

# Private sector auditors functioning in the public sector domain

## A two-edged sword?

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The *Public Audit Act*, Act no 25 of 2004 [PAA] (section 11), allows the Auditor-General to engage registered auditors from the private sector to assist in performing public sector audits. This requirement is not new and echoes similar provisions to those in the now repealed Auditor-General Act (Act 12 of 1995) and the Audit Arrangements Act (Act 122 of 1992).

Although such involvement of private sector auditors in the public sector domain may seem like a logical and reasonable practice (for example, to overcome bottlenecks due to 31 March year ends), a number of factors affect whether or not such arrangements are ultimately in the public interest. This article attempts to examine three of the most important factors.

- The effect of such practice on the cost of public sector audits.
- Possible threats to the Auditor-General's independence.
- Assuring the competence of private sector auditors.

### The effect of such practice on the cost of public sector audits

The fees that private sector auditors are paid to perform contract audit work for the Auditor-General are agreed upon annually by the Auditor-General and the South African Institute of Chartered Accountants. In this regard the fees paid to audit partners, provides a good benchmark against which to measure the general costs and costs increases of this service.

It has become clear, especially over the last few years, that the Auditor-General has implemented a strategy that has increased the Auditor-General's reliance on private sector auditors.

It seems that as this reliance has increased, so has the percentage increase in fees paid to the private sector auditors. It seems a logical conclusion that whereas previously, the Auditor-General

was able to perform most audit work by utilising its own capacity, now an over reliance on private sector auditors and a declining capacity within the Office has weakened the Auditor-General's negotiating powers. This is apparent from the accompanying graph, which clearly shows the acceleration of private sector audit partner fees during the most recent years. Taking 2000 as a base year, the charge-out rate of private sector audit partners performing contract work for the Auditor-General, has increased by 144% (from R530/hour to R1,321) over six years. Whereas in the last three years in particular, general salary increases in South Africa were kept to around 8% (and in some industries even below this level) the contract work fees of private sector auditors have increased by 21%, 16% and 27% in 2004, 2005 and 2006 respectively.

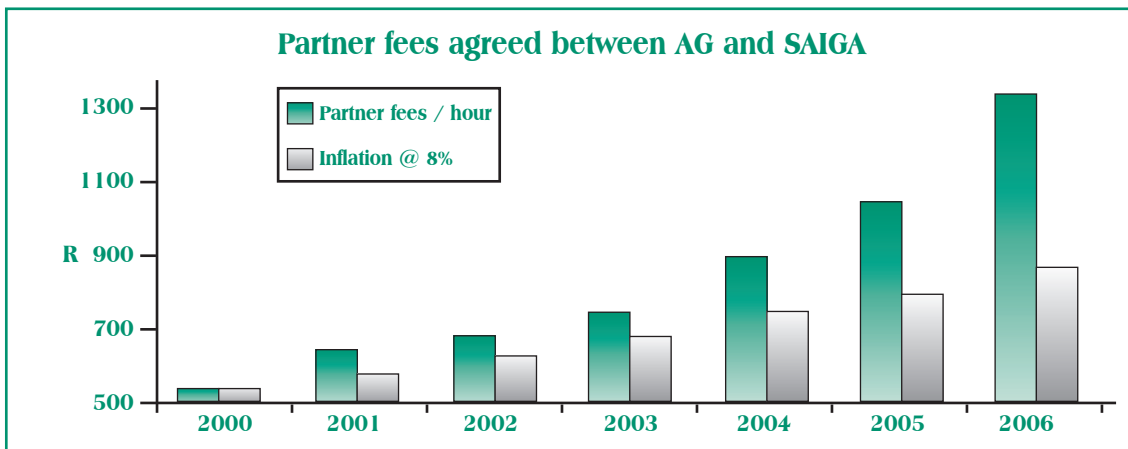
The Auditor-General's Report does not provide an explanation for these abnormally high increases.

