The regulation of auditor ethical behaviour in Australia - the problem of conflicts of interest and proposal for structural reform

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Table of Contents

SYNOPSIS vii
STATEMENT OF CANDIDATE ix
LIST OF ABBREVIATIONS AND ACRONYMS x
ACKNOWLEDGMENTS xii
Chapter 1: Theoretical Overview 1
1.1 The Theory That Underpins This Thesis 1
1.2 Governmentality 2
1.3 Theories of Regulation 5
1.3.1 Public Interest Theories 6
1.3.2 Private Interest Theories 8
1.3.3 Institutional Theories 8
1.4 Markets 9
1.5 Insurance Theory 11
1.6 Ethical Theory 12
1.7 Theory of the Professions 14
1.8 Accounting Theory Relevant to This Thesis 17
1.8.1 Accounting as a Social Science 17
1.8.2 Alternative Research Methodologies - Critical Accounting Studies 19
1.9 The Role and Rationale of Auditing 20
1.9.1 Economic Theory 20
1.9.2 Concession Theory of Incorporation 21
1.9.3 Agency Theory 22
1.10 Conclusion 22
Chapter 2: The Nature of Accounting and True Disclosure 25
2.1 True Financial Statement Disclosure 25
2.2 Financial Statement Disclosure and User Requirements 28
2.2.1 Defining Financial Statement Reporting 30

2.2.2 The Purpose of Financial Reporting 32
2.2.3 Financial Accounts - the User Perspective 33
2.2.4 Auditor Ethics, Disclosure and Market Exchange 39
2.3 The Contradictory Nature of Accounting Rules 41
2.3.1 Incoherent Systems of Accounting: the Opportunity for Misstatement 45
2.4 Responsibilities of the Auditor 46
2.5 Corporate Collapse and the Role of Accountants and Auditors 49
2.5.1 The Enron Collapse 50
2.5.2 Corporate Collapse in Australia 56
2.6 Restoration of Financial Reporting Credibility 67
2.7 Conclusion 71
Chapter 3: The Nature of Ethics and Ethical Theory 73
3.1 Introduction 73
3.2 The Nature of Ethics 74
3.3 Morality and Ethical Theory 75
3.3.2 Approaches to the Study of Ethical Theory 76
3.4 Contemporary Ethical Theory 78
3.4.1 Egoism 79
3.4.2 Normative Ethical Theory 83
3.4.3 Utilitarian Theory 83
3.4.3.1 The Features of Utilitarianism 85
3.4.3.2 Some Criticisms of Utilitarianism. 87
3.4.4 Kant and Deontology 88
3.4.4.1 Deontological Theory 89
3.4.4.2 Some Criticisms of Kantianism 90
3.5 Challenges to the Dominant ethical Theories 92
3.5.1 Rights Theories 92
3.5.2 Virtue Ethics 93
3.5.3 Common Morality Theories 95
3.6 Descriptive Ethics - Ethical Standards and Codes 96

3.7 Conclusion 98
Chapter 4: The Rise of Accounting as a Profession 101
4.1 The Professions 101
4.2 Professions, Their Nature, Roles and Responsibilities 102
4.2.1 Trait Model of Professions 104
4.2.2 The Structural - Functional Model of Professions 106
4.2.3 Professionalism and Theories of Action 107
4.2.4 Professions and Occupational Authority 110
4.2.5 Professional Knowledge 112
4.3 Professionalism and the Accounting and Audit Functions 113
4.3.1 Accounting Professional Occupational Authority 116
4.3.2 Occupational Authority and Market Closure 120
4.3.3 The Rise of Professionalism and Accounting Practice 123
4.4 Professionalism and the Expansion of the Audit Product 126
4.4.1 Auditing and Accountability 127
4.4.2 Auditing and the Construction of the Auditable Object 129
4.4.3 Making New Things Auditable 130
4.5 Conclusion 133
Chapter 5: Ethical Behaviour and the Accounting Profession 135
5.1 The Importance of Ethics for the Accounting Profession 135
5.2 Ethics and Public Company Management 137
5.3 Ethical behaviour and the Accounting Profession 139
5.3.1 Ethics and the Professions 139
5.3.2 Accounting as a Profession - the Social Contract 143
5.3.3 Capital Markets and the Accounting Product 147
5.4 Ethics and Auditing 148
5.4.1 Ethical Decision Making in Audit Practice 150
5.4.2 Ethical Theory in Audit Practice 151
5.4.3 Ethical Rule Making for Audit Practice 153
5.5 APES 110: Code of Ethics for Professional Accountants in Australia 159

5.5.1 The Structure of APES 110 161
5.5.2 Part A: General Application of the Code 161
5.5.2 Part B: Members in Public Practice 166
5.5.3 Part C: Members in Business 171
5.6 Conclusion 173
Chapter 6: Auditing Governance and Accountability 175
6.1 Auditor Governance and Accountability 175
6.1.1 The Nature of Audit 177
6.1.2 The Audit Requirement 179
6.1.3 The Role and Rationale of Auditing 181
6.1.4 Legal Framework and the Legal Obligations of Auditors in Australia 186
6.1.4.1 Statutory Functions of the Auditor 186
6.1.4.2 Duties of the Auditor at Common Law 189
6.1.5 Corporate Collapse and the Role of Auditors – HIH Insurance Ltd 196
6.2 The Audit Expectation Gap 203
6.2.1 Judicial and Practitioner Views 206
6.2.2 Bridging the Expectation Gap 210
6.2.3 Out of Court Settlements 211
6.2.4 Expanding the Scope of Audit in Australia 213
6.2.5 Auditor Communications 215
6.3 Meeting User Expectations – The Detection of Fraud 219
6.4 Conclusion 225
Chapter 7: Auditor Independence 228
7.1 Introduction 228
7.2 Conflicts of Interest 230
7.2.1 Conflicts of Interest, Ethics and Morals 232
7.2.2 Conflicts of Interest in the Accounting and Auditing Profession 234
7.2.3 Agency Theory 236
7.3 The Requirement for Auditor Independence 238
7.3.1General Requirements for Auditor Independence 240

7.4 Auditor Provided Non-audit Services and Auditor Conflicts of Interest 243
7.4.2 The Occurrence of Non-audit Services in Australia 246
7.5 Non-audit Services in the Australian Context 248
7.5.1 Consequences of the Supply of Non-audit Services 250
7.5.1.1 Economies of Scope 250
7.5.1.2 Effects on Competition in the Audit Services Market 251
7.5.1.3 Effects on Competition in the Market for Non-audit Services 253
7.5.2 The Impact of Non-audit Services upon Auditor Independence 254
7.5.3 The Current Debate in Australia 260
7.5.4 Arguments Supporting the Provision of Non-audit Services 262
7.5.5 Arguments Opposing the Provision of Non-audit Services 263
7.5.6 The Impact of Non-audit Services upon Audit Opinions 266
7.6 The Regulatory Response to Non-audit Services in Australia 271
7.6.1 The Disclosure Based Solution 276
7.7 Effectiveness of the Disclosure of Non-audit Service Fees 278
7.7.1 Disclosure and Agency Costs 280
7.7.2 Client Diversification as a Regulatory Objective 281
7.8 Conclusion 283
Chapter 8: Financial Statement Insurance 286
8.1 The Insurance Alternative 286
8.2 Traditional Financial Statement Auditing – Faults and Flaws 287
8.3 The Financial Statement Insurance Model 291
8.3.1 The FSI Model Steps 292
8.4 FSI Impact Upon Stakeholders 303
8.4.1 The Insurer 304
8.4.2 The Auditor 306
8.4.3 Capital Markets 309
8.4.4 The Public Company 310
8.4.5 The Regulators - Australian Insurance Law 311
8.5 Financial Statement Insurance - Advantages and Imperfections 314

8.5.1 Eliminate Auditor Conflicts of Interest 315
8.5.2 Financial Statement Insurance as a Market Based Solution 316
8.5.3 Promoting Auditor Competition 319
8.5.4 A Risk Based Model 320
8.5.5 An Effective Claims Process 322
8.5.6 Incentives and Disclosure 324
8.6 Eliminating the Traditional Registered Auditor Role and Audit Opinion 326
8.6.1 An Alternative Assurance Function 326
8.6.2 Eliminating the Need for an Audit Opinion 328
8.7 Conclusion 330
Chapter 9: Conclusion 334
9.1 Introduction 334
9.2 The Structural Power Imbalance Between Management and the Auditor 336
9.3 The Professions and Closure 337
9.4 Restoring Public Trust 339
9.5 Ethical Codes of Conduct 340
9.6 Restructuring the Auditing Market 341
9.7 Conclusion 344
BIBLIOGRAPHY 346
APPENDIX ONE – FINANCIAL STATEMENT INSURANCE OVERVIEW 361

SYNOPSIS

Accounting scandals have shaken the foundations of investor confidence in the transparency, integrity and accountability of corporations and capital markets more generally. The accounting profession and more specifically auditors are claimed to have played a role in these events in Australia. Public disquiet about the audit role has surfaced amongst allegations that these gatekeepers have helped facilitate financial accounting irregularity. While the narrative behind each instance of corporate failure comprises a complex array of facts and relationships, questionable ethical auditor behaviour stands as a significant chapter of each story.

For the audit profession, these developments highlight the gap between public expectations and the reality of what the auditor's role entails. Public perception finds the auditor either incapable of detecting, or choosing not to control, unscrupulous management practices. The conclusion reached by many members of the community and corporate regulators is that auditors have failed in their responsibility, and that their independence from auditee management has been compromised in many instances of corporate collapse. These types of perceptions must be acknowledged and addressed by the audit profession for it to restore trust in both the capital markets and itself more importantly.

Conflicts of interest are allowed to develop and flourish within auditor-client relationships. The current regime relies upon auditor legal liability to ensure truth telling in financial reporting; however this approach has not delivered the level of assurance required by financial statement users. This situation could be markedly improved through the introduction of financial statement insurance ('FSI'). This insurance approach offers a market-based solution to more effectively deal with bias existing in financial statements, to ensure fewer misrepresentations arise and smaller shareholder losses are incurred. Financial statements insurance is shown by this thesis to be an effective market mechanism, that if introduced would bring about significant change to the structure of financial reporting

relationships and auditor incentives. This shift would align auditor and manager incentives with those of shareholders to ensure better quality audits, and produce higher quality financial statements.

Although the FSI model is not perfect, it does promise considerable advantages over the current auditor liability model. While some existing imperfections are sustained or reappear in different guises under FSI, none of these are aggravated and most are mitigated. While FSI does hold considerable promise, it is a bold and somewhat radical proposal given the present entrenched nature of audit stakeholder relationships and the significant change needed to realign these. No matter what the future holds for the audit function, in the end, there should never be a black box of unquestioned audit processes or conflicted relationships. Regulators and researchers must be vigilant and question concepts and discourse that might otherwise restrict the market for auditor services at the expense of information users.

STATEMENT OF CANDIDATE

I certify that the work in this thesis entitled "The regulation of Auditor ethical behaviour in Australia - the problem conflicts of interest and proposal for structural reform" has not previously been submitted for a degree nor has it been submitted as part of requirements for a degree to any other university or institution other than Macquarie University.

I also certify that the thesis is an original piece of research and it has been written by me. Any help and assistance that I have received in my research work and the preparation of the thesis itself have been appropriately acknowledged.

In addition, I certify that all information sources and literature used are indicated in the thesis.

Signed

Steven Rex Townsend (31416608)

Date

LIST OF ABBREVIATIONS AND ACRONYMS

The following abbreviations and acronyms are used throughout the thesis. When the term first appears in the text or footnote in each chapter, both the abbreviation/acronym and the definition are given. Thereafter, only the abbreviation/acronym is used in the chapter.

AASB	Australian Accounting Standards Board
AGM	Annual General Meeting
All ER	All England Law Reports
ALR	Australian Law Reports
APES 110	APES 110 Code of Ethics for Professional Accountants (or 'the Code')
APESB	Accounting Professional & Ethical Standards Board
APNAS	Auditor provided non audit services
ASIC	Australian Securities and Investments Commission
ASIC Act	*The Australian Securities and Investments Commission Act 2001*.
ASX	Australian Securities Exchange
ATO	Australian Taxation Office
AUASB	Auditing and Assurance Standards Board
CALDB	Companies Auditors and Liquidators Disciplinary Board
CEO	chief executive officer
CFO	chief financial officer
CGT	capital gains tax
CJ	Chief Justice
CLERP 9	Corporate Law Economic Reform Program Paper No. 9, *Corporate Disclosure —Strengthening the Financial Reporting Framework*
Corporations Act	*Corporations Act 2001*
CLR	Commonwealth Law Reports

Corporations Act	Corporations Act 2001
CPAA	CPA Australia
Cth	Commonwealth
Esanda	*Esanda Finance Corporation Limited* v *Peat Marwick Hungerfords* (1997)
FRC	Financial Reporting Council
FSI	financial statement insurance
Higgs Review	*Review of the role and effectiveness of non-executive directors*
HIH	HIH Insurance Ltd
ICAA	The Institute of Chartered Accountants in Australia
IFAC	International Federation of Accountants
IOSCO	International Organization of Securities Commissions
IPA	Institute of Public Accountants
J; JJ	Justice; Justices
Kingston Cotton Mill	*re Kingston Cotton Mill Co (No 2) (1896)*
LJ	Lord Justice
NSW	New South Wales
NSWLR	New South Wales Law Reports
OBS	off balance sheet
p; pp	page; pages
Pacific Acceptance	*Pacific Acceptance Corporation Ltd* v *Forsyth & Ors* (1970)
para; paras	paragraph; paragraphs
Ramsay Report	*Report on Independence of Australian Company Auditors*
s, ss	section, sections
SAC	Statement of Accounting Concepts
SEC	United States Securities and Exchange Commission
Trans.	Translated by
UK	United Kingdom
US	United States

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Chapter 1: Theoretical Overview

1.1 The Theory That Underpins This Thesis

The regulation of accounting practices has taken on particular importance in Australia. Different episodes of reform have been brought on at various times of economic crisis and corporate collapse, which in turn have led researchers and the profession to the search for principles and theory in support of accounting practices.

This thesis has drawn upon a broad collection of theory and models to explain a range of issues that impact on the accounting profession in Australia. Particular attention is paid to how accountants were able to achieve their professional status and the regulation that governs their conduct. The behaviour of registered company auditors comes under close examination. This theoretical overview addresses systems of ideas that explain the regulation of auditor ethics in Australia together with the general principles upon which audit practices are based. This thesis takes an original approach when applying that theory, and steps outside traditional ideas on regulating the professions. It offers a unique solution to the problems of auditor conflicts of interest by proposing that the assurance function break free of its current model. The assurance task would instead be redesigned so that new insurance relationships restrict the opportunity for conflicted stakeholder relations to dominate.

From a regulatory point of view, this thesis explains how rule making contributed to the accounting profession's emergence, which actors contributed to that appearance and the typical patterns of interaction between these actors. Legal theory and the theory of other disciplines including politics, economics and sociology are relevant to the rise of the accounting profession. These theories offer useful insights and ideas about the professions and their status within the community, and can also help model direction and formulate corrective action if needed. The final section of this overview provides a theoretical basis for

regulating the audit function in Australia. Theories that centre on the development and expansion of the audit function are referred to, together with how these ideas can be used to fix wrongful auditor practices.

The following analysis steps through several theories that underpin the regulation of auditor behaviour in Australia which have been applied in this thesis.

1.2 Governmentality

Techniques of government have come under close examination in recent times[1], including research undertaken by Bruno Latour [2] who coined the phrase 'action at a distance'. This phrase described the way in which maps and tide-tables enabled eighteenth-century France to direct the movement of ships to colonise the East Pacific. In doing so, these distant places were translated into stable information traces – for example maps – which could then be transmitted efficiently to centres of control.[3]

A government is faced with an almost impossible task when regulating its citizens. The state cannot regulate every aspect of community life nor be expert in every possible aspect of laws that concern their citizens. Governments must thereby accept a degree of risk when governing and making rules. There is little alternative in some cases but to in effect rule from a distance as described by Latour.

This approach to governing is evident in the role that the professions play, their power, and the status they are given. More particularly for this thesis, focus is placed on the role of those accountants who carry out the audit function. One approach to address this regulatory

[1] The governmentality concept was developed by Michel Foucault between 1977 and his death in 1984.
[2] See Bruno Latour, *Science in Action: How to Follow Scientists and Engineers Through Society* (Open University Press, 1987) 241.
[3] Miller and Rose extended Latour's concept through their examination of 'government at a distance'. They point out that the government of populations, as opposed to the government of places, requires the transmittal of information about populations. That is, distant populations must be translated into transmittable and stable information traces. See Peter Miller and Nikolas Rose, 'Governing economic life' (1990) 19(1) *Economy and Society* 1-31.

problem of the state is reflected in the concept of governmentality developed by Michel Foucault. The concept is highly useful in understanding the accounting profession, its nature and its practices. Governmentality can be understood as the:

- way governments try to produce the citizen best suited to fulfil government policies, and;

- organised practices (mentalities, rationalities, and techniques) through which subjects are governed.[4]

These elements are reflected in Dean's contribution to the definition of governmentality. He argued that the term government according to Foucault was not so much concerned with political or administrative structures of the modern state, but rather the way in which the conduct of individuals or of groups can be directed. To analyse government is to analyse those mechanisms that try to shape, sculpt, mobilise and work through the choices, desires, aspirations, needs, wants and lifestyles of individuals and groups.[5] According to Dean, governmentality expands the analysis of governing populations from a focus on describing how authority operates in particular situations and spaces, to include the practices of government. These practices 'form the basis on which problematisations are made and what happens when we govern and are governed'.[6]

These points on governmentality are relevant to the control of audit practices. The submission of a subject to audit will establish legitimacy regardless of the operational substance of how the audit is performed. As such, although the demand for audit services is largely driven out of shareholder self-interest, benefits also flow to the audited entity. For example, the cost of capital for an auditee would be expected to be less if an unqualified report is issued. Further to this, the managers and directors of an audited company receive

[4] Susan Mayhew (ed), *A Dictionary of Geography* (Oxford University Press, 2004) Article: Governmentality.
[5] Mitchell Dean , *Governmentality: Power and Rule in Modern Society* (Sage, 1999) 12.
[6] Ibid 28.

independent verification of the quality of their stewardship. In addition, the techniques used in the conduct of a modern audit comprise organised practices that act to police an auditee's transactions. These types of practices and the role of audit are discussed in detail in Chapter 6, Auditing Governance and Accountability - and the Audit Expectation Gap.

