

The end of the road ... need for a new dispensation

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Background

The role and function of the auditing industry changes continually. Since the Industrial Revolution, a clear rhythm in the developments and events can be discerned. Political, social and economic development and events do force the auditing industry to reposition itself time and again to remain relevant to and to meet the needs of society. Because the auditor has a statutory monopoly to carry out the attest function, in the long term he must simply meet the needs of society that are embodied in legislation. In other words, auditors have traditionally been reactive to forces of change, rather than proactive, and leading the change process.

The extent and nature of change in the auditing industry is determined time and again by the amount of pressure that society, in all its diversity, brings to bear. The audit industry's first reaction to this pressure, is normally one of strong denial, followed shortly by attacks on the agents of change. If pressure from the various social and economic structures lasts long enough and debate gets through to the press, the auditing industry becomes part of the change, then tries to manage the process, and finally it tries to acquire ownership of it.

In the late 1980s the brief audit report was replaced worldwide by the extensive audit report. This development can be linked to the findings of the *Macdonald Commission*. With this change the auditing industry attempted to narrow the expectation gap between the auditing industry and its clients by providing more information in the audit report.

Reaction to the introduction of the extensive audit report varied. The ACCA indicated that the main issues in the auditing industry, namely the independence of the auditor and the auditor's responsibility to discover errors and fraud, were not addressed in the extensive audit report. Other comments on the new format also indicated that the amendments were not enough. Internationally, the audit industry seemed reluctant to support changes that might have a negative effect on income.

Events in South Africa Masterbond Group

The Nel Commission report on the events surrounding the Masterbond group of companies identified various issues. As usual, the losers were members of the public, and pensioners in particular. The evidence in the final Nel Commission report does not do the audit industry credit; on the contrary, it provides proof of dishonesty, collusion with management and lack of independence because of non-audit services that were rendered to audit clients.

The disciplinary committee of the Public Accountants' and Auditors' Board found the first accused guilty on ten counts of improper conduct. If one reviews the magnitude of the ten counts as published in Maneo in March 2001, it is clear that the offences are serious. The disciplinary committee imposed the following sentences: A fine of R10 000 (being the maximum applicable fine at the time the offences were committed) and suspension from practice for a period of two years, which suspension was suspended for a period of three years on condition that the accused was not found guilty of contravening the Disciplinary Rules during that period. The impact of the fine was negligible as R10 000 was a partner's fee for a single day's work. And he was allowed to carry on with business as usual. Neither justice nor the long term best interests of the audit industry were well served.

Real Africa

In 1995 Real Africa Holdings and Real Africa Investments published substantial downward revisions of an earlier profit announcement. The audit firm that had been asked by Real Africa to prepare the original accounts acknowledged responsibility for the errors. The Chief Executive of the audit firm was quoted as having said: "It was our fault and we are very embarrassed about it. The people drawing up the consolidation were acting as accountants and not as auditors. We should have sent in a different team to check their work." If the first team comprised accountants providing accountancy services, and there was no second audit team, the consolidation was not, in fact, audited.

LeisureNet

From the debate in the newspapers during the past few months it is clear that the root of the problem at Leisurenet was the involvement of the auditors in providing non-audit services. According to BusinessReport (4 October 2001), the auditor of LeisureNet "was aware of VAT evasion by LeisureNet executives and tacitly accepted the situation whereby the company would carry the expenses".

BusinessReport (4 October 2001) also reported that "the commission also heard that the offshore headquarters of Healthland International, in which LeisureNet had a 57,8% stake, was registered in Malta. Far from being the bustling office of a multinational, it was a sham with a telephone and a fax machine and a woman employed on a half-day basis. Board meetings were never held in Malta and because LeisureNet directors were concerned about the tax implications they asked their auditors for advice" (one of the big five audit firms). The auditors advised them: "Hold occasional meetings in South Africa but ideally all meetings should be held outside the country".

From this it is clear that the auditors become part of the schemes of management, and by so doing, lost their objectivity and independence.

The King report

King 2 recommends the following on non-audit services:

"The audit committee should set the principles for using the accounting firm of the external auditors for non-audit services.

In accordance with the related Companies Act requirements, there should be separate disclosure of the amount paid for non-audit services as opposed to audit services.

A detailed description of non-audit services rendered by the external auditor and the nature thereof should be provided in the annual financial statements of the company, together with particulars of the amounts paid for each of the services described. Where appropriate it might be useful for the annual corporate governance statement to provide for additional explanation or justification for these services"

The impact of King 2 on providing of audit and non-audit services to the same client is that the audit committee of the company should set the principles under which the audit firm should render audit and non-audit services to the same client. However, no principles are laid down for the audit committee. It all depends on the views of the audit committee members and when an audit committee does not exist, the recommendation has no effect. The practical effect of King 2's recommendations are minimal: more hope than substance. There is a weak recommendation that the audit committee of the company "should" (not "must") set the principles. The charter of the audit committee, or even its very being, is not deemed worthy of comment or guideline.