**Table1**

Private sector audit partner fees for audits on behalf of the Auditor-General

Year	Rand	Increase
2000	540	-
2001	645	19%
2002	684	6%
2003	735	7%
2004	891	21%
2005	1037	16%
2006	1321	27%
Increase from 2000 basis year		144%

Graph 1



The above table and graph illustrate the rate of increase in the fees that are agreed upon between the Auditor-General and the SAICA relative to broad based fee inflation.

A closer look at this arrangement highlights another aberration. Members of the SAICA are entitled to the designation CA (SA). However, membership of the SAICA does not convey the right to perform audits in the private sector. In order to do that, practitioners have to be registered with the Independent Regulatory Board for Auditors (IRBA). Furthermore, the PAA also requires authorised auditors to be registered with the IRBA. The right to perform an audit is not dependent on membership of the SAICA, whether in the private, or the public sector. It would then appear logical that the IRBA, rather than the SAICA, should be responsible for negotiating the fees for public sector engagements by private sector auditors.

Or why are there not more parties at the fees negotiating table in order to provide a more balanced process and a wider spectrum of interests to be represented? The IRBA as regulator has a definite role to play. Its involvement would introduce two much needed elements into the negotiating process: the public interest and independence. If the SAICA, as a private sector Institute, is involved, why not also invite the Southern African Institute of Government Auditors as a body representing public sector interests?

Lastly, the fee setting process needs to be subjected to full transparency and openness. Since the agreement of contract work fees directly affects the utilisation of public money (the departments that are being audited pay the audit fees), the public must be allowed to oversee proceedings. The negotiating process should therefore be open and transparent. Members of the public and other interested role-players should be allowed to follow the deliberations - the meetings must be open to any one wishing to observe the proceedings.

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**The fee setting process needs to be subjected to full transparency and openness.**

### Possible threats to the Auditor-General's independence

Not only did the fee rate of private sector auditors auditing for the Auditor-General increase substantially, but private sector audit firms are responsible for an increasing percentage of the Auditor-General's work. The steep increase in audits contracted out to private sector audit firms may in fact indicate a critical shortage of skills within the Auditor-General.

- Contract work given to private sector auditors rose from an average of R35 Million in the middle and late 1990s to R109 Million in 2001 (a 210% increase) and then to

R137 Million in 2002 (a 25% increase in a single year). Three years later these private sector fees have risen to R175 Million (an additional R6 Million is shown as irrecoverable).

- Whereas contract work represented 21% of audit fees earned by the Auditor-General in 1995/96, it now represents 29% (a 38% ratio increase).

The 2005 contract work fee of R175 Million is most significant as it indicates that the Auditor-General may actually not be capable of performing its Constitutional mandate without the assistance of private sector audit firms.

If factors such as the limited capacity of higher education institutions to deliver suitable graduates are taken into account, and the Auditor-General's current position as employer of graduates, the general availability of trainee auditors and other capacity issues are discounted, it becomes clear that the Auditor-General will find it difficult to change the existing dependence on the private sector audit industry. This factor alone is a major threat to the Auditor-General's Constitutionally required independence.

Just how dependent the Auditor-General may have become of particular firms or how dependent the Auditor-General may be on outside assistance on specific audits,

remains an area of major speculation. Unfortunately, the PAA does not assist the South African public to make an informed assessment of these critical aspects (so critical they may threaten the Constitutionally required independence of the Auditor-General) as the PAA does not require the disclosure of the Auditor-General's reliance on outside auditor expertise in respect of each audit.

In addition, the figure of R175 Million does not include the fees earned by private sector auditors performing the audits of public entities which the Auditor-General has chosen not to audit (the *Public Audit Act* allows the Auditor-General to exercise a choice in this regard<sup>11</sup>). Unfortunately, the PAA also does not require the disclosure of the fees that private sector auditors earn in auditing public entities, thereby further hindering an objective assessment of the capabilities of the Auditor-General to audit all public sector institutions and of the Auditor-General's true independence or as may seem more appropriate in this context, its level of dependence.