The concept of governmentality offers a broad understanding of power and freedom which is not only thought of in terms of the hierarchical top-down power of the state. Power is also understood to include forms of social control placed in disciplinary institutions with ownership of particular forms of knowledge. These concepts are considered in Chapter 4's examination of the accounting profession's ascendency to become a disciplinary institution. The profession has manifested power within professional accounting bodies through ownership of accounting knowledge and discourse. That discourse has been internalised by the membership who then shape and guide the conduct of accounting matters on behalf of the state. Accountants thereby regulate accounting procedure and ultimately determine the nature of financial reporting upon which financial markets rely. More particularly for this thesis, accountants who act as registered company auditors have closed the market for their assurance services. This has come about from privatisation strategies used which positioned auditors in a monopolistic position, and at the same time allowed the state to rule from a distance. Power is de-centered to members of the profession who play an active role in their self-government, thereby allowing these individuals to in effect self regulate.

Under these ideal state created conditions and restrictions, those outside the profession are blocked from entry to the profession. This thesis finds that the knowledge produced by accountants has allowed them to construct an environment in which they have chief responsibility to regulate accounting matters. As such, the accounting profession as represented by the professional bodies is part of a broad ensemble of government institutions. The procedures, analysis, reflections, calculations, and the tactics used by this institution have allowed accountants to exercise a very specific form of power, and to profit from it.

As a component of government, the accounting profession acts as a means by which government can maintain a well ordered and happy society. When functioning effectively, accounting technique can help society come to a feeling of economic, political, and cultural wellbeing. For example, Chapter 2 of the thesis highlights the problems caused by inaccurate financial reporting and falsely assured accounts. Accountants can play a leading role in correcting these problems. Although the Australia accounting profession has recently lost its self regulatory status with respect to standard setting, [7] it continues to have significant influence over standard development under a co-regulation regime.[8] It continues to play a leading role in the design and application of accounting practices as a critical and specific apparatus of the state which is used to govern its subjects.

1.3 Theories of Regulation

There may a single reason or a combination of reasons why regulation is needed. Regulation may be necessary to rationalise or coordinate an economic activity. It may also be needed to control individual behaviour or organise industries in an efficient manner. In addition, a degree of central planning may be required by using a regulatory approach. Regulation can be negative in the sense that it prevents or restricts some type of behaviour, or positive in situations where it serves to encourage or facilitate an activity. [9] For accounting stakeholder relationships, regulation has been used to address the problem of information inadequacies caused by information asymmetries arising from accountant and client relationships.

Regulation theory refers to theoretical frameworks which explain and model the connection between regulatory agencies and the various social groups participating in, and affected by the rule making process. These frameworks often compete and sometimes overlap. A theory of regulation offers a set of propositions or hypotheses about why regulation has emerged, which actors have contributed to that emergence, and the typical patterns of interaction

[7] These functions have shifted to the Australian Accounting Standards Board and the Auditing and Assurance Standards Board.
[8] See 4.3.1 The Extent and Origins of Accounting Professional Occupational Authority.
[9] Michael Gaffikin, 'Regulation as Accounting Theory' (Working Paper 05/09, University of Wollongong, School of Accounting & Finance, 2005) 4.

between these regulatory actors. Theories of regulation can be broadly divided into three kinds; public interest, private interest and what may loosely be described as the institutionalist approach. Characteristics of these models are interwoven throughout this thesis.

1.3.1 Public Interest Theories

Public interest theorists call for regulatory design and implementation to pursue collective goals and promote the general welfare of the community. Such theories are generally prescriptive in orientation. They typically evaluate if and to what extent a regulatory scheme fulfils particular collective goals from an economic or political point of view.

Advocates of public interest theories of regulation claim that these theories achieve publicly desired results. If left to the market alone, collective outcomes would not be obtained and the community's welfare would suffer as a result. Rules made according to the public interest are responsive to public demands. They are claimed to correct inefficient and inequitable markets, thereby this type of regulation is motivated for community reasons rather than for private interests and objectives. [10]

Interest Group Theory

Interest group theory is an extension of the public interest theory. Under this model, regulation is the product of a relationship between an interest group and the state. As an example, Chapter 4 of this thesis examines the rise of accounting as a profession. It gives an account of how accountants have competed against others outside the profession in order to gain ascendency and political power.

Advocates of interest group theories extend their ideas beyond public interest theorists. They argue that regulation should originate from competition for power rather than just rule

[10] Richard A. Posner, 'Theories of Economic Regulation', (Autumn, 1974) 5 (2) *The Bell Journal of Economics and Management Science* 335, 335.

making that serves in the public interest. A range of interest group theories exist, from open minded pluralism to more corporatist approaches. At one end of the spectrum, competing groups struggle for political power. Those who are successful will use their power to shape regulation. At the other end of the continuum, interest groups' using the corporatist approach seeks to enter partnerships with the state to develop legislative regimes at the exclusion of other groups. [11] This approach can be seen in Chapter 4 which discusses the ways in which professional accounting bodies used political strategies to close the market for their services.

The Economic Theory of Regulation

Public interest theory is positive theory which objectively views accounting practices based on fact. Under these theories, regulators are understood to be political actors and utility maximisers who seek to secure and maintain their political power.[12] In order to achieve that outcome, regulators seek votes, money, and other resources from those groups affected by their decisions. Regulators are in this sense conflicted and captured by interest groups that support them. These groups can then use that influence to expropriate wealth and derive benefits from that relationship.[13] In the case of the accounting profession, some of those benefits are derived from regulatory restrictions placed on entry to the profession and the restricted supply of particular business services. For example, control of the audit industry by accountants has handed them an ongoing and unchallenged revenue stream. In addition, accountants benefit from providing complementary services to their client base (for example, auditor provided non-audit services as discussed in Chapter 7), and by the restrictions they place on advertising to control pricing. Chapter 5 examines the *Code of Ethics for Professional Accountants* ('APES 110') for Australian accountants and discusses accountant made rules and restrictions that benefit their various lines of business.

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[11] Robert Baldwin and Martin Cave, *Understanding Regulation, Theory, Strategy and Practice* (Oxford University Press, 1999) 21.
[12] Giandomenico Majone, *Regulating Europe* (Routledge, 1996) 31.
[13] George J. Stigler, 'The Theory of Economic Regulation' (1971) 6 *Bell Journal of Economics and Management Science* 3, 3.

1.3.2 Private Interest Theories

In contrast to public interest theories, private interest theorists are sceptical of regulator and policy maker claims of public interest and community concern. Instead, they recognise that regulation often benefits particular interest groups and does not always advantage those whom the regulation is claimed to assist. Private interest theorists view regulation as a contest between selfish rent-seeking participants who oppose each other in a regulatory contest. The theory analyses the ways in which political and law-making processes are used by these participants to secure regulatory benefits for themselves.

Private interest ideas and approaches feature throughout this thesis. This theory helps to explain the nature of the professions and the ascendency of accounting as profession. Importantly for this thesis, these theories provide an explanation about how accountants have taken control of the audit services market for themselves. The strategies used by auditors in Australia[14] to expand audit into new areas are relevant to private interest theory thinking and analysis. The theory can explain how and why regulation emerged to govern the conduct of company audits, and why these regulatory processes have taken a particular form. Rule making for the audit function has not however successfully addressed corporate collapse in Australia. This failure can partly be attributed to those private interests that drive regulation with little regard to public concern.

1.3.3 Institutional Theories

There is also an array of approaches broadly labelled as institutionalist theories. These theories analyse regulatory interactions at high level of abstraction. [15]Rather than focus on

[14] See section 4.4 Professionalism and the Expansion of the Audit Product.

[15] As discussed in section 1.2, some of Foucault's later writings organised his ideas around a broader concept of institutional power which he described as a theory of governmentality. Under Foucault's governmentality logic, the state and other organisations shape and form a compliant population by using scientific discourses, defining and regulating new subject categories, and through the proliferation and evolution of new micro-technologies of control. The concept is helpful in

the dynamics between individual actors, they instead centre on the dynamics of the legal system, economic system and the political system, and the interaction between these systems. For example, a political science institutional theorist may examine the manner in which political structures, institutions, and decision-making processes shape political outcomes. [16]

Institutional theorists reject the rational actor model. They argue that individual preferences do not drive and develop regulation. Rules instead emerge from organisational and social settings within which institutional structures, institutional arrangements, and social processes shape regulation.[17] Under this theory, regulation is determined less by notions of the public interest or the competitive bargaining power of private interests, but rather by institutional arrangements and rules.[18]

In conclusion, the different regulatory approaches discussed in this overview are intended to give an understanding about why the accounting function is regulated and how these rules have come about. These theories provides rule makers with ideas to model regulation and govern accounting practices and the audit function. Accounting texts traditionally have addressed the private and public interest theory distinction in the context of accounting standards. However, the regulation of accounting extends well beyond standard setting matters to impact on how the accounting profession is organised. Rules are made about how the professional bodies are operated and the manner in which the membership conducts themselves. Although these rules are intended to reflect broader societal views, this thesis finds the regulatory framework for registered company auditors' in Australia is misaligned with those community expectations.

1.4 Markets

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understanding the role of institutions and engagement between them as explained by institutional theories, including the dynamics between these institutions when making rules.

[16] Baldwin and Cave, above n 11, 29.

[17] Gaffikin, 'Regulation as Accounting Theory', above n 9, 10.

[18] Baldwin and Cave, above n 11, 27.

The rise of the accounting profession in Australia is an example of a successful professionalisation project. In that case, accountants translated their scarce resource of specialised accounting knowledge and skills into social and economic rewards.[19] The key to extracting these rewards lay in the profession's ability to exert market control over this resource and ensure its scarcity.[20] This process has created a monopoly for the accounting profession together with market recognition for the services it provides.

Core accounting services include consultation and advice on taxation, accounting and audit. These areas are heavily regulated in Australia. In addition, laws regulate the operation of the accounting bodies and prescribe how members of the profession must conduct their affairs. Those believing in market efficacy however argue that this type of regulation is unnecessary. Moreover, that market forces should be allowed to serve the interests of society and optimise the allocation of resources without the need for excessive rule making.

This thesis examines how regulation has intervened in the free exchange of services in the context of Australian company auditors. Those supporting a strong form of market efficiency contend that regulation of audit services is not necessary where markets are properly informed. That information helps audit services consumers and those relying on financial statements to decide what level of reliance is placed in the auditor assured reports. It can alternatively be argued that there are few, if any, instances of completely strong and efficient markets, so that some level of regulation is necessary. In addition, markets do not always operate in the best interests of society, so that some form of intervention by regulators is needed.[21] Under this view, regulation is claimed to protect the public interest against market failure.

The balance between regulating accountants on one hand, and greater reliance on free markets on the other is discussed in this thesis. Although the regulation of auditors has been

[19] Magali Larson, *The Rise of Professionalism: A Sociological Analysis* (University of California Press, 1977) xvii.
[20] Ibid vii.
[21] United Kingdom Office of Fair Trading, *Why Competition Matters – A Guide for Policy Makers* (Office of Fair Trading, 2009) 1.

favoured in the past, this thesis finds that a market driven approach can better align assurance stakeholder relationships. It is proposed that market forces could be harnessed to align the interests of those who provide financial statement insurance ('FSI') with those of information users. Under this novel approach as set out in Chapter 8, FSI would be delivered by insurers, who would now control the assurance function as a viable and non-conflicted alternative.

1.5 Insurance Theory

Insurance cover acts as a financial intermediary. It is a commercial enterprise that performs a critical financial services industry function. The supply of insurance products significantly impacts upon society by changing who will bear the cost of losses and damage. Insurance operates by pooling the funds of insured entities, where these funds are used to pay for losses that these entities incur. The insured entities are thereby protected from risk for a fee which is dependent upon the frequency and severity of the insured event.

Insurance is most effective when the losses incurred are common enough to be of concern but not so frequent to be routine. In addition, unobservable actions (or moral hazards) must not be too significant. A moral hazard may arise when an insured entity is more willing to take a risk knowing that the potential costs or burdens of taking that risk will be borne in whole or in part by others. For insurance to be fully effective, insurance risk must be diversifiable, and the insurer must be capable of bearing the risk. Insured risks are more likely to be diversified where the insured entities sit within large pools, and where these entities are independent of each other.[22]

Chapter 8 of this thesis puts FSI forward as a solution to address breached auditor ethics and failed financial statement reporting assurance processes. Although competition within the insurance industry is not perfect, the industry is well placed to supply FSI insurance.

[22] David M. Cutler and Richard Zeckhauser, *Extending the Theory to Meet the Practice of Insurance*, (2003) Unpublished working paper <http://post.economics.harvard.edu/faculty/dcutler/papers/cutler_zeckhauser_theory_and_practice_of_insurance.pdf> 7.

Australian insurers work within an environment of strong competition, modest barriers to entry, and a sound regulatory infrastructure. This thesis finds FSI to be a solution capable of shifting the assurance function away from conflicted accountants, and give that responsibility to the insurance industry. This move if adopted would rely on the competitive forces within that industry, so that insurers cover shareholder loss without influence from conflicts of interest.

1.6 Ethical Theory

Chapter 3 of this thesis examines the nature of ethics and ethical theory. This assessment is critical to understanding the nature of auditing and auditor duties which are discussed in later chapters. The government is faced with the difficulty of correcting conflicted behaviour and breached independence when regulating the ethics of Australian auditors. Problems of financial statement inaccuracies and falsely assured audited financial accounts are commonly seen in public company accounts. One solution available for legislators is to govern the moral substance of audit by correcting auditor unethical behaviour. An understanding of ethical theory is thereby essential to rule making for auditors and their practices.

Ethical theories prescribe justifying principles and reasons why a course of action should or should not be pursued. Disagreement on which ethical principle to follow and which takes precedence over the other may arise where ethical approaches are in conflict. In these circumstances, an individual who decides in favour of himself or herself is likely to be egoist. Individuals who decide according to what will benefit society reflect a utilitarian disposition, while those with a preference toward fairness or justice will follow deontological lines. These approaches are introduced in this thesis together with virtue ethics and egoism.

The utilitarian approach will determine an action to be ethically correct depending on the outcome of that action. Utilitarianism is characterised as forward looking because an ethically correct action is decided on by its consequences, and that outcome can only be determined at a future point in time. Utilitarians believe that ethical behaviour will promote

human welfare by minimising harms and maximising benefits. They take account of the good of all people affected by an action, where that welfare takes priority over issues of fairness rights and commitment. For utilitarians, the ultimate reason to justify an action is that it brings about more good than harm for more people including that of the decision maker. Although self-interest is factored into the overall good, that individual concern must be set aside if it conflicts with the overall good. Thus, utilitarianism maintains that only those actions that bring about the greatest good for the greatest number of people should be undertaken. [23]

In contrast, the deontological principles taught by Immanuel Kant focus on the ethics of duty rather than the ethics of consequences. According to Kant, an ethical person acts according to the right intentions. Kant described three fundamental principles of ethics; to act only on principles which you know to be universally morally permissible, to always treat the humanity in a person as an end and never merely as a means, and act as if you were a member of an ideal kingdom in which all people are both subject and sovereign at the same time. Considerations of fairness take priority over the consequences of an act for deontologists given that actions themselves can be ethical in spite of their consequences. For deontologists, the end does not justify the means. Deontological theory thereby gives precedence to the questions of fairness, rights and commitment, and requires that the right thing be done no matter the consequences for the individual whose action will impact on others.[24]

In comparison to the utilitarianism and deontological approaches, virtue ethics gives priority to ethical practices. This theory gives a habitual or reflexive response, and so does not fit within the conventional understanding of ethical responsibility. [25]A virtuous person will recognise an ethical problem when confronted with it, and attempt to resolve the problem through honest deliberation in order to reach a principled and defensible conclusion. The

[23] Larry Alexander and Michael Moore, "Deontological Ethics", *The Stanford Encyclopedia of Philosophy (Winter 2012 Edition)*, Edward N. Zalta (ed.) <http://plato.stanford.edu/archives/win2012/entries/ethics-deontological/>.
[24] Ibid.
[25] The Institute of Chartered Accountants in Australia, *CA Program Unit 1 Ethics and Business Application* (ICAA, 2009) 12.

character of the person making the deliberation is most important given that a virtuous person must be disposed towards honesty and generosity at all times.

Egoism is a further ethical theory. This theory allows for considerations of what is good for oneself, and teaches that self-interest takes priority over considerations of what is good and fair for others. Egoism, like utilitarianism, uses the 'good of consequences' as the ultimate determinant of whether an action is ethically acceptable; however egoism gives priority to consequences of self-interest and recommends self-serving actions rather than the greatest balance of value.[26]

These contemporary ethical theories are explained in detail in this thesis. Their relevance for the accounting profession is examined, together with how these ideas might be used to elevate auditor ethical behaviour above current levels.

