

CURRENT AFFAIRS IN AUDIT

Welcome to *Current Affairs in Audit* where we will highlight and discuss latest developments in auditing. In this excerpt of *Current Affairs in Audit* we will review the current state of auditing by discussing the question, ‘is auditing presently in a state of crisis?’ We will undertake this investigation by looking at a chronology of significant events that occurred between 1998 and the present. In later excerpts of *Current Affairs in Audit* we will, among other things, discuss various aspects of this chronology in more detail.

In recent times the amount of press coverage of auditing has been vast. Thus, the events that could be included in this chronology could be endless. I have endeavored to limit the events or statements included in the chronology to those that involve authoritative bodies or persons. This gives the chronology some objectivity and also keeps the chronology to manageable proportions.

This analysis of auditing takes a relatively short-term perspective of the current problems facing the auditing profession. The analysis starts with speeches by Arthur Levitt, the former Chairman of the Securities and Exchange Commission (SEC), that dealt with the importance of confidence in a nation’s financial reporting system, earnings management and auditor independence. Levitt stated that confidence is needed in a nation’s financial reporting system as more people are investing in shares as part of their retirement plans. He added that capital flows between countries are of increasing importance in this

internationalised business environment and confidence is needed in the reporting system to maintain these capital flows. Levitt contended that earnings management and auditor independence were undermining that confidence. Earnings management is the process whereby companies manipulate the earnings to ensure they meet profit forecasts previously announced to the market. The aspect of audit independence that Levitt was most concerned about was the provision of non-audit services by auditors to their clients.

The Securities and Exchange Commission originally proposed that auditors should be banned from offering some consulting services to their clients. After a period of debate about auditor independence, the SEC implemented a series of water-down proposals about independence. The debate about Levitt's and the SEC's criticisms of auditor independence was reported in Australia. When Harris Scarfe, HIH Insurance and One.Tel collapsed in early 2001, the question of auditor independence and consulting services was immediately raised. The Federal Government announced a royal commission into the collapse of HIH Insurance, with one of the terms of reference being to investigate the auditor's conduct. The debate about auditor independence was fuelled by the revelations that former partners of Arthur Andersen, the auditors of HIH Insurance, were board members of HIH Insurance.

In Australia, increasing numbers of people have a direct or indirect interest in the sharemarket. The year 2001 was a federal election year. This probably explains why the Australian Labor Party introduced a policy about corporate governance that included a brief policy on auditor independence. The Australian Democrats already had a policy

where they wished to have companies form corporate governance boards, which would be responsible for the appointment and remuneration of the auditor. This policy is designed to overcome executive management handling these matters and thus gaining excessive power in the audit-client relationship. In the lead up to the election, the Australian Democrats publicised this policy. The Australian Shareholder Association had a long-held policy of banning the provision of non-auditing services by auditors to audit clients. This policy also received publicity in the lead up to the federal election.

No doubt the Australian Labor Party and Australian Democrats' interest in auditing affairs led to the federal government announcing an investigation into auditor independence. Professor Ian Ramsay, a law professor at the University of Melbourne, was to conduct this investigation. Professor Ramsay produced his report in October 2001 and while his recommendations were not entirely welcomed by the auditing profession, they were at least palatable to the profession. Ramsay did not recommend that auditors should be banned from providing consulting services to their audit clients. His recommendations included that companies disclose non-audit services, divided by category of service, in the financial report and that the audit committee make declarations in the financial report that the level of non-audit services provided by the auditors was compatible with maintaining independence.

At this stage of our tale it could be concluded that auditors were under fire, but it was felt that they could ride out the criticism and then things would return to normal. However, two investigations upset the equanimity of the auditing profession. A sleeping issue that

received some publicity in Australia but later was to assume catastrophic proportions for auditors was the Enron crash in the United States of America. This, combined with the revelations in the royal commission into the collapse of HIH Insurance, substantially changed media criticism of auditors. Enron was the seventh largest company in the USA. Public outrage markedly increased when it was revealed that the auditors shredded documents relating to the audit and that the amount of non-auditing services provided by Arthur Andersen to Enron was a significant factor in Arthur Andersen retaining Enron as a client. This latter fact was significant as supporters of auditors providing non-audit services to audit clients pointed to the fact that no instance could be shown of the link between auditors providing non-audit services and negligent auditing.

The revelations of the auditors' conduct in Enron and HIH Insurance led many media commentators to harshly criticise auditors, with some even suggesting that the profession be abolished. Editorials appeared in the *Australian Financial Review* and the *Age* criticising auditors and suggesting that substantial change was needed. Debate about the change necessary for the auditing profession centred around four areas. They were (1) the establishment of an oversight board consisting of a majority of independent members to oversee independence matters, (2) the ban or control of sale of non-audit services, (3) strengthening audit committees' dealings with auditors and (4) some form of auditor rotation.

Alan Knott, the chairman of the Australian Securities Investment Commission, and Paul Volcker, the former head of the US Federal Reserve and Chairman of the Trustees of the

International Accounting Standards Committee Foundation, were concerned that audit fees are not high enough to conduct a quality audit. In Australia between the early 1980s and early 1990s, a highly competitive audit market resulted from companies placing their audit for tender. The tendering process created a market where prices of audits were kept low. There was a fear that prices occurring in this market were insufficient for a quality audit.

Finally, it should be noted that auditors in Australia must ensure that the company has followed accounting standards. David Boymal is concerned that products are being devised with the expressed objective of offering some reporting advantage to companies and suggests that failure to follow the intent of a standard be a violation of the professional body's by-laws.

The question remains. 'what is the present position confronting the auditing profession?' At present, there are several investigations into the aspects of auditing where the final outcome is incomplete. As noted in the chronology, there are 11 congressional investigations into the collapse of Enron in the USA. In accounting and auditing matters, Australia generally follows the United States lead and no doubt developments in Australia will be influenced by changes implemented in the USA. Secondly, the royal commission into the collapse of HIH Insurance is still conducting hearings and the government is interested in hearing the findings on the conduct of the audit before legislating change. Thirdly, the Australian government has invited responses to the Ramsay Report and these responses will have to be analysed before the federal

government makes reforms to the auditing function. Finally, the Joint Committee of Public Accounts and Audit recently announced it is to undertake an investigation of the important regulatory question of the balance between external controls through government regulation and freedom for industry self-regulation.

What is the position of Arthur Andersen, the auditors of Enron and HIH Insurance?

Worldwide, Arthur Andersen is negotiating to be absorbed by different firms in different countries. In Australia, Ernst and Young announced that it would take over Arthur Andersen. One matter involving Arthur Andersen that has received relatively little publicity is the legal case between Arthur Andersen and Southern Equities Corp (formerly Bond Corporation). At the time of , Arthur Andersen had moved to settle the lawsuit. The lawsuit resulted from the 1988 audit of Bond Corporation and this indicates that lawsuits involving auditors can be lengthy and involve considerable legal costs. The large legal costs, when compared to limited professional indemnity insurance available to satisfy legal claims, favours an out-of-court settlement. Out-of-court settlements of the various auditing cases caused through the collapse of several companies in the late 1980s may be a factor explaining why the present crisis in auditing exists. The out-of-court settlements do not permit a full investigation into the firm's conduct in these audits and there remains the question of whether the problems confronting auditors in this period have been identified and addressed.

Further issues of *Current Affairs in Audit* will develop points made in this analysis and report on current developments in auditing. There is no doubt we are facing a period

where substantial reform will be demanded of the auditing profession. The nature of these reforms remains to be seen.

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