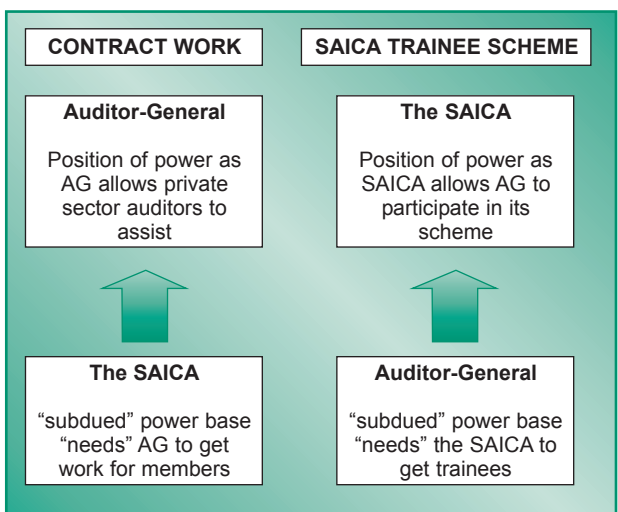
The steep increase in the charge out rate paid to private sector auditors, particularly in recent years, seems to indicate that the Auditor-General has lost a considerable amount of bargaining power, and ultimately its independence.

It is generally accepted that the more dependent we are on certain groups, the less likely we are to take an unsympathetic stance towards that group. How effective can the Auditor-General negotiate to confine fee increases to a reasonable level, if the Auditor-General is *dependent* on the other party? With no possible short term reserve capacities to utilise, and a declared long term reliance on the private sector audit industry, a threat by the private sector to withdraw from the contract work scene if fees do not rise astronomically, is very real and cannot, given the Auditor-General's dependence, be met by counterbalancing arguments.

Another factor in the relationship between the Auditor-General and the SAICA that also emphasises the word *dependence* rather than independence, is the Auditor-General's involvement in the SAICA trainee accountant scheme. Here the traditional power bases have reversed (refer to the Table of Power Bases). The Auditor-General had to approach the SAICA to get permission for it to be accepted as a registered training office and to be allowed to participate in the SAICA scheme. In terms of the trainee accountant scheme, the Auditor-General has to convince the SAICA of its capabilities to train chartered accountants and is subjected to quality reviews. According to the Auditor-General's Report for the year ended 31 March 2005 a total of 550 SAICA trainee accountants were employed by the Auditor-General. This raises the question: can the Auditor-General really afford to take a hard bargaining position with the SAICA on fee issues if, on the other hand, it is so clearly dependent on the services of 550 audit staff members whose employment is dependent on the Auditor-General receiving the SAICA's continued permission to operate as a SAICA training office?

A more critical question may therefore be: To what extent has the Auditor-General already compromised its Constitutionally required independence by participating in the SAICA trainee scheme to the extent that has now been disclosed?

Table of Power Bases (Auditor-General versus the SAICA)



## Assuring the competence of private sector auditors

The quiet revolution started by the *Public Finance Management Act* has fast gained momentum and the financial management reforms in the public sector, together with the implementation of advanced accountability concepts have transformed the public sector beyond recognition. In an article in a previous issue of this journal (*Auditing SA*: Winter 2000) I stated:

*"To compare and discuss all governance and accountability arrangements between the private and public sector is not possible in an article of this length. The above discussion has, however, provided sufficient basis to support the supposition that the Public Finance Management Act has not only introduced a paradigm shift as far as financial management and accountability of the public sector is concerned, but also drawn attention to the fact that the statutory accountability and management duties of private managers are now some way behind those of their counterparts in the public sector."*

**To what extent has the Auditor-General already compromised its Constitutionally required independence by participating in the SAICA trainee scheme to the extent that has now been disclosed?**

**Why therefore should private sector auditors not be subject to a reciprocal requirement and also be required to pass a formal assessment of their public sector knowledge and competence before being allowed to audit in the public sector?**

Since then the public sector has further developed into a highly specialised and unique auditing and accounting environment: the PFMA has been given further effect by the publication of the various versions of the *Treasury Regulations*; the *Municipal Finance Management Act* has been promulgated; South Africa's Accounting Standards Board has become operational; the first GRAP statements have been finalised and public sector regulatory bodies such as the National Treasury and the Office of the Accountant-General, require the application of a host of advanced concepts, standards and approaches.