1.7 Theory of the Professions

The professions are a subset of occupations more generally. Although the boundary of that division is largely ill-defined, similar characteristics are common to most professions. These qualities and requirements include training and entry qualifications, licence to practise requirements, a code of ethics, self-regulation and a monopoly over services provided. These features are helpful in understanding the nature of professionals, but do not provide a workable definition, nor do they remain stable over time.[27]

The earliest views of the professions were idealised portrayals. They were generally reverential in their tone and descriptions, and stressed [28] the altruistic nature of professional service. This ideal view sees the professions as accepting moral and ethical responsibility,

[26] Robert Shaver, 'Egoism' *The Stanford Encyclopedia of Philosophy (Winter 2010 Edition)*, Edward N. Zalta (ed.) <http://plato.stanford.edu/archives/win2010/entries/egoism/>.
[27] Michael Eraut, *Developing Professional Knowledge and Competence* (The Falmer Press, 1994) 100.
[28] Brian P West, *Professionalism and Accounting Rules* (Routledge, 2003) 14.

and deserving of their elevated role within the community.[29]

In contrast to these reverential understandings, theories of action give a less respectful view of the professions. Under this approach, the processes used by occupational groups to ascend the occupational hierarchy are explored to explain the nature of professional occupations. Enquiries made under this theory are centred on how and why certain occupations have gained power and achieved their enhanced status and privileges while others have not.[30]

The theories of action view of the professions has radically changed the way in which professionalisation is understood. These views are reflected in several parts of this thesis and conclusions made in it, particularly with respect to the rise of the accounting profession and expansion of audit into new areas. This thesis finds that sentiments of altruism and ethical service espoused by some theories are misplaced. In the case of accountants, the profession has conducted itself as self-interested collective using strategies of closure and collective social mobility. Theories of action philosophers view the accounting profession's closure to others as a process of mobilising power to enhance and defend the group's share of rewards and resources.[31]

The structural - functional model of the professions is also referenced in this thesis. This theory emerged out of claims that the existence of the professions is evidence enough of their social utility.[32] A structural-functional interpretation understands the professions to be party to a social contract.[33] They strike a bargain with society under which they exchange their competence and integrity in return for client and community trust, the relative freedom from lay supervision and interference, protection against unqualified competition, higher levels of

[29] Emile Durkheim, *Professional Ethics and Civil Morals*, trans. C. Brookfield (Routledge, 1957) xxii.
[30] Paul Halmos, 'Introduction' in P. Halmos (ed.) *Professionalization and Social Change* (University of Keele, 1973) 6.
[31] Raymond J. Murphy, 'The Structure of Closure: a Critique and Development of the Theories of Weber, Collins and Parkin' (1984) 35(4) *The British Journal of Sociology* 547, 548.
[32] Philip Elliott, *The Sociology of the Professions* (Macmillan, 1972) 11.
[33] West, above n 28, 17.

remuneration, and elevated social status.[34] Under this theory, emphasis is placed on the characteristics of a profession which support its societal undertakings. For example, codes of ethics cease to be a benign checklist used to evaluate occupational status to instead become a necessary social control device.[35]

Max Weber adopted a structural-functionalist theoretical framework in his explanation of the professions. [36] This work has led to some important understandings about the social organisation of work. Following Weber's theory, professionalism can be viewed a kind of social structure that functions to coordinate and resolve issues between competing interests within society.[37] The formation and maintenance of strong specialism boundaries is central to Weber's approach. Specialism functions to demarcate and accumulate privileged access to specialised knowledge and the right to practice this knowledge. Members of a profession have privileged status within the community, and use that knowledge to achieve higher levels of secure income and exercise control over their working conditions.[38]

The need for the professions can however be questioned. Despite some of the positive principles expressed in Weberian theory, in practice the professions can be seen to place private interests above those of the public, and so have dimmed belief that professionalism serves social cohesion. Notwithstanding that view, society continues to demand that professional services be supplied, and protects those who own knowledge and deliver these services. In return for that protection, the community expects that those vested with professional status will nurture and safeguard their public mandate.[39] Features of Weberian

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[34] D Rueschemeyer, 'Professional Autonomy and the Social Control of Expertise', in Robert Dingwall and Philip Lewis (eds), *The Sociology of the Professions: Lawyers, Doctors and Others* (Macmillan, 1983) 41.

[35] Julius A Roth, 'Professionalism: the Sociologist's Decoy' (February 1974) 1 (1) *Sociology of Work and Occupations* 6, 6.

[36] Clive Kanes, *Challenging Professionalism, Studies in Elaborating Professionalism Practice and Theory Volume 5* (Springer, 2009) 5.

[37] Max Weber in Guenther Roth and Claus Wittich (eds.), *Economy and Society: An Outline of Interpretive Sociology* (University of California Press, 1978) 341 and 443.

[38] Kanes, above n 36, 5.

[39] Magali Larson, 'Professionalism: The Third Logic' (2003) 46(3) *Perspectives in Biology and Medicine* 458, 462.

theory are evident in Chapter 4 of this thesis. That chapter examines the rise of accounting as a profession and the nature, roles and responsibilities of accountants.

The remaining theory discussed in this overview is centred on the accounting profession. This thesis applies these models and ideas to problems associated with accounting practice and the regulation of auditors in Australia. In particular, structural problems inherent in current audit function relationships are examined. Using this theory, a solution is formulated to treat conflicts of interest arising from regulatory gaps in the rules that govern auditors.

1.8 Accounting Theory Relevant to This Thesis

Accounting can be understood to be a sub-discipline of economics. It relies heavily on economic theories and methodologies. While accounting serves the purposes of capitalist economics, there are several aspects of accounting which are separate from simple economic analysis, for example internal control system development and information processing. Further to this, attempts have been made to understand accounting as a science. Proponents of this approach have employed scientific methodology as a technical expression of economic theory. Their ideas are dominated by research in finance and law regulation, and significantly influenced by economic and political ideology. [40]

There are however other more helpful perspectives on accounting theory. A common element in many of these alternative approaches is to view accounting as a social science. Some of these ideas and concepts are considered in this thesis to help explain the behaviour of accountants and the nature of their practices.

1.8.1 Accounting as a Social Science

[40] Gaffikin, Michael, 'The Critique of Accounting Theory' (Working Paper 06/25, University of Wollongong, School of Accounting & Finance, 2006) 3.

Accounting is a system of thought designed by humans to assist human decision making and influence human behaviour. It is a discipline concerned with aspects of human society.[41] On that basis, accounting as a discipline together with accountancy practices can be regarded as integral parts of social science and social behaviour.

Hopwood agrees with this point of view. He stated that:

> Accounting is coming to be regarded as an interested endeavour. Rather than being seen as merely residing in the technical domain, serving the role of neutral facilitator of effective decision-making, accounting is slowly starting to be related to the pursuit of quite particular economic, social and political interests.[42]

This statement is reflective of the growing realisation that accounting is not merely a neutral technical endeavour, but reproduces the economic, social and political viewpoints of those engaged in its practice. As a social science, accounting must reflect the changing ontological, epistemological and methodological assumptions found in the other social sciences. Accounting researchers as social scientists must thereby keep abreast of new developments and adopt a fluid approach in responding to them.

The problems and difficulties common to other social phenomena are also likely to present in the accounting discipline. Community expectations of accountants grow alongside the expanding nature of accounting practices, which in turn require that accountants take on increased responsibility. Some argue that the discipline must accept more accountability for value judgements. Although an accountant may attempt to adopt an impersonal and disinterested view, in practice, the financial records and reports produced by him or her will take in personal value judgements.[43] This aspect is of particular concern in conflicted situations where an auditor may be tempted to breach his or her duty to act independently.

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[41] Ibid 4.

[42] Anthony Hopwood 'Accounting and the Pursuit of Social Interests', in W. F. Chua, E. A. Lowe, and A. G. Puxty (eds.), *Critical Perspectives in Management Control* (Macmillan, 1989) 141.

[43] Robert Kuhn Matuz, 'Accounting as a Social Science' (1963) 38(2) *The Accounting Review* 317, 319.

This problem is discussed in detail in Chapter 7 of this thesis which examines auditor independence and situations of conflicts of interest.

1.8.2 Alternative Research Methodologies - Critical Accounting Studies

If accounting is accepted to be a social practice, then accountants must be aware of the social implications of their practices. Critical accounting studies comprise a varied collection of approaches to accounting theory. Although critical accounting studies take a range of positions from highly conservative to extremely radical, they all have a primary purpose of improving accounting practice. These thinkers believe that accountants must have greater awareness of the wider social, political and economic consequences of their practices. This is reflected in the concern expressed by Morgan, that:

> "….the more one recognizes that accounting is a social practice that impacts on a social world, the less appropriate natural science approaches become."[44]

The role of language in producing knowledge is a dominant theme in critical accounting studies. In the case of the accounting profession, these theorists argue that accounting language is used to construct a reality. Chapter 2 of this thesis discusses accounting practices and techniques, together with broader concepts of accounting including accounting method and discourse. Accounting is found to function as a distinctive body of knowledge that provides discursive representations and vocabularies.[45] Language plays an important role in the methodologies developed by critical accounting theorists. Evidence in support of this theory can be found in how language is used to control modern day accounting techniques and practices.[46]

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[44] Gareth Morgan, 'Social Science and Accounting Research: A Commentary on Tomkins and Groves' (1983) 8 *Accounting, Organizations and Society* 385, 385.
[45] Susan Greer, 'Governing Indigenous Peoples: A History Of Accounting Interventions in the New South Wales Aborigines Protection and Welfare Boards 1883-1969' (2005) unpublished paper (copy on file with author) 73.
[46] Gaffikin, 'The Critique of Accounting Theory', above n 40, 18.

1.9 The Role and Rationale of Auditing

The role and rationale of audit, and the development of the assurance function more broadly, have distinctive theoretical foundations. These models and approaches help explain how accountants have claimed the prized function of registered company auditor and closed the market for their services to others. Chapter 4, The Rise of Accounting as a Profession, discusses how auditors have gone about making new things auditable. The evolving character of audit practice and requirement that audit practice respond to new demands have seen audit extend into new areas. These opportunities have combined with the commercial motivations of some practitioners to expand the amount and range of non-audit services provided by auditors. The following theoretical concepts are provided to give context and clarity about the nature of the audit product and its development beyond the traditional assurance role.

1.9.1 Economic Theory

One justification for the audit function is that audits promote financial market confidence and empower investors to make rational and informed decisions. Economic theory supports this argument. Audits are said to improve the quality of financial statements to make them more reliable and increase shareholder confidence in them. In this way, audits are said to add value to financial statements.[47]

The statutory audit requirement provides financial statement credibility given that an independent third party has verified the financial information produced by a company's management. This process reduces the costs of information users given that they would otherwise need to verify information for themselves. Auditors can thereby be said to serve as reputational intermediaries who assist the efficient operation of the financial markets by enhancing corporate information. [48]

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[47] Ian Ramsay, *The Independence of Australian Company Auditors, Report for the Minister for Financial Services and Regulation* (Department of the Treasury 2001) [4.02].
[48] Stephen Bottomley, *'Governance and Accountability: a Legal Approach to Auditing'* in Tom

Given that the independent audit of public company financial statements functions to improve capital market efficiency, that assurance will add value to capital markets. The effectiveness of capital market resource allocation is improved given that higher quality information allows for more informed decision making. In addition, audits are claimed to reduce information risk and lower the cost of capital of companies that issue audited financial statements.[49] The role of the audit function is examined in Chapter 6. Although audit does support financial market transaction decision making, this chapter will show that gaps exist between how auditors perceive their responsibilities and how others outside the profession view them.

1.9.2 Concession Theory of Incorporation

A corporation comes into existence with the permission of the state, and will only be allowed to exist if it operates in the interest of society as a whole. A further justification for a mandatory audit requirement is found in the concession theory of incorporation. According to this theory, the grant of independent legal status to a company by the state creates a private actor with special powers and capacities. As a consequence, a company's status as a separate legal entity carries commensurate obligations. Concessional theorists argue that a corporation is given its legal status by a concession of the state which can be revoked at any time. The state can only so act in defined circumstances using defined procedures. The incorporation of a company as a creature of the state requires that it be subject to regulation by it. There would otherwise be potential for a company to exploit its separate legal entity status and serve individual interests if left unchecked.

Concessional theory of incorporation ideas are supported by audit practices in Australia. Auditors examine the operations of public companies by providing an oversight function that monitors corporate performance and managerial behaviour. Although the traditional audit

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Campbell and Keith Houghton (eds), Ethics and Auditing (Australian National University, 2005) 3.
[49] Ramsay, above n 47.

function has served in this role up till now, instances of corporate failure continue under that supervision. This continuing problem is discussed in Chapter 2.

1.9.3 Agency Theory

According to agency theory, rational, self-serving but not risk averse principals and agents have differing goals and objectives. This is because they have different time horizons, attitudes to risk and work ethics. For this thesis, company owners are considered to be principals, while the managers appointed by them are regarded as their agents. The differing goals and objectives of both sides may cause some company managers to operate a company out of self-interest rather than in the interests of the company owners. That self-interest may cause these agents to misreport the financial performance and financial position of the companies which they are entrusted to administer.[50]

Chapter 2 of this thesis gives an historical account of corporate collapse in Australia to highlight the problem of falsely assured financial information. Business owners are generally not able to fully monitor the behaviour of their managers in an economic manner. Hence owners will often estimate and deduct the cost of incongruent behaviour from a manager's remuneration. A rational manager therefore has an incentive to engage the services of an independent person to attest to the fairness of the financial performance and the financial position that they report on. An audit report which finds management representations to be true and fair will add credibility and positively confirm manager performance. This auditor oversight function helps to eliminate information asymmetry between a company and its investors.[51]

1.10 Conclusion

[50] Christopher Ikin, 'Do Auditor Provided Non-audit Services (APNAS) Fees Impair Auditor Independence?' in Tom Campbell and Keith Houghton (eds), *Ethics and Auditing* (Australian National University, 2005) 293.
[51] Ibid 294.

As can be seen in this overview, there are divergent views about the purpose and need for regulation. Economic purists argue that there is no need for regulation where market forces can instead operate to ensure the fair distribution of resources. Those opposing this view contend that regulation is always needed given the inevitable failure of markets.

The professional accounting bodies in Australia have worked hard to avoid the imposition of regulation from outside the profession. For most of the twentieth century, the accounting profession sought to maintain a regime of self regulation. Self regulation relies on confidence in market operations, so that regulation is only used to correct slight imperfections in the workings of the market.

In its efforts to maintain autonomy, the profession has searched for underlying theoretical structures to support its authority. It has issued accounting and audit standards and established a conceptual framework as a basis for its code of ethics. Notwithstanding those efforts, the profession has not been successful in keeping Australian regulators at bay. As a consequence, the government has intervened to make rules for the accounting discipline. Given that the state continues to legislate for accounting activities, it can be argued that there has been a failure on the part of the accounting profession to ground the profession on a sound theoretical footing. [52]

The claim that either regulation theory or reliance on free markets should decide what legislative change is needed is however too simplistic. This view ignores the broader social setting within which the accounting discipline is practiced. No amount of theory or regulation will prevent some members of the profession from engaging in inappropriate activities. There will always be ill-intentioned accountants and users of accounting information who will act against the interests of society. [53] Community concern about accountant involvement in corporate collapse and business fraud has ensured that the need for accounting regulation continues. Debate between regulators and the professional accounting bodies goes on, particularly with respect to accountant behaviour and whether the

[52] Gaffikin, 'Regulation as Accounting Theory', above n 9, 14.
[53] Ibid 18.

profession should self regulate or not. In addition, the problem of breached auditor independence persists in Australia alongside interrelated concerns about conflicts of interest. These challenges are discussed in detail in Chapter 7.

This thesis examines the conduct of auditors in Australian by navigating a course using theoretical ideas and concepts to understand and explain auditor behaviour. After completing that journey, it finds that regulating ethics is not the best approach. It suggests that a market solution which lies outside the control of accountants is a better option. If introduced, this unique insurance approach is hoped to ensure that more accurate financial information will flow to users who rely on it for their decision making.

Chapter 2: The Nature of Accounting and True Disclosure

2.1 True Financial Statement Disclosure

The objective of general purpose financial reporting is to provide useful information to users for making and evaluating decisions.[54] A reporting entity[55] is an economic entity for which it is reasonable to expect the existence of users dependent on its financial reports for information to make and evaluate decisions about the allocation of scarce resources.[56] The management and governing bodies of reporting entities must present financial reports in a manner which assists in discharging their accountability. Those financial reports disclose information about performance, the year-end financial position, financing and investing activities, and include information regarding compliance with externally imposed obligations.[57]

Financial reports are intended to meet the information needs common to users who are

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[54] Australian Accounting Standards Board, Statement of Accounting Concepts, SAC 2, *Objective of General Purpose Financial Reporting* (at 31 August 1990) [43] (‘*SAC 2, Objective of General Purpose Financial Reporting*’).

[55] The term “reporting entity” is defined in AASB 1025, *Application of the Reporting Entity Concept and Other Amendments* at paragraph 27 as follows:

> ‘reporting entity’ means an entity (including an economic entity) in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources, and includes but is not limited to the following:
> (a) a listed corporation
> (b) a borrowing corporation, and
> (c) a company which is not a subsidiary of a holding company incorporated in Australia and which is a subsidiary of a foreign company where that foreign company has its securities listed for quotation on a stock market or those securities are traded on a stock market.

This definition is the same as the definition of a reporting entity given in Statement of Accounting Concepts SAC 1: *Definition of the Reporting Entity*, except that the SAC 1 definition does not include illustrations of the type of entity encompassed by the definition, see CCH *Australian Company Law Commentary*, (at 28 October 2005) [¶108-060] *Reporting entity concept*.

[56] *SAC 2, Objective of General Purpose Financial Reporting* [5].

[57] Ibid [45].

unable to command the preparation of reports tailored to satisfy their information needs.[58] Financial statement auditors then provide assurance to these resource providers, which include financial institutions, suppliers and shareholders. Auditors must report on whether the claims made in the financial statements are accurate, the financial statements are free from material misstatement, and the asset and liability values reported in the financial statements at the balance date.

