

Current affairs in audit

Regulation of auditors

In Australia, the recent regulation introduced includes *The Corporate Law Economic Reform Program (Audit Reform & Corporate Disclosure) Act 2003* (CLERP 9), the ASX Corporate Governance guidelines and professional regulation in the form of *F1 Professional Independence*. A brief summary of the contents of CLERP 9 is included in October 2004 edition of *Charter* (Adam-Smith, 2004).

Regulatory problem of auditing the auditors

Due to the confidential nature of an audit it is impossible to observe the conduct of an audit. The key test to determine if a quality audit occurred is that no material misstatements could be reasonably be expected to remain in the audited financial statements. As the public cannot observe the operations of an audit, the best indication whether the audit work is sufficient that all material misstatements could be reasonably be expected to be detected is to examine the workpapers of the client's audit. Traditionally contract was the chief means of regulating auditors. Directors and management were in the best position to examine the conduct of an audit and they could highlight bad auditing by bringing a legal suit against auditors. Court hearings would examine auditor's workpapers to determine if the auditor was negligent though collecting insufficient evidence or breaching their reporting obligations. However with the rise of out-of-court settlements this form of regulation has declined in importance. We thus seem to be seeking an alternative form of regulation for auditors.

Following the enormous debate about independence arising from the recent corporate collapses in United States and Australia and the accounting scandals in United States, much regulation has been addressed at the independence of auditors. However an auditor can comply with all the independence requirements and still be negligent in the conduct of the audit. An examination of the contents of *Professional Statement F1: Professional Independence* illustrates this point.

Para. 10 of *F 1* states

In each professional assignment undertaken, a member in public practice must both be and be seen to be free of any interest which is incompatible with objectivity.

Furthermore para . 11 states ...

Thus a member performing professional work in commerce, industry or the public service must recognise the problems created by personal relationships or financial involvements which by reason of their nature or degree might threaten his or her objectivity.

It thus seems that the key to independence is avoiding personal and financial relationships that may threaten independence. However it should be noted that independence is important to the extent it influences objectivity and this indicates that independence is a subordinate consideration in ensuring a quality audit has taken place. The key aspects for a quality audit is that the auditor collects sufficient, competent and reliable evidence and relevant issues have been reported appropriately.

The Pacific Acceptance and AWA case provide evidence that independence is not the crucial element in determining negligence of auditors. The decisions in these cases concentrate upon evidence and reporting requirements. In the AWA cases the point was made that the auditors independence was compromised through the auditors being friendly with AWA's management. However this point was made as a means of explaining why the auditors failed to report internal control deficiencies to the Board of Directors. The auditors were found negligent in the AWA case not from being friendly with management, but through their failure to report internal control deficiencies to the Board of Directors.

Despite the above, many recent investigations and studies in auditing have concentrated upon audit independence. Although these studies and debates about independence were necessary, the concentration upon independence at the expense of discussions on evidence and reporting issues was unfortunate. Too limited a discussion occurred on issues fundamental to audit negligence.

However one study that involved issues other than independence was the study by the *Panel of Audit Effectiveness (2000)*. This study examined SEC Accounting and Auditing Enforcement Releases issued from approximately July 1 1997 to December 31, 1999, involving the Big 5 firms or their clients (p.223). The purpose of the study was to provide "insights into the apparent causes of actual or alleged fraudulent financial reporting or audit failures..." (para. 3.39) Some of the conclusions drawn from this Panel's report are noted in table 1. The point that can be appreciated from reading these findings is that audit failings can be clearly identified and the nature of the corrective action is obvious in that the corrective action merely remedies the problem noted. This is contrasted to noting that independence issues are a cause of audit failure. To understand why independence caused audit failure the immediate question arises is how did a lack of independence affect evidence collection and/or reporting? It is only by dealing with the evidence

collection and reporting issues that a finding on audit negligence can be reached.

Having made these comments about regulation in general we can now examine issues raised about auditor regulation in both Australia and United States in recent media articles and examine these issues in the context of these comments.

Regulation in Australia

In Australia, the Australian Investment and Securities commission (ASIC) will check the big four accounting firms' compliance to audit independence rules passed in CLERP 9. Findings will be reported to the Financial Reporting Council who "has the responsibility to oversee audit independence issues" (Ravlic, 2004, p.2). This is the first year of these checks and the review of the big four accounting firms' compliance to independence rules will help the ASIC to "form a view of general level of compliance by auditors of the majority of listed companies". Next year the program will be expanded to cover "audit firms with a smaller number of listed company clients and over time ... all firms" will be covered (p.2).

The objective of the checks is ensure audit firms "have the appropriate systems and processes in place to ensure compliance" to the independence rules incorporated in CLERP 9 (ASIC, 2004, p.2). Presumably the ASIC will check in part that auditors have maintained quality control systems that achieve objectives similar to that outlined in the newly issued International Standard on Quality Control (ISQC 1). For a summary of the provisions of this standard see the article by Locke (2004) in November's *Charter*.

References

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