will now be used as a basis for evaluating the regulation of the auditing profession in South Africa. Together, these aspects form a framework against which the acceptability of the regulatory system can be measured. The importance of each aspect is weighed up against the others in order to determine to what extent regulation takes place in the public interest.

The factors that are important to a regulatory system are addressed by the self-regulating structure of the auditing profession in the following ways:

- **Mandate**

The essence of laying claim to a mandate is that the form of regulation concerned must be justified. In the case of self-regulation the processes and organisational structures are sometimes designed by a body, such as the members of a professional association, with no democratic justification (Baldwin & Cave 1999:129). It is even argued that it constitutes abuse of power when self-regulators set rules and standards applicable to an industry

or profession without it being democratically justifiable (Ogus 1994:108).

In the case of self-regulation some of the rules and standards may not be legally enforceable because they were set by the self-regulator without government approval. This makes it difficult to ensure that the rules and standards are complied with. According to Ayres and Braithwaite (1992:110) compliance with rules and standards can be ensured only if government had endorsed them by granting statutory recognition to the regulations.

In the case of regulation of the South African auditing profession the PAAB was established by a legal structure (the Act) and consequently it disposes of a statutory mandate. The Act provides for the delegation of powers and duties to the PAAB but there is no comprehensive public supervision of the PAAB and its activities.

The ethical and auditing standards applicable to the auditing profession are not statutorily enforceable although the PAAB has the necessary powers to impose regulatory standards and rules on those being regulated.

- **Structure**

In the case of self-regulation society often makes no contribution to the form, content or objectives of regulation because they have no representation in the structure. And self-regulators have no statutory obligation towards non-members in the sense that they be consulted during decision-making or the formulation of rules and standards, or that they be given reasons for decisions (Baldwin & Cave 1999:132). This leads to self-regulators being easily captured by those being regulated as a result of pressure, influence and bribery aimed at promoting the interests of the regulated (Page 1987:318, Majone 1996:25-26). Kay (1988:34 in Ogus 1994:108) is of the opinion that in the case of self-regulation the danger always exists that the regulator may be captured by those being regulated.

Self-regulating bodies are not adequately exposed to external scrutiny and control (Page 1987:318). Government supervision over self-regulators and the role of the courts in evaluating self-regulating structures have not been spelt out clearly (Baldwin & Cave 1999:65). Where government does not exercise proper supervision or control, the risk remains that regulation may take place in the interests of the members and not necessarily in the interests of the community (public interest) (Flint 1988:89).

In the case of regulation of the auditing profession in South Africa, the Minister of Finance appoints the members of the PAAB, acting on nominations from the auditing profession. Members of the PAAB are mostly members of the auditing profession. Compounding this self-serving

situation, there is no comprehensive public scrutiny of the activities of the PAAB.

- **Competence**

One of the strongest arguments for self-regulation concerns the competence of self-regulating structures (Bernstein 1955:40, Page 1987:306-309, Hines 1989:72, Kay & Vickers 1990:240, Ogus 1994:107, Majone 1996:23, Baldwin & Cave 1999:64 & 126-127, Gray & Manson 2000:74). Such regulating structures have the necessary expertise and technical know-how and are au fait with the particular field or industry being regulated (Ogus 1994:107, Majone 1996:23, Baldwin & Cave 1999:126-127). Although independent regulators may buy such expertise from outside, the argument goes that expertise can only be retained through ongoing contact with the regulated (Baldwin & Cave 1999:126-127).

However, arguments that stress the expertise of self-regulators lose sight of the fact that the regulator must be competent not only in the field being regulated but also in respect of the public interest in order to give sufficient weight to the public interest (see Section 4).

As for regulation of the auditing profession in South Africa, the competence of the PAAB in the field being regulated should not be in doubt since it consists mostly of members of the auditing profession with specialist knowledge of the field being regulated.

- **Independence**

A self-regulating body consists mainly of members of the industry or profession being regulated, which prevents that body from being independent from the regulated (Ogus 1994:108). Bernstein (1955:157-158) refers to the close contact existing between the regulatory body and those being regulated. The role of the self-regulator as developer of the profession or industry is in conflict with its role as guardian of the public interest. In the case of self-regulation there is no guarantee that the interests of non-members will be protected (Baldwin & Cave 1999:65).

The administrative cost of self-regulation is carried by those being regulated (Ayres & Braithwaite 1992:114, Ogus 1994:107, Majone 1996:23, Baldwin & Cave 1999:128) which strengthens the view that the regulator is not independent from the regulated.

In the case of regulation of the auditing profession in South Africa the members of the PAAB consist mostly of members of the auditing profession. The profession is responsible for nominating members of the PAAB and because there is no remuneration, those members who are unable to offer their services free of charge are excluded from membership. This allows the view that this body is not independent. Because of its composition the PAAB could be perceived as

being controlled by the auditing profession with the result that the public interest is unlikely to be served.