The second recommendation (separate disclosure for audit and non-audit services) did not add anything to strengthen the independence of the auditors, as the recommendation refers to a company requirement, which already exists.

The third recommendation suggests that a detailed description of non-audit services, together with the amounts paid, should be disclosed in the annual financial statements. The flaw in this recommendation is that the nature of the non-audit services impairs the independence of the auditor. Non-audit services impacts negatively on the auditor's independence, respective of its nature.

From the *King report* it is clear that the recommendations regarding the provision of audit and non-audit services by the same audit firm are lacking relevance, and are lagging far behind international developments. Furthermore the lessons from Masterbond and Enron, as well as research done by the Department of Auditing at the University of Pretoria, has not been taken into account. There is an apparent lack of will within the profession to take up and resolve the challenges presented in the reports of the various commissions.

Advertisement by audit firms

According to advertisements in the Top Company surveys of the Financial Mail and of Finance Week, audit firms variously undertake to "uncover new opportunities; to create, to plan, to enable, to help". Other advertisements proclaim that they "assist"; that they believe in becoming "business partners"; that they will implement tax schemes, implement information technology policies and provide IT facilities.

A glance at their advertisements in journals shows that they are performing at least the following business functions: they recruit personnel for the companies they audit, including conducting the interviews for and scrutinise selection of directors and senior financial staff (who later appoint the auditors); they re-engineer company business processes, engineer listings and off-shore operations; assist in preventing so-called hostile take-overs; provide the information necessary for decision-making purposes; do corporate restructuring, and provide personal financial planning for the directors of the companies they audit.

International events

The Report of the Irish Review Group on Auditing

In July 2000 this report was published in Ireland, the product of two working groups, established to focus on the most burning issues in the audit industry, namely *self-regulation auditor independence*.

When evaluating the recommendations of the Irish Review Group on Auditing, we must take into account that the report was published in 2000, and since then certain important developments and events have taken place.

The Review Group agrees with the Committee of Public Accounts that the provision by an auditor of non-audit services to its audit client can pose a threat to auditor independence. This threat to auditor independence is increasing as the scope and profitability of non-audit services expands both in absolute terms and in relation to audit services.

In concluding that audit firms should not audit their own work, neither be permitted to provide valuation services or internal audit services to audit clients, the Review Group recommends that an auditing standard, acceptable to the Oversight Board, be developed to implement this decision. So far (June 2002) the proposed auditing standard has not yet appeared.

US Securities and Exchange Commission

In 2001 the US Securities and Exchange Commission published the *Revision of the Commission's Requirements for Auditor Independence*. It is a lengthy report of 175 pages, with numerous amendments all focusing on the auditor's independence. A clear message was conveyed and regulations amended to strengthen the independence of the audit industry.

Enron

Enron, the largest company to fail in the US, went bankrupt in 2002. Everything about this debacle is huge: a \$50 billion bankruptcy, \$32 billion lost in market capitalisation, and employee retirement accounts drained of more than \$1 billion. The lapses and conflicts on the part of Enron's auditors, Arthur Andersen, are equally glaring. Arthur Andersen had been Enron's outside auditor since the 1980s, but in the mid-1990s the firm was given the internal audit assignment as well. In effect the firm was working on the accounting systems and controls with one hand and auditing the figures they produced on the other. Enron's own Andersen partners dominated their financial team.

In 2000 Andersen earned \$25 million in audit fees and another \$27 million in consulting fees and from other work. This sorry record has cast doubt on a once honoured profession. Auditors have always been in the uncomfortable position of having to judge the financial integrity of the companies that pay them.

According to Phil Livingston, President of the Financial Executives Institute: "They (auditors) began to emphasise too much, being a business partner to the company." The conclusion of the press in the US is that the accounting industry, which largely regulates itself, has steadfastly resisted change, even in the face of repeated audit failures and scandals. The size and scope of the Enron disaster is simply too huge to ignore. The pressure is mounting for some form of super-regulator or government agency to police the industry should it not implement a ban on the provisions of both audit and business-focussed services.

New scandals like Worldcom in the United States are popping up.

The Office of the Auditor-General RSA

The Office of the Auditor-General must be commended for its sound policy on the audit independence issue. When the office contracts out work to private audit firms, a condition is that they are not allowed to perform any non-audit services for the auditees, thus strengthening the integrity of the audit function.

Conclusion

If one takes into account the different audit failures and other developments that directly impact on the public interest, it is clear that the end of the road has been reached; the end of providing audit services and non-audit services to the same client. If this situation is not rectified by the audit industry through its processes of self-regulation, the legislators will do it for them, and sooner, rather than later.