The growing incidence of corporate failures have however lead regulators to express concern about the quality and value of audited listed public company financial statements. Attention has been called to a numbers game in which companies manipulate accounting data in order to produce a desired result. [59] That manipulated information is reported by an accountant and assured by an auditor. The techniques used may range from adjusting a company's results to meet share market projections, to smoothing quarterly results in order to portray a steady run of increases.[60] The economic and social damage caused by such behaviour is far-reaching. Negative outcomes can result not only for the investing public, but also for corporate management, company directors, audit firms who were involved in the mischief.[61]

Accounting scandals have shaken the foundations of investor confidence in the transparency, integrity and accountability of corporations and capital markets more generally. A contributing factor to these events was the unscrupulous practices of company officers who failed to meet their responsibilities. The accounting profession, and more specifically auditors also played a role in these events. Public disquiet about the role of auditors has surfaced with allegations that these professionals have facilitated corporate demise. [62] While the narrative behind these corporate failures is complex, a lack of gatekeeper ethical behaviour is a significant part of the story. For the audit profession, these developments have

[58] Ibid [5].
[59] Arthur Levitt Jr, 'The Numbers Game' **(**1998) 68(12) *The CPA Journal* 14, 14.
[60] Ronald Duska, Brenda Shay Duska and Julie Anne Ragatz, *Accounting Ethics* (John Wiley & Sons Ltd, 2nd Ed, 2011) 9.
[61] Bill Edge, 'Foreword: Restoring Public Trust' in Tom Campbell and Keith Houghton (eds), *Ethics and Auditing* (Australian National University, 2005) xiii.
[62] Ibid.

again highlighted the gap between public expectations and the reality of what the auditor's role entails. The Enron Corporation ('Enron') failure is a prime example of this. The public perceived the company's auditor did not act to control corrupt management practices in that case. The conclusion reached by many members of the public and members of government was that the auditor failed in its responsibilities, and that its independence from the management of Enron was compromised. These types of perceptions must be acknowledged and addressed by the audit profession if it is to restore trust in both the capital markets and in itself. The biggest challenge ahead for auditors is to identify how ethical behaviour can be restored and then repair the broken state of the accounting profession's ethics. Accountants must reconstruct public trust in the profession and in the practice of auditing more broadly. [63]

Several major corporate collapses have occurred since 2000, including Enron and WorldCom Incorporated ('WorldCom') in the United States and HIH Insurance Ltd ('HIH') in Australia, to trigger new corporate governance debates and initiatives. Without doubt, the main response to these failures in recent years has been the passing of the *Sarbanes–Oxley Act* of 2002 in the United States. In a similar vein, the Australian Stock Exchange ('ASX') released its *Principles of Good Corporate Governance and Best Practice Recommendations*[64] in March 2003.[65] In addition to these advances, the *Review of the Role and Effectiveness of Non-Executive Directors*[66] and the *Audit Committees Combined Code Guidance* [67] were released in the United Kingdom in 2003. The recent global financial crisis and collapse of several large companies in Australia in more recent times have again prompted many to look at the existing corporate governance regime and the effectiveness of the assurance role that auditors play. [68] Notwithstanding that statutory reform and guidance, the structural limitations of the financial statement audit ('FSA') model have failed to stop

[63] Ibid.
[64] Australian Stock Exchange Corporate Governance Council, *Principles of Good Corporate Governance and Best Practice Recommendations* (ASX, 1st ed, March 2003).
[65] A second edition was released in August 2007
[66] Also known as the 'Higgs Review'.
[67] Also known as the 'Smith Report'.
[68] The Institute of Chartered Accountants in Australia, *CA Program Unit 2 Corporate Governance* (ICAA, 2009) 10.

the growing incidence of public company financial report restatements.[69]

The genesis of these corporate calamities can be traced to investor irrational exuberance and infectious greed.[70] Company officer ambition and the allure of greater profits contribute to the intentional financial position misstatement of listed public company accounts. In some circumstances auditors are complicit with this behaviour. This was the case where the accounting devices employed to hide debt and losses by Enron were accepted by its auditor. This type of unethical auditor conduct and the lack of values shown is a focus of this thesis. Perverse incentives are found to compel some auditors to facilitate corporate officer greed that ultimately ends in corporate demise. This chapter examines the nature of accounting rules and information user needs, and finds that financial misstatement and corporate failure is inevitable under the present reporting mechanisms and the FSA regime. This thesis then investigates auditor ethical responsibility throughout the following chapters to culminate and in proposing a remedy for the accounting profession's ethical failings in Chapter 8.

2.2 Financial Statement Disclosure and User Requirements

Present day accounting practices and techniques include notation, computation, calculation and assessment procedures. Broader concepts of accounting then include both accounting technique and discourse. Accounting operates as a distinctive body of knowledge that provides discursive representations and vocabularies. Accounting incorporates aspects of measurement including the production of data and data collection techniques, and the creation of information and reports from this data. Accounting also supplies the criteria for the evaluation of this information against plans, targets and standards. [71]

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[69] Joshua Ronen, 'Symposium: Enron: Lessons And Implications: Post-Enron Reform: Financial Statement Insurance and GAAP Revisited' (2002) 8(1) *Stanford Journal of Law, Business & Finance* 39, 41.

[70] Alan Greenspan, The Challenge of Central Banking in a Democratic Society, (Speech delivered at the Annual Dinner and Francis Boyer Lecture of The American Enterprise Institute for Public Policy Research, Washington, D.C., 5 December 1996).

[71] Greer, above n 45, 73.

Accounting practice is an art or craft originally developed to assist users monitor their economic transactions by providing a financial picture of their affairs. An accountant may produce information for several users, each with different levels of access to that information. An organisation's managers use accounting information to assist them plan and control the organisation's operations. Owners, managers, and legislative bodies use the same information to help appraise an organisation's performance and make decisions about its future. Financial information can assist users decide how much time and or money to devote to an organisation, while the reports produced by an accountant may also be used to determine its taxation liability.[72] Hence, the accountant's role is to furnish useful information about the economic affairs of an entity to those having a legitimate right to information about an organisation's affairs. An accountant is obliged to present a true picture of those affairs to those users. [73]

Financial reports must contain broad types of information consistent with common user needs. That information is then assured by the audit function. Auditing Standard ASA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards* [74] ('ASA 200') sets out the objectives of an audit of a financial report. These objectives require an auditor to obtain reasonable assurance whether the financial report as a whole is free from material misstatement whether due to fraud or error. This is achieved when the auditor expresses an opinion on whether the financial report is prepared in accordance with the applicable financial reporting framework in all material respects. An auditor must report on the financial statements and communicate his or her findings as required under the Australian Auditing Standards.

More particularly, the audit must cover all aspects of the entity as far as they are relevant to the financial information being audited, so that the auditor can form an opinion on whether:

[72] Duska, Duska and Ragatz, above n 60, 10.
[73] Ibid 11.
[74] See para 200.11.

> (a) the financial information complies with relevant regulations and statutory requirements
>
> (b) the view presented by the financial information as a whole is consistent with the applicable financial reporting framework and the auditor's knowledge of the business of the entity, and
>
> (c) there is adequate disclosure of all material matters necessary to give a true and fair view.[75]

When conducting an audit and expressing an opinion, an auditor must not only comply with the requirements of auditing standards issued by the Auditing and Assurance Standards Board ('AUASB') but also the joint ethical requirements of the accounting bodies and applicable statutory regulation including the *Corporations Act 2001 (Cth)* ('*Corporations Act 2001*').[76] More specifically, an auditor's conduct is subject to the professions ethical requirements as set out in APES 110, *Code of Ethics for Professional Accountants* ('APES 110') and direction provided by APES 320, *Quality Control for Firms*.

2.2.1 Defining Financial Statement Reporting

Although contemporary accounting practice centres upon achieving compliance with prescribed rules, this function is largely unmentioned in definitions of accounting and its purpose. Instead, the reporting of financial or economic information for the purpose of informing decision making and discharging accountability obligations is stressed. This purpose is illustrated by statements drawn from accounting literature that define accounting and describe various specifications of its function: [77]

> Accounting is a means by which the complex data of the market, as they attach to the particular business, are translated into effective managerial criteria. It is the function of accounting to

[75] CCH Australia, *Australian Audit Manual* (at 16 September 2011) ¶5-050.
[76] Ibid.
[77] West, above n 28, 69.

record values, classify values, and to organise and present value data in such a fashion that the owners and their representatives may utilise wisely the capital at their disposal.[78]

... the primary duty of the accountant is to report information in the forms thought to be most useful to the persons who have legitimate interests in the enterprise affairs.[79]

... the ultimate goal of accounting is to produce relevant, accurate, and complete information, especially on the balance sheet and the profit and loss statement; for successful and intelligent business management must rely upon being given such information.[80]

The function of accounting is to record, collate, and present economic truths.[81]

The purpose of accounting is to furnish financial data concerning a business enterprise, compiled and presented to meet the needs of management, investors and the public.[82]

The committee defines accounting as the process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of the information.[83]

Accounting is a systematic method of retrospective and contemporary monetary calculation the purpose of which is to provide a continuous source of financial information as a guide to future action in markets. [84]

The preparation of financial statements (accounting) and auditing both the statements and the

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[78] William Andrew Paton, *Accounting Theory - With Special Reference to Corporate Enterprise* (Accounting Studies Press, 1962, first published 1922) 7.
[79] John B Canning, *The Economics of Accountancy* (Arno Press, first published 1929, 1978 ed) 312.
[80] Henry W Sweeney, *Stabilized Accounting* (Holt Rinehart and Winston, first published in 1936, 1964 ed) 101.
[81] Kenneth MacNeal, *Truth in Accounting* (Scholars Book Co, first published 1939, 1970 ed) 295.
[82] William Andrew Paton and Ananias Charles Littleton, *An Introduction to Corporate Accounting Stand* (American Accounting Association, 1940) 1.
[83] American Accounting Association, *Committee to Prepare a Statement of Basic Accounting Theory* (AAA, 1966) 1.
[84] Raymond J Chambers, *Accounting, Evaluation and Economic Behavior* (Prentice-Hall 1966) 102.

> accounts from which they are prepared are means of achieving accountability in society.[85]

> Accounting [is] broadly conceived as the measurement and communication of economic information relevant to decision makers. [86]

The Australian Statements of Accounting Concepts ('SAC's) also offer useful guidance on the nature of accounting. Under the statements, the function of general purpose financial reports is to provide useful information to users for making and evaluating decisions about the allocation of scarce resources.[87] General purpose financial reporting focuses on providing information to meet the common information needs of users who are unable to command the preparation of reports tailored to their particular information needs. These users must rely on the information communicated to them by the reporting entity.[88] Financial reports comprise financial statements, notes, supplementary schedules and explanatory material which are intended to be read together. Financial reports are not however the only source of relevant information about a reporting entity, and users of financial reports may need to access other sources to satisfy their information needs.[89]

2.2.2 The Purpose of Financial Reporting

General purpose financial reporting is not an end in itself, but rather a means of communicating relevant and reliable information about a reporting entity to users of that information. These user needs vary depending on how the reporting entity activities influence their decisions. Reporting entities control resources and engage with the community by providing goods and services, levying prices, charges, rates and taxes, and acquiring and investing in resources. The community's interests are best served if the scarce resources controlled by these reporting entities are used by them in the most efficient and effective manner possible. That efficient use of resources is likely to maximise the output of

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[85] Anthony M Tinker, *Paper Prophets: A Social Critique of Accounting* (Praeger, 1985) xvii.
[86] Ross L Watts and Jerold L Zimmerman, *Positive Accounting Theory* (Prentice-Hall, 1986) vii.
[87] *SAC 2, Objective of General Purpose Financial Reporting* [43].
[88] Ibid [7].
[89] Ibid [10].

goods and services, have desirable macroeconomic effects by enhancing employment and standards of living, and enable social policy objectives to be achieved at the lowest possible cost.[90]

The efficient allocation of resources will further be improved if those who make resource allocation decisions hold reliable financial information on which to base their decisions. General purpose financial reporting aims to furnish this information while also [91]providing a mechanism that allows management and governing bodies to discharge their accountability. Management and governing bodies are accountable to those who provide resources. They must plan and control the operations of the entity and ultimately report on their use of these resources. In a broader sense, because reporting entities can exert influence on members of the community at both the microeconomic and macroeconomic levels, those holding management roles are also accountable to the public at large for their actions. General purpose financial reporting thereby provides a means by which this responsibility can be discharged. [92]

The following discussion considers the types of different financial statement users and their needs in order to flesh out the broader role that reliable auditor assured financial information plays for market exchange. [93] During that discussion, it will be seen that that not all investors and capital providers have the same contractual rights regarding returns that employees and creditors enjoy.

2.2.3 Financial Accounts - the User Perspective

The provision of audit related services may include a review involving agreed procedures, or a range of engagements involving a systematic examination which require audit-based skills. These skills include financial information analysis, knowledge of internal control structures,

[90] Ibid [12].
[91] Ibid [13].
[92] Ibid [14].
[93] Ibid [15].

problem solving, risk assessment, sample selection,[94] and knowledge of accounting standards and financial reporting. These capabilities are then applied to an accountability matter which is capable of being evaluated against suitable criteria.[95]

An independent written audit report is issued at the completion of an audit, to offer users a level of assurance on the audited financial accounts.[96] Many individuals and organisations base their resource allocation decisions according to their knowledge of a reporting entity, and are dependent on the information provided in general purpose financial reports. Resource providers, recipient's of goods and services, and parties that perform a review or oversight function are primary general purpose financial report users. They share common information needs that must be met by the information disclosed by such reports. They are thereby significantly impacted if an auditor intentionally assures misstated financial reports given the losses that may flow from them.[97]

Resource providers

Providers of resources to a reporting entity are compensated either directly or indirectly for the resources they provide. Direct resource providers include employees, lenders, creditors, suppliers and, in the case of business entities, investors and capital contributors. The indirect category of resource providers may comprise donors, members of non-business entities such as clubs, societies and professional bodies, and in the case of public sector bodies, parliament, taxpayers and ratepayers.[98]

Resource providers require information that can tell them if the reporting entity will achieve the objectives for which it acquired the resources, and whether it is operating economically

[94] Auditing & Assurance Standards Board of the Australian Accounting Research Foundation, Auditing standard AUS 106, *Explanatory Framework for Standards on Audit and Audit Related Services* (at 31 December 2001) [.06(a)] (*'AUS 106, Explanatory Framework for Standards on Audit and Audit Related Services'*).
[95] Ibid [.06(b)].
[96] Ibid [.06(c)].
[97] *SAC 2, Objective of General Purpose Financial Reporting* [16].
[98] Ibid [17].

and efficiently when consuming those resources. Misstated financial reports will restrict investors from gaining knowledge of whether the entity is operating profitably and generating favourable cash flows. The amounts, timing and uncertainties of a reporting entity's cash flows is critical to dividend policy, and its ability to make payment. Any such uncertainty will influence resource provider decisions or whether to invest in a security or not.

Other providers of resources such as employees, suppliers, creditors and lenders, will principally be interested in the reporting entity's ability to generate cash flows that allow for the timely payment of its obligations to them. They are also indirectly concerned about the extent to which the entity will achieve its objectives, given the entity's capacity to generate cash flows relies upon its operational performance. Misstated reported financial information will restrict these providers of resources from making a proper assessment on performance and not allow them to determine if their continued support of the entity's activities is warranted. [99]

Recipients of goods and services

Recipients of goods and services represent those users who consume or otherwise benefit from the goods and services provided by the reporting entity. This category comprises customers and beneficiaries.[100] Recipients of goods and services require information about the reporting entity's ability to continue to provide goods and services to them. The reporting entity may be a critical contributor to the recipients supply chain, and so an accurate indication of continued supply is needed. These users need to know if goods and services will be supplied on time, at required volume levels, and under a satisfactory pricing structure.

As is the case of resource providers, recipients of goods and services require knowledge about whether the supplier entity is achieving its objectives and operating economically and

[99] Ibid [21].
[100] Ibid [18].

efficiently when providing its goods and or services.[101] This user group is focused on whether the reporting entity is sufficiently liquid to generate favourable cash flows. A liquid position will arise where sufficient cash is generated from business activities to allow the supplier to pay for the resources it consumes, and meet the other obligations it incurs when they fall due. In these circumstances, the entity is expected to continue as a going concern and provide goods and services to the recipient user group. Reliable auditor assured financial information allows that liquidity assessment to be determined. That assessment will thereby impact on user decisions to remain loyal, or source alternative suppliers for the goods and services they require.[102]

Parties performing a review or oversight function

Parties that perform oversight or review services on behalf of the community include parliaments, governments, regulatory agencies, analysts, labour unions, employer groups, media and special interest community groups. Members of this group tend to have indirect or derived interests in general purpose financial reports, as they are likely to represent those who have more direct interests.[103]

Parties performing a review or oversight services carry the interests of community members, and will require information about whether the reporting entity has been operating in the interests of the community. Accurate financial reports will tell them whether or not the entity is achieving its objectives and is operating economically and efficiently in carrying out its operations. The assessment of an entity's operating performance by these users will influence their decisions on what activities they will carry out with respect to the reporting entity. The messages or advice they give their constituents will also influence decision making more broadly.[104]

[101] Ibid [22].
[102] Ibid [23],[24].
[103] Ibid [19].
[104] Ibid [25].

Information relevant to users' needs

The objective of general purpose financial reporting is stated in Statement of Accounting Concepts, SAC 2, *Objective of General Purpose Financial Reporting.* General purpose financial reporting provides information to users for them to make and evaluate decisions about the allocation of scarce resources. Those responsible for managing a reporting entity and producing general purpose financial reports will discharge their accountability to report users if they meet this objective. The provision of information for accountability purposes is an important function of the general purpose financial reporting process together with the broader objective of providing information useful for making and evaluating decisions on scarce resource allocation.

The information required by different users for making and evaluating resource allocation decisions will overlap at times. All users are likely to be interested in knowing if a reporting entity is achieving its objectives and is operating economically and efficiently. Users must assess whether the entity is likely to continue to provide goods and or services into the future for themselves. They must also satisfy themselves that the resources they commit have been used for their intended purpose. Accurately prepared general purpose financial reports provide information for these purposes. They disclose the performance, financial position, and financing and investing activities of the reporting entity, including information about compliance with externally imposed regulatory or finance requirements.