The fact that the PAAB is financed solely by the auditing profession may further contribute to the view that this body is not independent.

- **Efficiency**

With self-regulation, the regulatory structures are quick and easy to put together (Baldwin & Cave 1999:64). They are also easy to adapt to changes in the industry because self-regulators function informally and they enjoy the trust of the group being regulated (Ogus 1994:107, Baldwin & Cave 1999:127).

In contrast to independent regulators, self-regulators can formulate "enlightened" rules and standards quickly and effectively because of their expertise and technical knowledge (Ogus 1994:107, Majone 1996:25, Baldwin & Cave 1999:65 & 127). Rules and standards formulated by self-regulators are couched in simpler and more specific terms to meet the needs of the industry being regulated (Baldwin & Cave 1999:40). Self-regulators can adapt their rules and standards more quickly to changing circumstances and new technical knowledge because their rules are less formal and are compiled for a specific industry (Ayres & Braithwaite 1992:111, Majone 1996:23, Baldwin & Cave 1999:40).

Where the rules and standards are set by the self-regulator, those being regulated tend to feel a stronger commitment to their "own" rules and standards which are regarded as more acceptable, which leads to increased voluntary compliance (Ayres & Braithwaite 1992:113, Baldwin & Cave 1999:40). Setting unacceptable requirements leads to lower levels of voluntary compliance, higher enforcement costs and ineffective rules and standards (Baldwin & Cave 1999:127).

Due to self-regulators' grasp of their rules and standards, interpretation is easy (Baldwin & Cave 1999:40). In the case of regulation by government, rules and standards are often applied too rigidly (Page 1987:304). Self-regulators have the ability to uncover transgressions quicker and easier than external regulators (Page 1987:304, Kay & Vickers 1990:240, Ayres & Braithwaite 1992:114, Majone 1996:25, Baldwin & Cave 1999:40). In the case of self-regulation, because of their grasp of the rules and standards and because they have unhindered access to those being regulated, it costs little to monitor compliance with the rules and standards and to dispense discipline in cases of non-compliance (Ogus 1994:107, Baldwin & Cave 1999:127). Although self-regulators have the ability to monitor compliance with the rules and standards and to dispense discipline in cases of non-compliance, it has been proved that they are less than successful in acting against members

who transgress (see Processes and procedures, to follow).

Self-regulation is a regulatory structure which is largely independent from government (Baldwin & Cave 1999:65). One advantage of self-regulation over regulation by government is that regulation takes place without the risk of being subjected to political influences (Bernstein 1955:129, Flint 1988:89). Regulation by government tends also to be more bureaucratic, which causes regulation by a private body to be more effective (Gray & Manson 2000:74).

Self-regulators have the necessary resources to perform their functions. According to a study by Braithwaite (Ayres & Braithwaite 1992:112) rules compiled by self-regulating structures tend to cover a more extensive range of malpractices than those compiled by government. The reason for this is, *inter alia*, that government does not have the necessary time and research resources. Reviews can be carried out on a larger scale than government is able to do with its limited resources, and reviews are carried out by people qualified to identify transgressions (Baldwin & Cave 1999:65).

However, arguments stressing the effectiveness of self-regulators do not take into account that a regulator must not only be economically effective, but must also fulfil certain social responsibilities and that there may be a conflict between economic effectiveness and the pursuance of social objectives such as protection of the public interest (see Section 4).

In the case of regulation of the auditing profession in South Africa, the PAAB is an external statutory body. This body would not be subject to much bureaucracy, which most probably enables it to function more economically and effectively. However, the PAAB may experience problems in fulfilling its social responsibility as the guardian of the public interest because of its lack of independence from the auditing profession, the majority of members being part of the auditing profession and the auditing profession being solely responsible for its financing.

The composition and structure of the PAAB should be able to adapt to changes quite easily.

- **Accountability**

Criticism of self-regulating systems centre mainly on the amount of power vested in structures that are not required to account for their actions through normal democratic channels (Ogus 1994:108, Baldwin & Cave 1999:129-130).

Self-regulators often account to a larger extent to their members (the regulated) than to government and society. Often they are subjected to external control measures only to a limited degree (Baldwin & Cave 1999:130).

In the case of regulation of the auditing profession in South Africa the PAAB must report annually to the Minister of Finance on the PAAB's affairs and activities during the year.

- **Processes and procedures**

Society is affected by decisions of regulators, such as the setting of standards for competence and conduct, while having made little or no inputs (Majone 1996:26, Baldwin & Cave 1999:132).