None of these unique requirements are found in the private sector - yet they have to be dealt with in detail during the audit of public sector entities. They influence audit approaches, detail procedures, audit judgement and decisions.

It is therefore a valid question to ask if private sector auditors do in fact possess the necessary competence to audit in the unique public sector environment, particularly taking into account that these public sector developments do not form part of the prescribed syllabi of either the South African Institute of Chartered Accountants (SAICA) or the Independent Regulatory Board for Auditors (IRBA). Whilst the PFMA did, for a few years, form part of the SAICA syllabus, it has now been removed from it. Neither chartered accountants nor IRBA registered auditors are therefore formally assessed on these topics in the private sector's professional qualifying examinations.

## In search for a public interest solution

The recent promulgation of new legislation in both the private and public audit sectors has necessitated the reassessment of traditional audit models and approaches:

- In the private sector, the *Auditing Profession Act* (APA) requires the IRBA to develop an accreditation model and to stipulate applicable requirements for persons wishing to audit in the private sector.
- In the public sector, the *Public Audit Act* (PAA) requires the Auditor-General to determine required qualifications, experience and competency of so-called authorised auditors.

The IRBA, in its Accreditation Model, has taken a firm stand and ruled that *no* person will be allowed to audit in the private sector, unless he/she has passed the IRBA's qualifying examination

(PPE). This means that public sector auditors (employed by the Auditor-General) who, for example, may have decades of audit experience, possess high qualifications from tertiary institutions, and who have successfully discharged responsibilities in respect of the audit of entities that dwarf the largest listed private sector companies, will also have to write and pass the IRBA's examination in order to operate as auditors in the private sector.

Why therefore should private sector auditors not be subject to a reciprocal requirement and also be required to pass a formal assessment of their public sector knowledge and competence before being allowed to audit in the public sector?

This would ensure that private sector auditors and their staff engaged in public sector audits possess at least a minimum level of competence with regard to the unique, advanced concepts and approaches in the public sector.

Whereas in the past, no formal evaluation and assessment mechanisms existed to assess public sector audit competencies (other than those the Auditor-General may have employed), this has changed during the last seven years. The Southern African Institute of Government Auditors (SAIGA) has now codified the required audit knowledge and skills pool in the form of a Common Body of Knowledge and Skills (COBOKS) for public sector auditors. In its most recent version (2006), SAIGA's COBOKS also now incorporates all the Auditor-General's requirements. To examine competence in these specific COBOKS requirements, SAIGA has developed a professional examination process (the RGA-QE) - thereby providing an effective and efficient method for formally assessing the competency of private sector auditors and their staff. Another benefit of utilising this available model is that it would not result in any additional cost to the Auditor-General.

Since the PAA obliges the Auditor-General to determine the competency requirements of authorised auditors, the utilisation of an existing model that has been developed over almost a decade and which is operated at no cost to the Auditor-General, may seem worthy of consideration by the Auditor-General. Taking this a step further, the requirement of full membership of SAIGA (i.e. to register as Registered Government Auditor) would be even more beneficial, as the Institute, with effect from 1 April 2007, is also implementing a comprehensive and compulsory system of continuing professional development (compulsory CPD). This would also ensure that the writing of the RGA-QE is not the end of the process of ensuring private sector auditors' competency in public sector matters.

These developments once more indicate that the public sector is evolving at a dynamic pace and that structures and processes are now in place to ensure the adherence to minimum standards. Why should private sector auditors be excluded from such processes, particularly if one takes into account the real risks in this regard due to the one-sided syllabus content of private sector auditors.

The Southern African Institute of Government Auditors has taken up this matter with the Auditor-General and is aiming to assist the Auditor-General in advancing both public accountability and government auditing.

## The way forward

A number of steps need to be implemented urgently, either by changing existing legislation or by the Auditor-General voluntarily implementing standards of transparency and accountability:

- 1 The audit contract fee-setting process must be made more inclusive and transparent.
- 2 A logical reciprocal requirement should be implemented regarding training and formal qualifications: the private sector auditors' knowledge of and competence in the unique public sector requirements and topics must also be formally assessed. SAIGA's existing RGA-QE model is ideally suited for immediate implementation, without any cost for the Auditor-General.