A reporting entity's performance can be measured in both financial and non-financial terms. Profit and loss figures together with balance sheet items provide financial report users with information that can assist them assess financial performance over the reporting period, across several financial years, and when making comparisons between entities. For example, information users can evaluate the change in the entity's control over resources by reference to the resources or funds used to achieve a change net equity for a reporting period. This information allows users to predict both the capacity of the entity to generate cash from its

existing resource base, and also the effectiveness by which these resources are employed.[105] Other information relevant to a reporting entity's financial position includes details of its financial structure, capacity to restructure, and state of solvency. [106] That information can be used to predict the entity's ability to continue as a going concern, meet its objectives, generate future positive cash flows and continue to provide goods and or services into the future. [107]

In addition, information about an entity's financial structure including the source, type and terms of finance, the mix between debt and equity, and the nature of assets employed can be taken into account when users make decisions on scarce resource allocation. This information allows consumers to predict future cash flow distributions to resource providers. It is also indicative of an entities ability to attract further resources to fund activities and future expansion. Restrictions placed on the use of resources under a loan covenant or other security terms is relevant to this type of financial analysis.[108] Similarly, information about an entity's capacity to vary the composition of its resources will impact upon management's resource allocation decisions. The location, realisable value, and the current state of repair of assets are important to users, together with disclosure of any restrictions imposed on the use of those assets.[109]

The present state of an entity's solvency is particularly significant to financial statement users. Information concerning the availability of liquid assets to meet financial commitments as they fall due is most important. Net asset liquidity levels and the capacity to source cash from external parties can be used to predict whether an entity has capacity to meet its financial commitments on time. Predictions on whether it can continue as a going concern and provide goods and, or services into the future can be made using this information . [110]

[105] Ibid [29].
[106] Ibid [32].
[107] Ibid [33].
[108] Ibid [34].
[109] Ibid [35].
[110] Ibid [36].

Information about a reporting entity's financing and investing activities is considered by users when making and evaluating decisions on resource allocation. For example, information about an entities sources and applications of funds during the reporting period will show how it has financed its operations and invested its resources. This information allows users to decide if the resources they contributed have in fact been used for the purposes intended, and provides a reflection of the present state of solvency. That information then allows for an analysis of those factors that contribute to the entity's changed financial position over a period of time. This information is again useful to assess the reporting entity's ability to continue to provide goods and services, while also measuring if it has or will achieve its objectives. [111]

2.2.4 Auditor Ethics, Disclosure and Market Exchange

Several examples of corporate failure are discussed later in this chapter to demonstrate how different pictures of a company's performance can be created by an accountant. Quite often the picture developed by an accountant and then assured by an auditor is constructed to serve the interests of the party who appoints the accountant rather than the other users of the organisation's financial reports. Depending on the techniques adopted, an accountant can ensure that reported results appear more or less favourable. For example, accounts prepared for loan application purposes can be made to appear more favourable than those prepared to complete an income tax return for the same entity. [112] The preparation of financial statements requires skill, judgment, technique, and the application of principles in order to fairly state the assets and liabilities of an entity. On most occasions, the assets and liabilities are clear and unambiguous, but at other times their measurement and disclosure are dependent on the accountant's judgment which may be influenced by the pressures of his or her financial situation.

All Australian entities that prepare financial reports under the *Corporations Act* must comply with the Australian equivalents to International Financial Reporting Standards for the

[111] Ibid [38].
112 Duska, Duska and Ragatz, above n 60, 1.

financial years beginning on or after 1 January 2005. These standards detail various acceptable ways to prepare financial reports. As with all general policy, there are times when the principles do not apply to a situation and individual judgment is required. During the preparation of financial statements, accountants are given significant scope to depict different pictures of an organisation's financial affairs. As such, a manager in fear of jeopardising his or her position may place pressure on an internal accountant to undertake creative accounting and manipulate financial results,[113] or an external auditor may be pressured to acquiesce and issue an unqualified audit report.

As discussed above, an accountant is obliged to disclose the true financial picture of an entity for a range of users who rely upon the same accounting information. That information may persuade a user to act in a particular way, where that action may either benefit or harm the person giving or getting the information. That exchange of accounting information thereby takes on ethical importance. The ideal market transaction operates where two people freely bargain to exchange goods or services in the hope the exchange will make both of them better off, and that the relative position of each individual will improve because of the trade. Ideally, perfect information about the worth of what is being given and gotten in return is available to the parties. A situation of free trade with full information will maximise satisfaction on both sides. This free-market system and freedom of exchange leads to an overall improvement of the traders' lot. The market system will however be undermined where one of the parties is misled, or deception causes the deceived party to receive something different and of less valuable than what they had expected. The deceived party is less likely to have freely entered into the exchange had it known the full truth about the product. [114]

The conditions for an ideal market transaction require participant autonomy and full knowledge of the product traded in order to arrive at informed consent. Consent cannot be presumed if either party is forced into an exchange or lacks adequate knowledge of the product to be bargained for. A decision using inadequate information is either a poorly made

[113] Ibid 13.
[114] Ibid 14 .

or inadequately informed choice.[115] A financial statement user who has made a decision based upon misstated information may have changed his or her view of the financial health of the company if the true position were known. From an economic point of view, any behaviour that generates misstated financial information violates the ideal market principle of free exchange based on perfect information. More importantly from a moral point of view, the buyer has been induced to act in a different way than if ideal market conditions existed. The seller takes the buyer's real choice away in this situation to deceive the buyer for the seller's own ends. From a moral perspective, the primary reason for lying is to subordinate another without their consent and without concern for their benefit. The action of deliberately withholding information or manipulating information to get others to act in a contrary way had true information been available does not allow for an informed choice.[116] Ethical and independent auditor behaviour, which is free of conflicts of interest, helps to remedy this problem and assist the market place achieve ideal market conditions. The contradictory nature of accounting rules does not however assist the auditor's task. This aspect of accounting rules and the consequences that flow from it are now discussed.

2.3 The Contradictory Nature of Accounting Rules

The professions are characterised by elevated occupational authority. They typically have an exclusive and state-sponsored mandate to provide certain services and define the nature of those services. Both individually and through their formal associations, accountants exercise authority over financial reporting matters. They maintain the exclusive rights to provide company audit services and are largely unfettered by external regulations in the performance of this work.[117] Within this setting, accounting work processes are largely hidden, thereby

[115] Ibid.
[116] Ibid 20.
[117] The Australian Securities and Investment Commission state that to be eligible to register as an auditor, applicants must have completed the educational requirements needed under the law. This means the applicant must have:

> 1. the appropriate tertiary qualifications and have completed a prescribed course in auditing or, have other qualifications or experience that we consider equivalent to both requirements; and
>
> 2. have the skills requirements needed under the law. This means the applicant must meet one of the

preventing any confident evaluation of auditor performance.[118]In the end there is no alternate course but to trust the auditor about what they produce.[119] In addition, the authority of the accounting profession is accentuated by its ability to influence the processes that define accepted financial reporting practices. These processes include the development of accounting standards and other regulatory statements, together with systems of education that impart particular understandings of the nature of accounting services.[120]

The users of financial reports produced by accountants may not have access to expertise needed to help them assess the quality of that information. When faced with a general lack of alternative information, decision makers are forced to rely upon audited financial reports. The accounting techniques used to generate these financial reports are however largely defined by formally stated rules which have been developed without cognitive justification for their use. The usefulness of accounting rules and expertise needed to interpret and apply them is contingent upon those rules being systematically connected to the purposes of accounting.[121] This link does not always exist in the case of Australian accounting standards.

Many Australian accounting rules are disconnected from commercial phenomena, and prescribe discretionary calculation methods which are not derived from any robust theoretical framework.[122]Accounting methodology is not based on observed phenomena and does not produce outputs able to be independently verified. Accounting is instead based on imaginary concepts such as cost allocations and future economic benefits. The profession is distinguished from knowledge-based disciplines in this sense. Accounting practices are seen

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following requirements: satisfy all the components of an ASIC-approved competency standard; or have the level of practical experience that is prescribed in the Corporations Regulations or experience that we consider equivalent; and

3. meet the fit and proper person test under the law. This means the applicant must satisfy the commission that he or she is capable of performing the duties of an auditor and are otherwise a fit and proper person to be registered as an auditor. See http://www.asic.gov.au/asic/asic.nsf/byheadline/ >.

[118] West, above n 28, 64.

[119] Michael Power, *The Audit Society: Rituals of Verification* (Oxford University Press, 1997) 28.

[120] West, above n 28, 64.

[121] Ibid 65.

[122] Ernest Greenwood, 'Attributes of a Profession' in H.M. Vollmer and D.L. Mills (eds) *Professionalization* (Prentice-Hall, 1966, originally published 1957) 11.

to yield to manipulation, misstatement and fraud. Some choices available under Australian accounting standards allow for calculations that do not give independently verifiable amounts, and so make the content of financial reports conditional on personal judgements.[123]

In the end, published financial reports must aid the decision-making processes of shareholders and reliant user groups to be of any worth. They are needed to assess debt-paying capacity, determine the rate of return on invested funds, and evaluate a reporting entity's financial flexibility to respond to changed financial conditions. Notwithstanding that consumption of information, the data offered by financial reports is of often of limited value. In particular, the historical cost basis of accounting cannot be used to evaluate solvency or liquidity. The approach does not reveal the ability of the reporting entity to access cash or show the spending power needed to facilitate debt repayment or resource procurement.[124] This approach is merely a snapshot of the past which has little relevance to real time decision making.

The personal judgement offered and allowed by accounting rule choice means that the accounting method adopted becomes a matter of reporting entity policy, so that the wide choices available under these rules contradict the purpose of the accounting task.[125] Choosing which accounting standard to follow and how to apply it is sometimes based upon a vague criteria that guides the selection of an accounting method. That diversity of choice [126] profoundly affects the form and content of financial reports. [127] That discretion in

[123] West, above n 28, 71.
[124] Ibid.
[125] Some examples of accounting method choices can be found in:

- AASB 1019, *Inventories*, permits alternative inventory flow assumptions to be made.
- AASB 1022, *Accounting For The Extractive Industries* provides that certain exploration and evaluation costs incurred within the extractive industries may be carried forward.
- AASB 1041, *Revaluation of non-current assets* permits, but does not require, upwards revaluations of non-current assets.
- AASB 1010, *Recoverable Amount of Non-Current Assets* provides that non-current assets are not to be carried at more than their recoverable amount, and that this amount may be determined using either discounted or undiscounted cash flows.

[126] Some examples can be found in:

selecting an accounting method contradicts the purpose of accounting; that accounting information is intended to inform users. [128]

In practice, the choices permitted under the Australian accounting rules displace accountant objectivity. For example non-current assets may or may not be revalued, [129] or first-in-first-out or weighted average assumptions may be adopted to assign inventory costs. As a further example,[130] the term and pattern of depreciation and amortisation charges are subject to cautious or optimistic speculation about the future use of assets. The choices in

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- AASB 1008, *Leases,* the method of accounting to be adopted in respect of leases under is dependent on whether substantially all of the risks and benefits incident to ownership of the leased asset effectively remain with the lessor (para. 5.3.1).
- AASB 1009, *Construction Contracts* prescribes that the recognition of revenues and expenses under a construction contract is contingent on the outcome of the contract being reliably estimated (para. 7.1).
- AASB 1011, *Accounting for Research and Development Costs*, research and development costs may be recognised as an asset under where such costs 'are expected beyond any reasonable doubt to be recoverable' (clause.31).
- AASB 1012, *Foreign Currency Translation* prescribes two methods for translating financial statements denominated foreign currency, with the selection dependent on whether the foreign operation is perceived to be 'self-sustaining' or 'integrated' (para 7).

[127] Others have made comments along these lines. See:

Houghton and Walawski found that professional accountants attach different meanings to terms contained in accounting standards and statements of accounting concepts. See Houghton KA and Walawski JB 'Asset Recognition and Probabilistic Judgements' (1992) 1(3) Australian Accounting Review 2-9.

In a similarly vein, Chambers commented on the nature of accounting rules to highlight their tendency to contradict each other, a feature which is contrary to system of knowledge. He stated that;

> The system should be logically consistent; no rule or process can be permitted which is contrary to any other rule or process, In particular the symbols used should have a sensibly uniform meaning throughout the system. In accounting this involves that equal things should be represented by equal symbols.

See Raymond J Chambers, 'Blueprint for a Theory of Accounting' [1955] 6(1) Accounting Research 17, 22.

[128] West, above n 28, 72.

[129] Australian Accounting Standards Board, AASB 1041, *Revaluation of Non-Current Assets* (at 31 July 2001) [4].

[130] Australian Accounting Standards Board, AASB 1019, *Inventories* (at 31 March 2012) [7]

accounting method as sanctioned by the present accounting rules contradict the function of accounting. Given this subjectivity, financial reporting cannot serve the needs of broad user groups, but rather satisfies the particular personal wishes of one user or class of users that controls their preparation. This causes financial reports to contain information which is generated as a function of personal preferences. The accountability function of financial reports is not served where opportunistic selection of accounting methods is undertaken by those whose accountability is under evaluation. [131]

2.3.1 Incoherent Systems of Accounting: the Opportunity for Misstatement

As discussed in the previous section, accounting rules have a propensity to contradict each other.[132] Accounting systems are not logically consistent given that some accounting rules and processes are contrary to each other.[133] The incongruous nature of accounting rules breeds inconsistencies within the accounting function by allowing broad discretion in the selection of individual accounting standards which then lends itself to the misstatement of financial accounts.

Financial reports are often depicted as descriptive statements that portray the financial position, profit or loss, total assets, and total liabilities of an entity. However, when prepared strictly in accordance with accounting rules, financial statements may lack descriptive power and fail to adequately describe the actual features of the entity being reported on. As accounting rules are not derived from a reliable body of accounting knowledge, the financial reports resulting from their application do not reflect the fundamental consistency that characterises knowledge-based statements. [134]

Accounting rules place an emphasis on abstractions including future economic benefits, unamortised costs, allocated costs, predicted future cash flows and present values. These

[131] West, above n 28, 73.
[132] Raymond J Chambers, 'Blueprint for a Theory of Accounting' [1955] 6(1) *Accounting Research* 17, 22.
[133] West, above n 28, 76.
[134] Ibid 79.

rules cannot be independently authenticated and have no empirical basis. Against this illogical basis of standard setting, the accounting profession produces and enforces accounting rules which do not ensure the serviceability of financial information. Accounting rules in Australia do not currently provide a means to fully discharge this serviceability requirement, as was pointed to by one entrepreneur:

> [Accounting] is becoming less useful as it becomes more regulated. I began to think of this issue as I signed my company's annual returns. For the first time in 30 years I could no longer say that I really understood the returns. And if I could not understand them, who could? I studied accounting at university, I have kept up to date with accounting issues and, more relevantly, I have an intimate knowledge of my company's affairs. Yet the highly stylised figures in the returns I signed raised no glimmer of recognition. They no longer gave a picture, in any way, to which I could relate, of the economic activity of which I am a part. [135]

The accounting profession does not always achieve the expected levels of information usefulness. The profession operates within an environment of conflicted audit behaviour. In some cases, financial statement users are left with unreliable and misstated information. To date, the FSA assurance function has attempted to grapple with incoherent accounting rules and the self-interested motivations of the audit client's management. The role of the auditor is now explored in the context of financial accounting misstatement, corporate collapse and unethical behaviour which has flourished under the FSA regime.

2.4 Responsibilities of the Auditor

An auditor is appointed by an entity for the purpose of expressing an opinion on the financial report of that entity, and is primarily responsible to the entity's shareholders or owners for his or her findings. The auditor must comply with all standards relevant to the audit when determining which audit procedures will be performed. While the auditor is responsible for forming and expressing an opinion on the entity's financial report, the responsibility for

[135] R Fallshaw, 'Getting it Wrong by Following the Rules' (letter) [1993] 26 March *Business Review Weekly* 105, 105.

report preparation rests with the organisation's management. In this respect, management must maintain adequate accounting records and internal controls, select and apply accounting policies, and safeguard the entity's assets. The audit of the financial statements does not relieve management of any of these responsibilities.[136]

The engagement letter between the auditor and client is a contract that governs the terms of the engagement and sets out what is expected of each party. In addition, the auditor has legal duties and responsibilities including those imposed by the *Corporations Act* and case law. These legal requirements apply regardless of the terms agreed to between the auditor and his or her client.[137]

The auditor must remain independent of the audit client at all times, and carry out all audit duties with integrity and with an appropriate degree of care and skill. He or she must respect the confidentiality and privacy of information acquired during the course of the audit, to document matters and gather evidence that demonstrates the audit was carried out in accordance with auditing standards and guidance statements. The auditor must obtain sufficient appropriate audit evidence through planning, risk assessment and the performance of audit procedures that will enable reasonable conclusions to be drawn on which to base an opinion on the financial information. [138]

Auditing Standard ASA 200 sets out the mandatory requirements for the conduct of an audit of a financial report. This standard emphasises that the auditor is responsible for providing reasonable assurance that the financial report when taken as a whole is free from material misstatement. These mandatory aspects include the requirements to:

(a) comply with the ethical requirements of the professional accounting bodies;

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[136] CCH Australia, *Audit and Assurance Manua*l (at 11 October 2012) ¶5-100.

[137] Refer to Auditing and Assurance Standards Board, ASA 210 *Agreeing the Terms of Audit Engagements* (at 27 June 2011). That the standard deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged with governance.

[138] Auditing and Assurance Standards Board, ASA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards* (October 2009) [14]-[20] ('*ASA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*').

(b) conduct an audit in accordance with all relevant Auditing Standards;
(c) plan and perform an audit by exercising professional judgment with an attitude of professional scepticism, recognising that circumstances may exist which could cause the financial report to be materially misstated;
(d) plan and perform an audit to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptable low level consistent with the objective of the audit, and therefore enable the auditor to draw reasonable conclusions on which to base the audit opinion. [139]

An external auditor appointed to report on financial information must thereby perform procedures to obtain audit evidence about the amounts and disclosures in the financial report. The procedures selected depend on the auditor's judgement, including his or her assessment of the risk of material misstatement within the financial report due to fraud or error. In making that risk assessment, the auditor must review the auditee's systems of internal control and design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of those internal control systems. An auditor must also evaluate the appropriateness of accounting policies used, the reasonableness of accounting estimates made, as well as evaluate the overall presentation of the financial report.[140] When carrying out this work, an auditor may be faced with the opportunistic use of accounting standards by an entity's management to depict an untruthful financial position.