It is further argued that it is almost impossible for complaints against members to be handled satisfactorily by a body consisting mainly of members (Baldwin & Cave 1999:65). Criticism is also levelled at the monitoring of self-imposed rules and standards by private structures that are not independent because they allegedly favour their own interests (Baldwin & Cave 1999:41). This is especially the case where the functions of the self-regulator include the updating and formulation of rules and policies and the interpretation and application of the rules (including the dispensation of punishment) (Ogus 1994:108). The principle of divided functions is completely disregarded. Although self-regulating structures are better able to detect malpractices because they are better informed than, say, the government, they do not publicise such misconduct because that would alert external parties to the misdeeds of the regulated. According to Baldwin and Cave (1999:129) it has been proved that self-regulating structures have little success in acting, in the public interest, against members who transgress. Offenders are often not disciplined as effectively as would happen if regulation were effected by government (Kay & Vickers 1990:240, Ayres & Braithwaite 1992:114, Majone 1996:26).

The processes and procedures of self-regulators prove not to be open, transparent, accountable and acceptable to the community (Baldwin & Cave 1999:40).

In the case of regulation of the auditing profession in South Africa the PAAB is responsible for the formulation of ethical and auditing standards. Although the PAAB has accepted the international auditing standards from the beginning of 2005, the ethical and auditing standards of the auditing profession are not legally enforceable because they were neither set or approved by government.

The PAAB is also responsible for monitoring the actions of auditors in order to ensure that auditors comply with the ethical and auditing standards, for instance by conducting regular inspections (practice reviews). The PAAB is also responsible for the investigation of alleged offences, hearing of cases of alleged misconduct and the imposition of punitive measures in cases of misconduct.

Due to the lack of adequate external representation the processes of the PAAB are not open nor transparent in respect of the formulation

of rules, meetings, reporting on activities and disciplinary activities.

From the above it is clear that those aspects that are important to a regulatory system are not addressed adequately by regulation of the auditing profession.

The root causes why the aspects important to a regulatory system are not adequately addressed by regulation of the auditing profession can be traced back to the *composition* and the *financing* of the regulator.

The fact that almost all the members of the regulator may be auditors, influences the independence of regulation of the auditing profession and the processes and procedures of regulation such as ethical and auditing standards, monitoring and discipline.

The fact that the auditing profession is solely responsible for the financing of the regulator has a further influence on the independence of regulation of the auditing profession and the processes and procedures of regulation.

It also has an influence on the efficiency of regulation because the regulator, as a result of a lack of independence from the auditing profession, may encounter problems in fulfilling its social responsibility as guardian of the public interest.

There are two final reasons why some aspects important to a regulatory system are not adequately addressed by the self-regulation of the auditing profession:

- No provision has been made for external supervision of the regulator, nor for the periodic evaluation of the structure of regulation.
- There is no requirement that account be given to the community, and no provision has been made for action to be taken against the regulator if its mandate is not carried out properly.

7 SUMMARY

This article evaluated the self-regulating structure of the auditing profession with reference to the factors important to a regulatory system.

Firstly, the following core aspects of regulation were identified with reference to the properties of regulation as deduced from the literature: *Public interest, independent party, actions, dynamic process and coercion*. With reference to these core aspects, regulation was defined as follows:

Regulation is a dynamic process whereby, through actual or implied coercion, an independent party

brings about actions in another party, all in the public interest.

Next, the factors giving rise to the demand for regulation were described. Regulation can take place in two ways, namely regulation of the structure of an industry (structural regulation) or regulation of the actions of an industry (behavioural regulation).

In order to evaluate regulation of the auditing profession, it is important to have clarity about the factors that are important to a regulatory system. In the literature, several authors have identified factors or aspects important to a regulatory system. For the purposes of this study these factors important to a regulatory system are grouped under the following headings: Mandate; Structure; Competence; Independence; Efficiency; Accountability; Processes and procedures.

Then the role of regulation of the auditing profession was described. It is clear that the role of regulation of the auditing profession, because of the nature and substance of auditing, is to protect the interests of society. The auditing profession exists as a result of legislation by society. Regulation of the auditing profession is a mechanism through which society may gain assurance that the auditing profession is under appropriate control and can therefore be *trusted*. From the role of the auditing profession and the reasons for regulation it appears that the auditing profession must be regulated in order to meet the needs of society and, more specifically, to justify the *trust* of society.

Finally, the factors important to a regulatory system were used as the basis for evaluating regulation of the auditing profession by determining to what extent regulation of the profession actually addressed those factors.

8 CONCLUSION

It is clear that in cases where there is a public interest, as in the case of the auditing profession, self-regulation with little or no interference from government and no representation or financing from various interested parties is inappropriate. This is because the structure, processes and procedures of regulation are not independent from those who are being regulated and there is no guarantee that the public interest will be pursued. Neither can self-regulation be justified where the public interest is involved, unless account is given to the community about the way in which the regulator carried out its mandate as guardian of the public interest.

Self-regulation therefore appears to be an inherently flawed option as it is not able to deal with issues caused by a lack of public confidence.

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