Promoting and utilising the Registered Government Auditor (RGA) qualification that is specifically designed to produce a professional competent to audit in the public sector environment and to meet the Auditor-General's requirements, seems a logical and long-term approach to limit the Auditor-General's dependency on the private sector audit industry and to counter its accompanying shortcomings<sup>11</sup>.

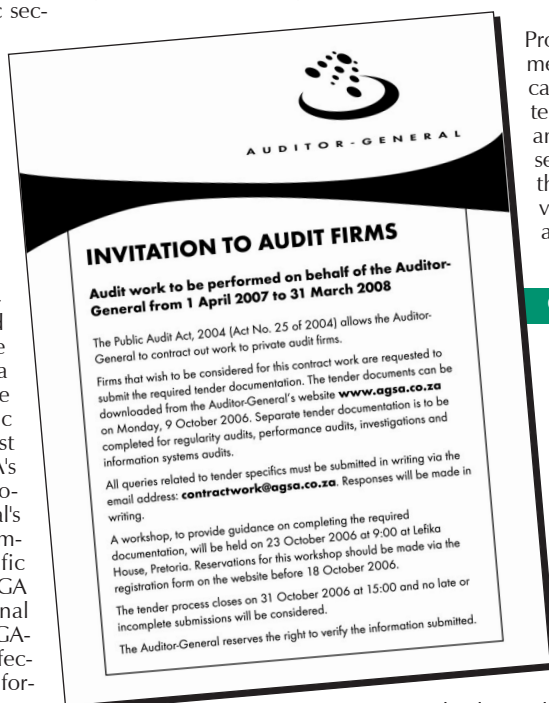
## Conclusions

The above discussion has focused on three factors that are important to determine whether or not the arrangement to use private sector auditors to assist the Auditor-General are ultimately in the public interest.

All three factors discussed indicate that real dangers exist if the practice is not administered with extreme caution, if it is not subject to greater public scrutiny and monitored and accounted for very closely. The alarm bells are ringing.

One may even conclude that this arrangement indeed symbolises the proverbial two-edged sword, which, given the existence of other, less dangerous and more constructive weaponry, should be severely restrained and ultimately discarded.

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## Editor's Note:

Since submission of this article and the publication date, the Auditor-General's Report for the year ended 31 March 2006 was published. This report indicates that the total amount of contract work has risen from the R175 Million mentioned in the article (2005) to R238 Million in 2006. This represents a 36% increase. Contract work done by private sector auditors now represents 32% (2005: 29%) of the Auditor-General's audit fees. These latest facts further support the author's arguments raised in the article.



## Capacity building initiatives

During January 2005, the South African Management Development Institute (SAMDI) developed a Financial Management Training Strategy in association with the National Treasury. In terms of this strategy, SAMDI will be responsible for, amongst others, entering into partnerships with training service providers for the large scale roll out of financial management courses, overseeing the development of course material and the presentation of courses, providing post training support and benchmarking financial management training both nationally and internationally.

National Treasury elected to provide SAMDI with support by, amongst others, rendering financial assistance for the roll out of financial management training and providing human resource support to facilitate strategic sessions for financial management training.

After going through a bid process, SAMDI has identified training service providers who will soon roll out training on courses related to Governance and Audit Committees, Revenue Management, Expenditure Management and Public Financial Management for Non-Financial Managers, to name but a few.

Consideration will also be given to packaging short courses into structured programmes/certificates for the various levels and target groups, particularly senior management, middle management, chief financial officers, programme managers, non-financial managers, etc.

## Conclusion

The National Treasury has embarked on several initiatives with a view to assisting departments rectify concerns raised by the Auditor-General in his General Report for the 2004/2005 financial year. To this end, frameworks and guidelines have been developed, practice notes have been issued and formal and informal engagements have taken place with departments, all with the view to ensure improvement in financial management.