An auditor must express an opinion on whether the financial report presents fairly in all material respects, to gives a true and fair view of the financial position of the entity, its financial performance and its cash flows for the year then ended in accordance with Australian Accounting Standards.[141] The recent crop of high profile corporate failures has featured examples of unqualified audit reports. The blame in these cases has been pointed squarely at audit failure with claims that responsibility rests with the auditors.

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[139] CCH Australian, *Audit and Assurance Manual*, above n 136.
[140] Duska, Duska and Ragatz, above n 60, 132.
[141] Auditing and Assurance Standards Board, ASA 700, *Forming an Opinion and Reporting on a Financial Report* (27 June 2011) [27] (*'ASA 700, Forming an Opinion and Reporting on a Financial Report'*).

Auditing typically involves many judgment calls allowing scope for management pressure to influence the audit opinion. This pressure can be even more intense if the accounting firm has supplied high levels of auditor provided non-audit consulting services to its client. These services have become a major source of income for many practices, and are offered in conjunction with audit services in an extremely competitive market for professional services. In these circumstances, audit partners may be reluctant to disagree with the auditee's management in fear of losing the consulting engagements.[142]

The Enron case makes it clear that financial statements must be both truthful and accurate so that users who rely on them can make rational decisions. Notwithstanding that aspiration, financial reports do not always achieve this. They may be intentionally distorted to produce the desired results of management, for example, to meet projections or smooth quarterly reported results. This chapter now examines the extent that such distortions have been helped by the actions of auditors, with focus on the unethical conduct of the auditors in those cases.

2.5 Corporate Collapse and the Role of Accountants and Auditors

While it is generally acknowledged that the primary reason for the recent spate of corporate collapses lies in ineffective corporate governance, other causal factors must be considered in order to fully understanding this phenomenon. To start with, a new age of materialism developed during the 1990s together with corporate and investor greed. This combination of factors encouraged the misuse of accounting devices. These tools and approaches were key contributors to the demise of corporations including Enron, WorldCom, HIH, One.Tel. Ltd ('One.Tel'). Coupled with this corporate deception was conduct of traditional trusted gatekeepers who betrayed the community. Compromised accountants and breached auditor ethical behaviour featured heavily in each of these cases, to bring on community calls for more regulatory intervention of the accounting profession.

[142] Duska, Duska and Ragatz, above n 60, 3.

2.5.1 The Enron Collapse

Enron operated as giant energy trading company in the United States and was listed on the New York Stock Exchange. It used the services of the largest audit firm in the United States at that time, namely Arthur Andersen ('Andersen') and installed a 'blue ribbon' board of directors to oversee its governance. The company's share price rose from US$20 in 1999 to a peak of US$90 in August 2000. Before its collapse, Enron was the seventh largest company in the United States and one of the world's leading electricity, natural gas and communications providers. Enron was valued at US$70 billion [143] before the company's financial position was found out to have been subject to a systematic accounting fraud. By December 2001 Enron's shares were worthless, and the company filed for Chapter 11 bankruptcy protection under the *US Bankruptcy Code* on 2 December 2001. [144]

Enron's management used a multitude of fraudulent and creative practices to create fictional profitability and low liability balances, to achieve rising share prices and good credit ratings. Many income items reported in Enron's financial accounts were inflated, while other items did not exist. Sophisticated off balance sheet ('OBS') entities were created to remove unprofitable entities and assets from the company's financial reports. The results of those accounting devices boosted Enron's profits and revenues. Several senior Enron executives and their families took up minority holdings in these special purpose entities ('SPEs')[145] which were used to deceive the market, and received many millions of dollars in revenue for their roles in that deception.[146]

This core technique using SPEs required the construction of non-subsidiary entities. These vehicles were generally partnerships structured to fall outside the reporting rules that would otherwise require their accounts to be consolidated with Enron's group accounts. This in

[143] The Institute of Chartered Accountants in Australia, *CA Program Unit 2 Corporate Governance*, above n 68, 17.
[144] Ibid.
[145] Or special purpose vehicles ('SPV').
[146] The Institute of Chartered Accountants in Australia, *CA Program Unit 2 Corporate Governance*, above n 68, 17.

effect kept the SPE's off balance sheet. The United States Securities and Exchange Commission ('SEC') guidelines at that time only required that 3% of an SPE's capital investment be held by an independent body, and that investment must be at risk throughout the life of the transaction. The independent SPE owner must also be able to exercise control of the vehicle for it to be treated as an SPE.[147] These requirements were relatively simple to satisfy in Enron's case.

Enron's share price continued to increase up to August 2000 with the support of manipulated profits and revenues. This translated into significant gains from share sales for several senior Enron executives. These executives had publicly announced that the company was expected to continue its remarkable rise, and encouraged Enron shareholders and employees to invest in Enron shares. At the same time these trusted individuals privately sold down their own shares. As a result, the senior executives made gains from their disposals, while many Enron employees lost their savings and pensions when the company finally met its end. [148]

The Enron story was only made possible because of weak corporate governance practices combined with the unethical behaviour of the company's auditors. The fraudulent accounting practices used were authorised at the highest levels of company management. Although devised by Andy Fastow as chief financial officer, the chief operating officer Jeff Skilling, and former chief executive officer and founder Kenneth Lay also helped construct these accounting tools and approaches. Skilling was sentenced to 25 years in prison in October 2006 for his part in this dishonesty, while Lay died of a heart attack in 2006 before his sentencing. Fastow's evidence assisted the prosecutors convict others involved in the scandal[149]which gave him a reduced sentence for that cooperation.[150]

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[147] Frank Partnoy, *Infectious Greed* (Profile Books 2003) 210.
[148] The Institute of Chartered Accountants in Australia, *CA Program Unit 2 Corporate Governance* , above n 68, 17.
[149] Ibid 18.
[150] These officers were also found guilty of insider trading, while several other senior managers were found guilty of criminal activities including security and wire fraud, conspiracy, fraud, money laundering and insider trading.

Given that Enron's senior management team were all involved in the fraud, the company's corporate governance safeguards (including the independent auditor function) were called into question by the enquiries that followed. The company was found to not have an independent board of directors, nor did it engage an independent external auditor to protect the interests of its shareholders. Enron was Andersen's most lucrative client, paying some US$100 million in fees for professional services per annum. It was later found that the independence of Arthur Anderson audit staff was impaired given the size of this commercial arrangement. Andersen's complicity and breached independence were revealed when explanations were sought by the enquiries. In particular, Andersen knew of the SPE's used to boost Enron profits and revenues. The auditor destroyed a large volume of its Enron audit working papers and evidence in October 2001, soon after learning that the Securities and Exchange Commission had planned an investigation into the Enron collapse.[151]

Perverse and unethical behaviour filtered down through the Enron board of directors, starting with Kenneth Lay as chairman. The board approved the use of SPE's developed by Fastow and conspired to adopt the other fraudulent accounting techniques that followed. It was not however the board alone that failed the Enron shareholders. The checks and balances expected of good corporate governance did not exist. In addition, no company advisor, including the directors, auditor, lawyers, analysts and bankers stood in its way of the company's actions despite their knowledge of what was transpiring. These individuals earned significant fees from Enron's business and yet did speak up for risk of losing that income.[152] Barbara Toffler, a former partner-in-charge of Andersen's ethics and business practices division commented on Andersen's culture to state that:

> I also experienced a culture rife with conflict and an organization consumed by never-ending financial and political pressures. I worked with people so in thrall to the great bull market of the 1990s and the power and wealth of their corporate benefactors that they completely forgot

[151] The Institute of Chartered Accountants in Australia, *CA Program Unit 2 Corporate Governance*, above n 68, 18.
[152] Ibid.

that the true purpose of their job was to protect the investing public. [153]

The implosion of Andersen in 2002 followed the collapse of Enron, to arguably mark the defining moment when public trust was lost in the accounting profession. The profession's gate keeping role was clearly breached, as was evident in Andersen's lost integrity and impaired independence in its roles as both Enron advisor and auditor. [154]Arthur Andersen was paid US$5.7 million for its advice on Enron's accounting treatments in addition to the ongoing stream of audit fees it received. Even after acting on Andersen's advice, accounting restatements were needed for SPE transactions. The composition of some of these vehicles did not comply with the SEC criteria and were thereby deemed to be dependent entities. Financial restatements were made for the financial years commencing 1997 through to 2001, and included recording losses of US$1.2 billion incurred by SPEs that had not been previously consolidated to Enron's accounts. In the end, the Enron collapse was fuelled by a failed board of directors and inadequate governance procedures combined with a series of accounting frauds and poor corporate ethics. Most importantly for this thesis, a lack of auditor independence and objectivity was clearly evident, and that breached ethical behaviour raised serious questions on the FSA model's effectiveness and utility. [155]

A senate sub-committee [156] conducted an investigation into the cause of the Enron collapse. A range of issues was uncovered. The report issued by the Senate sub-committee ('Powers Report') told of substantial and unauthorised bonuses paid to company managers and executives. The investigation also exposed the use of partnerships established to depict more favourable financial results. Many of these entities were formed without bona fide economic objectives and were not properly accounted for under the accounting rules and SEC

[153] Barbara Ley Toffler and Jennifer Reingold, *Final Accounting: Ambition, Greed and the Fall of Arthur Andersen* (Broadway Books 2003) 7.
[154] Barry J Cooper, 'Where Were the Gatekeepers? Corporate Collapses and the Role of Accountants' in Tom Campbell and Keith Houghton (eds), *Ethics and Auditing* (Australian National University, 2005) 165.
[155] Ibid 166.
[156] William Charles Powers Jr. 2002, *Report of Investigation, Special Investigative Committee of the Board of Directors of Enron Corp*, <http://news.findlaw.com/wsj/docs/enron/sicreport/index.html> at 15 October 2012.

regulation set down at the time. In addition, transactions were inappropriately recorded in order to disguise US$1 billion in losses. That incorrect accounting treatment was adopted with the knowledge and involvement of Andersen as Enron's auditor. [157] The Powers Report also found several breaches of director fiduciary duties, director conflicts of interest and a lack of independence. An extensive array of undisclosed activities was reported on by the Senate sub-committee, together with excessive compensation paid to conflicted company officers and management, and the use of high-risk accounting practices more broadly.

Enron in context of legal accounting

The Enron case headlined a grey area that exists between outright accounting fraud and techniques of creative accounting. Creative accounting techniques are those carefully constructed practices used to undermine accountability and transparency while at the same time are claimed to be legal. Such innovative techniques continue to be used as a matter of common business practice, and are able to pass present day auditor assurance processes. These practices have been fostered by a culture that chooses to manipulate the letter of the law in order to defeat its spirit, and are exploited by those who claim this inventive approach has legitimate status. When faced with this attitude, statutory rules alone cannot ensure an auditor will stand firm before management that engages him or her or guarantee their independence. A change in culture is necessary to encourage ethical attitudes towards the application of law at both the company management and auditor levels alike.[158]

The Enron collapse generated headlines that questioned both auditor and management ethics alike. Fraudulent accounting was apparent, while the creative accounting techniques employed by the company raised many ethical concerns. Many examples of creative accounting are evident in this case, including group structuring and financial reporting that circumvented the concept of legal control. Some of the approaches taken may be claimed as legal and literally compliant with the letter of the law, although they defeated policy intent

[157] Cooper, above n 154, 166.
[158] Doreen McBarnet, 'Perfectly Legal: a Sociological Approach to Auditing' in Tom Campbell and Keith Houghton (eds), *Ethics and Auditing* (Australian National University, 2005) 25.

and the spirit of the reporting provisions at that time. The Enron case has laid bare not only extensive examples of fraud, but also gave up many illustrations of creative accounting to demonstrate the routine nature of these practices, and questioned the ethical behaviour of those who designed the approaches, prepared the accounts and audited them. [159]

Enron's OBS transactions were purposefully designed to mislead shareholders about the company's precarious financial position and restrict capital market transparency. This is as deeper concern than fraudulent accounting given the general acceptance of creative accounting by trusted community gatekeepers.[160]Enron used a multitude of fraudulent and creative practices involving the construction of highly complex transactions.[161] Yet even if Enron had not breached any regulation, its accounting approaches would still have mislead the market given that even legal OBS structuring allows for significant debts and losses to be hidden. It can be argued that much of Enron's OBS activity did not fall into this category to breach the rules, but rather creatively exploited them or made use of regulatory gaps.[162]

The Enron fallout found Arthur Anderson as gatekeeper to have endorsed financial statements that mislead the market. As a consequence, public trust in those auditor assured accounts was violated. The lessons learnt from Enron's manipulation of its accounts and Andersen's complicity are highly relevant to accounting and audit practice in Australia. Those who take a legalistic approach and adopt creative accounting practices interfere with the goal of publishing true and fair accounts by distorting financial information.[163]Although technically proper, deceptive accounting techniques are found in mainstream reporting in Australia as is evident in the regular restatement of public company accounts. The creative exploitation of rules and regulatory gaps by listed Australia public company management

[159] Ibid 30.
[160] Ibid 28.
[161] Powers, above n 156, 5.
[162] Frank Partnoy, *The Unregulated Status of Derivatives and Enron, Testimony at Hearings before the US Senate Committee on Governmental Affairs, 24 January 2002*, 2 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=302332>.
[163]Edward Spence, 'Conflicts of Interest in Auditing: are They Conducive to Corruption? ' in Tom Campbell and Keith Houghton (eds), *Ethics and Auditing* (Australian National University, 2005) 124.

with auditor approval amounts to false assurance being given to financial statement users. This willingness to engage in creative accounting practices and falsely issue unqualified audit reports signals a broader problem about the FSA model to capital markets that rely on accounting transparency.

The remainder of this chapter continues to focus on the issue of misstated financial reporting and the types of unethical auditor behaviour found at the heart of the Enron case. It draws upon instances of corporate collapse in Australia to examine ethical theory in the context of the audit profession, and the regulation of ethics for Australian accountants. It will be shown that corrective intervention is needed to fix the current state of auditor behaviour, and that restructuring the current relationships that exist under the FSA approach is the best solution.

2.5.2 Corporate Collapse in Australia

The HIH Royal Commissioner lamented that for all the breaches of law and flaws of the system that he identified, and the thoughtful remedies he advanced, the core problem that caused the HIH failure was something he could not fix. The Commissioner, Justice Owen suspected that a profound failure of morality was at heart Australia's worst corporate disaster at the time. [164]An overview of recent corporate failure in Australia, including the headline failure of HIH is now discussed. The roles played by accountants in those cases will examined, with particular attention placed on unethical approaches and practices of registered company auditors .

The 1960s saw the collapse of several well known corporations which included Latec Investments Ltd, Stanhill Development Finance Ltd, Reid Murray Holdings Ltd and H. G. Palmer Consolidated Ltd. The common theme in these cases was the combination of a tight credit squeeze, the doubtful valuation of receivables and investments, optimistic recognition of unearned income, and the intermingling of private and public companies. The accounting profession was still under development at that time, and chose to blame deficient

[164] David Brearley, 'HIH: Moral Hazard', *The Australian* (19 April 2003, Sydney) 25.

management practices rather than examine the role that the profession played. For example, members of the profession were responsible for financial report preparation yet did not properly account for the market value of investments and the collectability of receivables in many of these cases. These examples of corporate collapse and those that followed offer important and instructive insights on auditor behaviour. They question the auditor's ability to understand the auditee's business and its transactions, and whether they have adequate knowledge of the structures and accounting techniques used by their clients.[165]

The collapses of Mainline Corporation, Cambridge Credit Corp Ltd, Mineral Securities Ltd and Gollins Holdings Ltd followed in the early 1970s and again caused community outcry. The search for those responsible resulted in action being taken against those involved, and saw several company directors charged. Criminal action was brought against two directors of Gollins Holdings Ltd. They received jail sentences of more than 10 years each. In addition, a $6 million settlement was awarded to the debenture holders in Gollins Holdings Ltd. In comparison to this, civil action was brought by the Cambridge Credit Corp Ltd debenture holders against its auditors which resulted in a then unprecedented out of court settlement of $20 million. These settlements have since been surpassed in cases of recovery against auditors where the courts have found them to have acted negligently.[166]

These types of failings were taken into account by Professor Ray Chambers, who forewarned of further dangers lying ahead for the accounting profession when he commented that:

> ...if due to the optional accounting rules available to them, the company managers and directors are able to conceal the drift (in financial position), shareholders and creditors will continue to support, and support with new money, companies that are weaker than their accounts represent them to be.[167]

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[165] Cooper, above n 154, 161.
[166] Trevor Sykes, *The Bold Riders: Behind Australia's Corporate Collapses* (Allen and Unwin 1994) 460.
[167] Raymond J. Chambers, 'Observation as a Method of Inquiry – the Background of Securities and Obscurities' (1973) 9 (1) *Abacus* 156,166.

In response to community calls for action to address the corporate collapses of the early 1970s, the NSW State Government formed the Accounting Standards Review Committee in 1978. The Committee was chaired by Professor Chambers. The report issued by the committee was critical of the accounting professions standards at that time, and was followed by threatened intervention by the NSW Attorney General in the accounting standard setting process.[168]

The 1980s saw a return to the excesses of the '60s and '70s where bankers, lawyers, accountants, and regulators yet again showed signs of unethical behaviour. Company officers again acted fraudulently to abuse shareholder trust freely and without interference from these guardians. The comments by Clarke, Dean and Oliver in respect of the practices employed by the accounting profession in the 1980s offer some insight:

> … our conventional standard accounting practices were unable to cope with the complexities. Primarily they failed because of their ad hoc, one-off orientation – methods drummed up as a quick fix for a current anomaly, the current object of complaint, the subject of current pressure on the accounting, irrespective of whether they meshed or conflicted with other practices or financial common sense …

and:

> … the use of Urgent Issues Groups to come up with a speedy fix to urgent accounting problems … the old reductionist approach and its one-off solutions continues, with as little hope of success in improving accounting data generally as the well-intentioned efforts in the past. [169]

These sentiments underline problems inherent in the accounting profession. The unwillingness of the profession to act to remedy its approaches has had a significant impact on a fundamental attribute of a profession, namely the ability to self regulate. That outcome means that the Australia accounting profession has now lost its self regulatory status with

[168] Cooper, above n 154, 161.
[169] Frank L Clarke, Graeme. W Dean, & Kyle G Oliver, *Corporate Collapse – Regulatory, Accounting and Ethical Failure* (Cambridge University Press, 1997) 148.

respect to standard setting, which has shifted to the government sponsored Financial Reporting Council's Australian Accounting Standards Board and the Auditing and Assurance Standards Board. Notwithstanding this change, the profession continues to have a significant influence over standard setting under co-regulation.[170]

The more recent incidents of corporate collapse in Australia include HIH, Harris Scarfe Ltd ('Harris Scarfe') and One.Tel. These corporate failures have all to some extent have been attributed to the heightened materialism and declining ethical standards of company directors, the accountants who produce the financial reports and auditors who assured them. David Knott, the former chairman of corporate regulator, the Australian Securities and Investment Commission ('ASIC'), strongly criticised the outbreak of management greed that surrounded these cases. He commented that boards of company directors had failed to constrain excessive and structurally unsound remuneration practices and allowed short-term pay-offs to prevail. The behaviour of analysts, and in some cases the auditors saw them forego their ethical obligations in return for excessive levels of fees and commissions.[171]

At around the same time David Knott expressed this view, others commentator lamented that the Australian regulators were caught sleeping. In particular, the Australian Prudential Regulation Authority ('APRA') as insurance industry regulator was criticised in connection with the HIH collapse. Some politicians and leading insurance executives claimed that the regulator was not adequately staffed to enable it to identify the weaknesses in failed company systems, and that the agency had not met community expectations in respect of HIH.[172]

From these examples, it is clear that these trusted community gatekeepers have failed in their role in public company corporate governance in Australia. Within that environment of poor management, inadequate internal controls and governance, and threatened competition and

[170] See 3.3.1 The Extent and Origins of Accounting Professional Occupational Authority.
[171] David Knott, 'Corporate Governance - Principles, Promotion and Practice', speech delivered at the Monash Government Research Unit (16 July 2002) Australian Securities and Investments Commission <http:www.asic.gov.au>.
[172] Cooper, above n 154, 164.

acquisitions, poor corporate culture had not only encouraged unethical conduct but also allowed it to flourish. In addition, the history of corporate collapse in Australia has shown that regulatory intervention and greater levels of corporate governance does not always deliver the outcomes as intended. Although there has been a steady flow of new rule making on corporate reporting and accounting standard development, there has not been an observable reduction in corporate failure as a result of this regulation.[173]

This thesis concludes that the long held reliance on auditor independence and integrity has been misplaced by report users. Self-interest and materialism have become so pervasive that auditors have become servants of their stakeholders and not independent guardians.[174] Their ability to act as effective community gatekeepers has been tainted by misguided business arrangements between audit firms that are willing to give up their autonomy and independence in order to provide profitable and conflicted services. The final section of this chapter provides an overview of some landmark cases of corporate collapse in Australia, namely HIH, Harris Scarfe and One.Tel. That review will underscore the reasons why the accounting profession has lost credibility as a corporate gatekeeper.

HIH Insurance Ltd

A story of weak or nonexistent corporate governance practices was repeatedly told to the Royal Commission enquiry into the failure of HIH Insurance.[175] In March 2001, HIH was placed into provisional liquidation with reported losses of approximately $800 million, although later estimates put that deficiency at between $2.7 and $4 billion making it Australia's largest corporate collapse at that time.[176] HIH was known in the insurance industry as a price cutter and more willing underwriter than its competitors. Although

[173] Ibid 168.
[174] Ibid.
[175] The Institute of Chartered Accountants in Australia, *CA Program Unit 2 Corporate Governance*, above n 68, 19.
[176] David Kehl, *Current Issues – HIH Insurance Group, Economics, Commerce and Industrial Relations Group* (2001) Department of the Parliamentary Library <http://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/Publications_Archive/archive/hihinsurance>.

excessive discounting was a factor in the company's failure, it was arguably the hostile takeover of FAI Insurance for $300 million[177] without a proper due diligence investigation firstly being undertaken that triggered the demise of HIH.[178]

A royal commission into the affairs of HIH was announced in June 2001. The terms of reference were sufficiently wide-ranging to enable the Commissioner to fully investigate the circumstances surrounding HIH's downfall. The effectiveness of commonwealth and state regulatory body oversight fell within scope, together with consideration of whether changes were needed to the corporate governance legal framework in place at that time. The Commission's report was issued in April 2003 [179] by Justice Owen who expressed his concern about moral issues he found which extended beyond the those employed by HIH, to also include external professionals engaged by the organisation.

In the aftermath of HIH, accountants emerged as the masters of trickery who falsified financial records. Although legal accounting devices may have been used, the results rendered by them were decidedly misleading and intended to deceive financial statement users. For example, the accounting approaches allowed for goodwill to be revalued at more than half the total of HIH asset values. In addition, HIH did not set aside the level of reserves needed to cover insurance claims, and the company was found to overvalue its other assets more generally.

Further to these accounting irregularities, Justice Owen reported that HIH had historically under provisioned for insurance claim liabilities. Towards the end, the company spiralled to its demise after having been called on to pay under-reserved insurance claims from current revenue without any the prospect of recovering to a liquid position. [180]Under questioning from the Commission, the finance director rejected the assertion that his responsibility to the

[177] HIH incurred significant losses from its United States and the United Kingdom operations which also contributed to its eventual collapse.
[178] Cooper, above n 154, 169.
[179] Ibid.
[180] The Institute of Chartered Accountants in Australia, *CA Program Unit 2 Corporate Governance*, above n 68, 19.

company required him to be prudent and conservative in assessing policyholder claims and ensure a claim safety margin was reserved. He continued to maintain this view even though the provisioning levels set by the company had proved to be inadequate in the past. [181]

In his report, Justice Owen expressed dissatisfaction with the accounting systems and the procedures adopted by HIH to find them inadequate. In one observation [182] Justice Owen noted that:

> Users of HIH accounts may not have understood it at the time, but in 1999 and 2000 – the years to which primary attention was given in the inquiry – the financial statements were distorted by questionable entries, heavy reliance on one-off end-of-year transactions, and aggressive accounting practices.
>
> Despite significant losses, continuing to record as an asset in its financial statements the full value of the future income tax benefits …

And in relation to the efficacy of the audits, Justice Owen commented that:

> … in my view, Andersen's approach in the audit of 1999 and 2000 was insufficiently rigorous to engender in users confidence as to the reliability of HIH's financial statements. This detracted from the users' ability to appreciate fully HIH's true financial position.[183]

In the end it proved difficult for the Commission to attribute blame for the HIH collapse to any one individual given the weak corporate governance observed by the company. Responsibility for governance was also shared amongst many individuals in different roles. On the surface, the HIH board appeared to pay heed to the notion of good governance and followed many of the expected principles of administration, including the requirement for independent directors. However, Justice Owen observed that,

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[181] Cooper, above n 154, 170.
[182] Commonwealth of Australia, HIH Royal Commission, *The Failure of HIH Insurance Vol. 1 A Corporate Collapse and its Lessons* (2003) xlvi.
[183] Ibid lvii.

> HIH is a glaring example of what can go wrong when a company makes it look as though it has good governance, when it fact it has almost none.[184]

First and foremost, problems were identified with the independence of the audit committee whose membership consisted mainly of accountants, several of whom were former Arthur Anderson partners.[185] In substance, the board of directors was heavily conflicted given that it comprised a majority of former Andersen partners, and that Andersen was also the current external auditor of the company. During 1998, the audit partner appointed to HIH had only retired from Andersen audit two weeks before being appointed to the HIH board, while the CFO was also a former Andersen partner.

Arthur Andersen could not be perceived as being independent of HIH in its role as external auditor given that the company had become an employer of so many former Andersen partners. As a consequence, the Royal Commission found the auditor did not apply sufficient professional scepticism when auditing HIH. The Commission's report stated that Andersen had been insufficiently rigorous in auditing HIH in 1999 and 2000. In addition, all 'independent' directors were found to have conflicts of interest to which they gave priority over the needs of company's shareholders.[186]

Accountants behaved unethically in the case of HIH, and their poor behaviour was compounded by the use of a complex array corporate structures used to hide the truth. The chief financial officer presided over an accounting system which made inadequate provision for future insurance claims, and which also reflected overvalued company assets. Tax losses were converted into assets even though it was obvious that future income tax benefits were

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[184] Commonwealth of Australia, HIH Royal Commission, *The Failure of HIH Insurance* (2003) in The Institute of Chartered Accountants in Australia, *CA Program Unit 2 Corporate Governance*, above n 68, 19.

[185] The chairman and another member of the committee were both former partners of Arthur Andersen, the auditors of HIH, the finance director was a former Arthur Andersen partner, and another two members of the audit committee had business relationships with the company.

[186] The Institute of Chartered Accountants in Australia, *CA Program Unit 2 Corporate Governance*, above n 68, 20.

unlikely to ever be realised from them. These representations, misstatements and approaches used to overstate profits and increase the company's net asset position were endorsed by the company auditors who failed to use a sufficiently rigorous audit approach. Arthur Andersen together with the audit committee members were not truly independent, and this was fundamental to the company's demise.[187]

Harris Scarfe Ltd

Harris Scarfe is a case of financial statement misstatement through the simple manipulation of inventory figures by the company's chief financial officer. That simple method of deception was carried out without detection by the company's auditor. Harris Scarfe had operated in the retailing industry for more than 150 years before it was placed into voluntary administration by its directors on 2 April 2001 owing $93 million to unsecured creditors and $50 million in company debt [188]after irregularities dating back six years were discovered. In their report to creditors, the administrators pointed to the systematic overstatement of profit which was funded by increased bank borrowing and creditor debt.[189]

After investigations were conducted by both ASIC and the company's receivers and managers, ASIC alleged that the chief financial officer, Alan Hodgson, had altered Harris Scarfe's accounts to inflate the company's profits and create a false picture of good financial health. That deception allowed the company to trade on when it was in fact likely to be insolvent.[190] In 2002, Hodgson, pleaded guilty to 32 charges, and was sentenced to five years and six months jail with a non-parole period of two years and nine months.[191]

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[187] Cooper, above n 154, 170.
[188] The Sydney Morning Herald Business, **'**Harris Scarf Knew Books Were Cooked**',** *The Sydney Morning Herald* (Sydney) February 10, 2005 <http://www.smh.com.au/news/Business/Harris-Scarf-knew-books-were-cooked/2005/02/09/1107890273052.html>.
[189] Sue Peacock, 'Probe Reveals the Extent of Scarfe's Debts', *The West Australian*, (Perth) 11 April 2001, 65.
[190] Cooper, above n 154, 171.
[191] Leonie Wood, 'Scarfe Trial Folds Over Split Jury', *The Sydney Morning Herald* (Sydney) April 7, 2005 <http://www.theage.com.au/news/Business/Scarfe-trial-folds-over-split-jury/2005/04/06/11124895

The fallout of this collapse included legal action taken against the Harris Scarfe's auditors by the ANZ Bank which sought to recover of at least $70 million in damages from Ernst & Young for its negligence. The bank claimed the auditor was expected to uncover the accounting discrepancies and irregular entries in the accounts. The action against Ernst & Young was settled out of court for an undisclosed sum. [192] In addition, Adam Trescowthick, the former chairman of Harris Scarfe was charged with a number of offences including failure to act honestly, dissemination of [193] false information, and intentionally failing to notify the board of falsely inflated profits. Commonwealth prosecutors withdrew all charges against Trescowthick after finding there were no reasonable prospects of conviction in December 2006. [194]

One.Tel. Ltd

Individual greed was encouraged under the One.Tel's remuneration system which handed out boardroom benefits and large consulting and underwriting fees. Although a common view is that the company failed due to a 'cash crisis', a deeper analysis of One.Tel's collapse reveals the company had a myriad of problems. These included weak corporate governance, unsustainable business strategies, aggressive financial reporting, low quality audits, poor working capital management, excessive management compensation and questionable related party transactions.[195]

One.Tel carried on its operations during the technology share market boom of the early 1990s. At that time, the telecommunications industry in Australia operated in an environment of largely unregulated competition. Those in the industry required a significant

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58729.html>.

[192] Sean Fewster, 'Harris Scarfe: Charges Dropped' Adelaidenow (Adelaide) December 21, 2006 <http://www.adelaidenow.com.au/news/harris-scarfe-charges-dropped/story-e6freo8c-1111112727125>.

[193] Cooper, above n 154, 170.

[194] Fewster, above n 192.

[195] Accounting and Finance Association of Australia and New Zealand, 'The Life and Death of One.Tel ' <*www.afaanz.org/openconf/2009/modules*>.

investment in fibre optic cables, satellites and microwave towers. The strategic decision taken by One.Tel was to invest in its own telecommunications system at significant cost rather than use the infrastructure owned by an existing carrier. This decision proved later to be a major reason for the company's eventual downfall. The cost of investing in these new technologies placed pressure on the company's financial position. This lead to One.Tel's management using financial manipulation to disguise the true financial position of the company and ensure that share and option prices were maintained at elevated levels. Salary levels were maintained and bonuses continued to be paid even though their payment was clearly financially unsustainable.[196] The creative accounting techniques employed by One.Tel's management to mask the company's poor financial position included the capitalisation of $245 million of costs that would be otherwise be expensed and not hidden as a balance sheet asset.[197]

One.Tel was placed in administration in May 2001 with debts estimated to be $600 million, and its liquidation commenced later that month. At the same time, ASIC announced that it had commenced a formal investigation into the One.Tel collapse for potential breaches of the *Corporations Act* including insolvent trading, insider trading and the breach of market disclosure regulation.[198]

The One.Tel liquidator uncovered multimillion dollar bonuses paid to the founders of the company, and had escaped public scrutiny through questionable accounting practices. Bonuses totalling some $14 million were paid during the 1999 financial year, however the accounting policy employed at the time treated them as deferred expenditure on the basis that they represented setup costs associated with One.Tel's European and Australia businesses. This treatment together with other imaginative accounting adjustments had the effect of converting a year end loss into an accounting profit by removing expenses from the profit

[196] Philomena Leung, Barry J. Cooper, 'The Mad Hatter's Corporate Tea Party', (2003) 18(6/7) *Managerial Auditing Journal* 505, 508.
[197] Paul Barry, 'One.Tel's cash SOS, Then it all Fell Apart', *Sydney Morning Herald* (Sydney) 31 July 2002, 3.
[198] BBC News, *Watchdog 'Swoops on One.Tel HQ* (2 June, 2001) BBC News <http://news.bbc.co.uk/2/hi/business/1365954.stm>.

and loss account. The substantial bonuses were clearly expense items but capitalised for nebulous reasons, and were later admitted in court by the company finance manager to be 'a bit of a stretch'. [199] All this was achieved and carried out under the watchful eyes of the auditor, and with Andersen's support of the accounting treatments used.

The stories of corporate collapse given in this section provide important lessons about corporate governance, business strategies, audit quality and the management of business operations. The challenge from these narratives is to work with this knowledge and restore financial reporting credibility. More particularly for this thesis, a response must be developed to direct registered company auditors towards a more ethical approach in their assurance role.

2.6 Restoration of Financial Reporting Credibility

The forgoing discussion on corporate failure in Australia is ample evidence that individual accountants (and by association the profession) have abandoned the traditional gatekeeper role to join the fray of greed and materialism. [200] This overview of corporate collapse and the role played by accountants and auditors finds that the profession has lost much of its credibility and public trust. The status of the accounting profession has diminished more broadly as a result.[201] Chapter 4 of this thesis will discuss accounting as a profession. It will be seen that professionals make a bargain with society under which they promise to conscientiously serve the public interest. Society allocates certain privileges and special status to professions on the condition that members of the professions must work to improve the common good and meet societal expectations. Accountant professional status will be put at risk if episodes of corporate failure at these levels continue into the future.

The problem of failed governance has been recognised and responded to internationally in the *Sarbanes-Oxley Act of 2001* in the United States, and also in the International Federation

[199] Cooper, above n 154, 171-172.
[200] Ibid 168.
[201] Ibid 173.

of Accountants ('IFAC') report on *Rebuilding Public Confidence in Public Reporting: An International Perspective*.[202] The IFAC report found that the credibility of reporting is both a national and international issue, with corrective action required at both these levels. The recommendations of the report included an increased regulatory focus on auditor independence and corporate governance processes. Under that approach, auditor effectiveness would primarily be achieved through quality control processes and strengthening auditing and reporting practices.[203]

Australia has also experienced a recent wave of public company audit regulatory reform. The key contributors to that development were the Ramsay Report and HIH Royal Commission Report, together with a raft of reports and submissions at federal government level, chief amongst these being the Commonwealth Government's Corporate Law Economic Reform Program ('CLERP'). These developments, together with ongoing ASIC investigation and media coverage of public company governance and reporting matters have influenced the direction of accounting and audit regulation in Australia. The key regulatory reform in this area can be summarised as:

- The CLERP implemented several key recommendations of particular importance to the accounting profession, financial reporting and audit reform. These measures broadened the membership of the Australian Accounting Standards Board and increased Australia's involvement in the development of international accounting standards. With respect to audit reform, the CLERP measures sought to bring about higher standards auditor independence. The *Corporations Act* now requires that an annual statement be made by auditors to disclose details of their non-audit services. Restrictions were also imposed on retired auditors becoming directors of former client companies. [204]

[202] IFA Task Force on Rebuilding Public Confidence in Financial, *Rebuilding Public Confidence in Public Reporting: An International Perspective* (International Federation of Accountants, 2003) 5.
[203] Ibid 23.
[204] *Corporations Act 2001*(Cth) s 300 ('*Corporations Act*').

- Australia's audit independence framework was then significantly strengthened by the passing of the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 (Cth)*.