In addition, forums have been established, training courses have been rolled out and a Financial Management Training Strategy has been supported, all being initiatives to assist with the development of human capital in the public sector. These initiatives are also consistent with National Treasury's responsibility [in terms of section 6(2)(d) of the PFMA] to assist departments and constitutional institutions in building their capacity for efficient, effective and transparent financial management. These initiatives will also assist in promoting implementation of the PFMA, both in letter and in spirit.

Sections 6(2)(b) and (c) also require the National Treasury to monitor, assess and enforce implementation of the Act in departments, constitutional institutions and public entities. In this regard, the National Treasury reiterates its commitment to ensure regular interaction with all PFMA compliant institutions with a view to exercising its enforcement and oversight responsibilities, as prescribed by the PFMA.

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### END NOTES:

<sup>i</sup> In its comments on the Draft Public Audit Bill the Southern African Institute of Government Auditors (SAIGA) pleaded that the Act should require disclosure (in the audit report) of certain facts regarding the use of "authorised auditors" by the Auditor-General during the audit of an institution or department. Details to be disclosed by the Auditor-General are:

- ▶ nature and extent of the assistance by private sector auditors
- ▶ names of all "authorised auditors" used
- ▶ total fees paid to each "authorised auditor"
- ▶ analysis of such fees into categories (type of work, level of engagement, etc).

This kind of information would not only empower the users of the Auditor-General's reports to assess for themselves the nature and extent of the reliance on private sector auditors, but where these private sector services were used responsibly and in a balanced manner, the information would underscore the Auditor-General's independence.

Unfortunately, the SAIGA proposals were not accepted, depriving the Auditor-General of a long held advantage of leading by example in areas such as transparency and accountability.

<sup>ii</sup> Given the current arrangements in the PAA, and the Auditor-General's decision not to engage in audits of public entities, these public entities which in some cases represent South Africa's largest companies (for example Telkom, Transnet, Eskom) are at risk of being audited in manners that do not harmonise with overall requirements set for these entities. Since, for example, the syllabus of the (private sector) Registered Auditors does not provide for performance audits and since performance audits are not regularly performed in the private sector, and since the PAA does not prescribe a performance audit of section 4(3) institutions, it is highly unlikely that the privately audited section 4(3) institutions will be subject to an audit of its efficient, effective and economical utilisation of its resources. Taking into account that the PFMA specifically requires these institutions to operate and report within a system of statutory per-

formance management, the performance audit is a definite requirement and the failure of providing such performance audit reports not only holds back efforts to implement the new management approaches introduced by the PFMA and *Treasury Regulations*, but also seems to be contrary to the public interest.

As is also apparent in other sections of the PAA, it seems as if the drafters of the PAA were obsessed with the objective of formulating sections that accommodate the private sector audit industry within public sector audit spheres under the most favourable circumstances to the private sector - circumstances which are not necessarily in the public sector interest. As is the case with many issues that are and have been driven by the power and influence of the private sector audit industry, the ultimate loser routinely turns out to be the public.

<sup>iii</sup> This year, the Southern African Institute of Government Auditors (SAIGA) presented a *Financial Skills Development Model for the public sector*. This model must be seen against the background of initiatives such as the Joint Initiative on Priority Skills Acquisition (JIPSA) and the broader objectives of the Accelerated and Shared Growth Initiative of South Africa (ASGISA). Although South Africa's public sector generally experiences skills shortages at many levels, the financial sector is particularly adversely affected. Whilst the private sector has in operation a highly effective system to ensure a constant supply of financial skills, no such system has to date been implemented for the public sector.

The SAIGA model shows how wider recognition of the RGA by specific role-players and the integration of the RGA concept in strategic approaches by specific public sector entities and universities will provide a continued long term supply of financially skilled professionals to the public sector. This is exactly what South Africa needs.

Wider recognition of the RGA (particularly by the Auditor-General) would not only address the Auditor-General's capacity issues, but that of public sector institutions and also advance professionalisation in all public sector entities and ensure a constant stream of competent professionals to join the public sector.

The full *Financial Skills Development Model for the public sector* is available on the SAIGA website.

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