- Auditor independence requirements were developed under a package of reforms contained in the *Corporations Legislation Amendment (Simpler Regulatory System) Act 2007(Cth)*. This package complements the legislative and professional requirements on auditor independence. Institutional arrangements were established to monitor compliance with those requirements, and to allow for compliance action where necessary. [205]

Australia has made some progress towards restoring community trust in financial reporting. Notwithstanding those advancements, the need to address creative accounting practices and rectify deficiencies in auditor assurance must be ongoing given that occurrences of unethical behaviour persist even though these measures have been put in place. Change will be most effective where it faces up to the distorted attitudes and strictly legal approach taken by some accounting practitioners towards accounting regulation. These attitudes must be realigned to work within the law's policy intent. Using regulatory intervention pointed at auditor independence alone will not resolve conflicted situations. Under that approach, auditors will continue to acquiesce to their client's desires and creative attitudes on accounting rule application. The issue is thereby not just a legal one. It is more about how FSA relationships can be positively restructured, to adjust the deficient cultural and ethical attitudes of those accountants involved in financial reporting and giving assurance.[206]

The culture that underlies and facilitates creative accounting practices is characterised by self-interested attitudes towards the application of law. Compliance is defined by those accountants in a minimalist way, to focus on conformity with the letter of the law rather than

[205] The principal organisations making up these institutional arrangements are ASIC, ASX, the professional accounting bodies, the Accounting Professional and Ethical Standards Board, the Audit Quality Review Board, the Companies Auditors and Liquidators Disciplinary Board and the Financial Reporting Council.
[206] McBarnet, above n 158, 38.

its spirit. That approach to compliance ultimately forces legislators to become more precise and redraft legislative content to close gaps in the law. If the law allows for application outside its policy intent, then that illegitimate application is likely to be used by some accounting professionals regardless of the lawmaker's intentions. This attitude dismisses the law's authority and ignores legitimate policy development so the law becomes an obstacle to be circumvented and tailored for personal advantage. A creative accountant may look for ways to justify the approach he or she takes within the law's meaning. The law is a contest for these individuals, where it is legitimate to devise an interpretation no matter how spurious that supporting argument may be, as long as it sits within the boundary of the law as drafted.

This creative approach to both the law and the application of accounting standards has resulted in some listed public companies issuing misstated auditor assured reports. This type of accountant and auditor behaviour is unethical. Ethical compliance would require compliance with the spirit and not just the letter of the law. A sound ethical foundation does not equate to compliance with law at a minimalist or literal level, or the adoption of bullish interpretations of compliance measures. The debates sparked by Enron and the Australian accounting scandals reviewed in this chapter have questioned the utility of auditor assured accounts within this setting of liberal rule interpretation and compliance. [207]

The regulation of accounting ethics and auditor independence must ensure compliance with legal policy. After examining ethical theory and the current ethical issues impacting the accounting profession in Australia in following chapters, this thesis contends that statutory intervention is not the most effective remedy to correct auditor behaviour. Instead, focus should be placed on the corporate and professional culture that allows manipulation of legal concepts to defeat policy intent. Changes to the law alone will not bring the shift needed to improve accountant conduct, however a realignment in the relationships that exist under the FSA model may help improve attitudes to compliance. [208] This thesis centres its attention on the role that auditors play in assuring financial reports, the significance that ethical attitudes play in that function, and what the community can and should expect from the profession. It

[207] Ibid.
[208] Ibid.

goes on to offers a novel market driven insurance approach to restructure stakeholder relationships for the benefit of financial statement users and financial markets.

2.7 Conclusion

The accounting profession is responsible for reporting on the financial affairs of an entity, where the accuracy of those reports is critical for capital markets decisions. The intentional creation of inaccurate financial pictures can be used to exploit users who have a right to that information. The ethical behaviour of accountants and the registered company auditors who produce and assure financial reports has been claimed to be deficient in recent times, and that the accounting profession is in crisis. That reactionary claim is understandable, and warrants a review of the ethical behaviour of the accounting profession. This thesis conducts that examination in Chapter 7 on auditor independence, to find the chief ethical difficulty for accountants as auditors has its roots in breached independence and objectivity. Conflicts of interest are found to obstruct the primary virtues of objectivity and neutrality required of accounting professionals. These conflicts then infect the practice of the public accountant, to restrict his or her ability to serve in the public interest and act in a neutral and objective manner.

This thesis proposes a market driven solution to remedy compromised auditor ethical behaviour. Since the collapse of HIH, there have been many proposals for reform of the accounting profession in Australia. Most of those have been neither constructive nor realistic. The simple idea offered by this thesis is based upon market principles, and is offered as a solution to help restore the credibility of the profession and deliver reliable financial information. Instead of appointing and paying auditors, a listed public company would now purchase financial statement insurance ('FSI') to protect its investors against losses suffered from misrepresented financial statements. The amount of FSI coverage taken out and the premium amounts paid are disclosed to the public, so that corporations with higher coverage and lower premiums are distinguished from an investor viewpoint. Under the FSI regime, insurance carriers would assess the risk they face by appointing and

remunerating an auditor. That audit opinion is then considered by the FSI insurance carrier to decide whether or not to extend coverage, and determine premium amounts to be levied.

The FSI model offered by this thesis has distinct advantages over the traditional FSA model. Published information about FSI coverage will allow investors to better assess which shares are likely to carry lower risk and which corporations are relatively more trustworthy. Most importantly, this model solves the problem of auditor conflicts of interest given that auditors are no longer engaged by the companies they audit.

In the aftermath of recent corporate failure, the Australian accounting profession has become noticeably fearful of greater levels of governmental regulation and anxious to redeem its reputation. Even if accountants made the move to rid themselves of conflicted auditor provided non-audit services, they continue to be fee dependant on the company they provide audit services to. Financial statement insurance is a practical and efficient solution to these problems which positively employs market incentives and redirects the auditor's loyalty to those most at risk of financial loss.

Chapter 3: The Nature of Ethics and Ethical Theory

3.1 Introduction

There has been a recent increase in awareness of the importance of ethics and morals in business and the professions, and the need for ethical sensitivity and ethical behaviour more broadly.[209] The application of ethical principles to accounting practice and for the audit function has drawn particular attention. [210]

Ethics is known as moral philosophy. It is that branch of philosophy that addresses questions of morality. Ethics in all its forms is concerned with establishing right from wrong, good or bad. It can be about the principles of an individual or group, or the study of ethical principles to analyse and evaluate human actions and practices. [211]

Grace and Cohen (2005) defined ethics as:

> The pursuit of excellence in human activities and relations through respect for the goods, values and conditions necessary for that pursuit.[212]

Ethical theories provide general principles for rule making and judgment which can be used to assist in the resolution of ethical dilemmas. Ethical dilemmas occur where a conflict of reasons exists, when a reason to act in a particular way is offset by a reason not to act. In

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[209] Bruce Warren, Susan D Sampson and Erin McFee, 'Business Schools: Ethics, Assurance of Learning, and the Future' (2011) 8(1) *Organization Management Journal* 41, 41.
[210] Further to this, there has been a call for broader ethical sensitivity brought on by new evaluations of ethics; for example, see James D. Faubion, 'Toward an Anthropology of Ethics: Foucault and the Pedagogies of Autopoiesis', (Spring 2001) 74 (1) *Representations* 83-104.
[211] Duska, Duska and Ragatz, above n 60, 34.
[212] Damian Grace and Stephen Cohen, *Business Ethics: Australian Problems and Cases*, (Oxford University Press, 3rd edn, 2005) in The Institute of Chartered Accountants in Australia, *CA Program Unit 1Ethics and Business Application* (ICAA, 2009) 8.

these circumstances, each rival ethical theory may suggest a reason why its approach should take precedence over the others. For example, a deontologist may articulate that reason by way of principles of fairness and rights over consequences, whereas consequences take priority over fairness and rights under the consequentialist approach.

This chapter focuses on ethics and morality, and centres on the relevance of these principles to accountants and registered company auditors in Australia. Having built this conceptual foundation, this thesis goes on to consider ethics in the practical context of auditor conflicts of interest, and more specifically, the ethical issues surrounding auditor supplied non-audit services.

3.2 The Nature of Ethics

The ethical landscape appears complex and daunting for many people. It may be a place far removed from their routine activities and foreign to their experiences, and at times may seem to have little bearing on the issues they confront on a daily basis. For others, the ethical terrain is bounded by specific sets of rules and standards, for example, APES 110*, Code of Ethics for Professional Accountants* (‘APES 110’, or ‘the Code’) is mandatory for members of accounting bodies in Australia. Under that code, ethical choice is prescribed for members who must follow these rules.

The types of issues that ethical theory is called to resolve is vast. Socrates taught that answering the question - *what ought one to do* - will assist those faced with an ethical decision. An individual must draw upon his or her understanding of what he or she considers to be the elements of a good life when responding to this question.[213] No single western ethical theory can however on its own answer this question and guide decision makers in their response to an ethical dilemma. An ethical principle may seem valid on its own, but irreconcilable tensions arise when other values are taken into account. This uncertainty is

[213] Simon Longstaff, *Ethics of the Accounting Profession: Staying Out of the Disciplinary Committee* (February 1992) <http://www.ethics.org.au/ethics-articles/ethics-accounting-profession>.

reflective of an ethical landscape painted in shades of grey, rather black and white. As a consequence, the limits of certainty must sometimes be accepted when making a decision, so that the range of choices is reduced to selecting the least bad alternative.

3.3 Morality and Ethical Theory

Ethics is about relationships given that all ethical considerations involve an essential social element.[214] Ethical concerns have a communal aspect, and as such, the response to an ethical question must take account of the quality and nature of relationships between the decision maker and others. Although they are related, ethics is not the same as morality. The word morality originates from the Latin word moralis. Morality is a set of pre-packaged answers to question on ethics, and is centred on social practices that define right and wrong. These practices, customs, rules, and traditions are shared and internalised within particular cultures, institutions and between generations. Morality shapes an individual's values and principles to influence their decision making. Moralities flow from the world's religions and the thinking of secular philosophers. Common to all theories and approaches on morality, whether sacred or secular in origin, is that they cannot give absolute guidance on what behaviour is required and what action must be taken.[215]

When contrasted with morality, ethical theory and moral philosophy concern the nature and justification of those actions which are right, and thereby seeks to introduce clarity, substance, and precision of argument to the sphere of morality.[216] Morality is about what an individual must do to conform to established norms of behaviour. In contrast, ethical theory provides philosophical reasons for and against social morality. Ethical theory seeks to justify a system of standards or moral reference points upon which concepts and principles can be analysed.

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[214] Simon Longstaff, *Understanding Ethics* <http://www.ethics.org.au/content/understanding-ethics> at January 2013.
[215] Simon Longstaff, *Ethics of the Accounting Profession: Staying Out of the Disciplinary Committee*, above n 213.
[216] Tom L. Beauchamp, Norman E. Bowie, and Denis G. Arnold, *Ethical Theory and Business* (Prentice Hall. 8th edn 2008) 2.

Divergent views about morality can be found within society and across different cultures. This in turn causes present-day principles of morality to be challenged and to evolve over time. A person who claims a practice is morally wrong or morally right may be challenged by his or her peers who disagree with that view. Each moral position must be capable of explaining why an action is wrong or right before it can influence others, so that each such assertion can be defended by reasoned argument that supports the position taken. In a similar vein, codes of ethics must be sufficiently rigorous and ethically sound, so that the occupational group which abides by those rules can be trusted. For example, APES 110[217] sets out the responsibilities of professional accountants. The Code requires them to act in the public interest and comply with the fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour in all their dealings. A registered company auditor who complies with the Code is more likely to be trusted given that information users are able to see that his or her morality is founded on rule following.

3.3.2 Approaches to the Study of Ethical Theory

The descriptive, conceptual, and normative approaches to ethical theory have dominated the literature on morality and ethical theory. The descriptive model is often referred to as the scientific study of ethics. Factual description and explanation of moral behaviour is typical of this approach. Moral attitudes and beliefs studied under the descriptive approach include corporate policies and trade association codes of ethics. The ethical behaviour of social collectives is also examined by observing the consequences where people either follow or deviate from social norms. No judgement is made on the outcomes of the events studied, as they are only described under the approach.

In contrast, the conceptual approach to ethical theory calls for the study of ethical terms. Here,

[217] Accounting Professional & Ethical Standards Board Limited, *APES 110 Code of Ethics for Professional Accountants* (December 2010) ('*APES 110 Code of Ethics for Professional Accountants*').

the meanings of terms such as right, obligation, justice, good, virtue, and responsibility are analysed. Important terms for business ethics including liability, deception, corporate intention, and stakeholder are conceptually analysed. Examination of the term morality, and the distinction between moral and non-moral behaviour are also typical examples of the types of conceptual problems considered under the approach. [218]

Of the three models, the normative approach to ethical study is most relevant to regulating the ethical behaviour of the professions. That approach requires prescriptive study to formulate and defend basic moral norms. Normative moral philosophy seeks to determine what ought to be done rather than what is currently practiced. Utilitarianism and Kantianism (or deontology) are well known normative theories. At a high level, utilitarians argue that one fundamental principle determines the right course of action, which can be stated as:

> An action is morally right if and only if it produces at least as great a balance of value over disvalue as any available alternative action.

In contrast to this utilitarianist doctrine, Kantians favour principles that specify obligations, for example, the obligation to never treat another person merely as a means to your own goals, even if doing so creates a net balance of positive value.

Principles of normative ethics are commonly used to treat moral problems found in accounting practice, such as a conflict of interest situation or the improper disclosure of information. Ethical theory is an important reference point when resolving problems of compromised auditor behaviour as described in Chapter 2. In this chapter, ethical principles will be explained together with how they are able to guide decision making for the types of moral problems commonly faced by accountants. These same ethical principles can be applied to moral problems across all professional fields, and thereby have universal application.

[218] Beauchamp, Bowie and Arnold, above n 216, 8.

3.4 Contemporary Ethical Theory

Ethical theories prescribe justifying principles and reasons why a course of action should or should not be pursued. Disagreement on which ethical principle to follow and which takes precedence over another will arise where ethical approaches are in conflict. In these circumstances, an individual who decides in favour of himself or herself is likely to be an egoist. Individuals who decide according to what will benefit society reflect a utilitarian disposition, while individuals with a preference toward fairness or justice will follow deontological lines. These approaches are introduced in this chapter together with virtue ethics and egoism.

As already touched on above, the utilitarianism approach will determine an action to be ethically correct depending on the outcome of that action. Utilitarianism is characterised as forward looking because an ethically correct action is decided on by its consequences, and that outcome can only be determined at a future point in time. Utilitarians believe that ethical behaviour will promote human welfare by minimising harms and maximising benefits. They take account of the good of all people affected by an action, where that welfare takes priority over issues of fairness rights and commitment. For utilitarians, the ultimate reason to justify an action is that it brings about more good than harm for more people including the individual deciding on what action will be taken. Although self-interest is factored into the overall good, that individual concern must be set aside if it conflicts with the overall good. Thus, utilitarianism maintains that only those actions that bring about the greatest good for the greatest number of people should be undertaken. [219]

In contrast, Kantianism focuses on the ethics of duty rather than the ethics of consequences. According to Kant, an ethical person acts according to the right intentions. Kant described three fundamental principles of ethics; to act only on principles which you know to be universally “morally” permissible, to always treat the humanity in a person as an end and never merely as a means, and act as if you were a member of an ideal kingdom in which all

[219] Alexander and Moore, above n 23.

people are both subject and sovereign at the same time. Considerations of fairness take priority over the consequences of an act for deontologists, given that actions themselves can be ethical in spite of their consequences. For deontologists, the end does not justify the means. Deontological theory thereby gives precedence to the questions of fairness, rights and commitment, and requires that the right thing be done no matter the consequences for the individual whose action will impact on others.[220]

In comparison to the utilitarianism and deontological approaches, virtue ethics gives priority to ethical practices. This theory gives a habitual or reflexive response, and so does not fit within the conventional understanding of ethical responsibility. [221]A virtuous person will recognise an ethical problem when confronted with it and attempt to resolve it through honest deliberation in order to reach a principled and defensible conclusion. The character of the person making the deliberation is most important given that a virtuous person must be disposed towards honesty and generosity at all times.

Egoism is a further ethical theory. This theory allows for considerations of what is good for oneself, and teaches that self-interest takes priority over considerations of what is good and fair for others. Egoism, like utilitarianism, uses the 'good of consequences' as the ultimate determinant of whether an action is ethically acceptable; however egoism gives priority to consequences of self-interest and recommends self-serving actions rather than the greatest balance of value.[222] These contemporary ethical theories are now examined in more detail together with their relevance for the accounting profession, and how they might assist in elevating auditor ethical behaviour above its current levels.

3.4.1 Egoism

It can be argued that all human beings naturally act in their own interest. If that tendency is

[220] Duska, Duska and Ragatz, above n 60, 62.
[221] The Institute of Chartered Accountants in Australia, *CA Program Unit 1 Ethics and Business Application*, above n 25, 12.
[222] Shaver, above n 26.

accepted, then egoism is a valid ethical theory. Some people claim that all actions are prompted by self-interest providing that you look deeply enough at the motivation that drives behaviour, such that:

> When there is a conflict between something good for me and for society, or when there is a conflict between something good for me and its fairness, egoism recommends the self-serving action. Consequently, egoism is defined as the theory that maintains that, one should always act in one's own best interest.[223]

The egoist principle to *always to act in one's own interest* can however bring about unethical outcomes as this approach promotes selfishness when applied in practice. Notwithstanding that possibility, there is some appeal in promoting self-interest but not selfishness. Economists like Adam Smith believed that society would be more productive if it established systems that exploited strong self-interest and legitimised it. Following this view, the more hardened economists argue that pursuit of self-interest is justified on the basis that taking such an approach will benefit society in the long run. Adam Smith's doctrine of the invisible hand does exactly that. It maintains that the invisible hand guides society by assuring self-interest, which ultimately leads to societal benefits. Adam Smith did not however believe that self-interest is the only guiding motivation, as he stated in the following passage:

> Howsoever selfish he may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it. [224]

Egoist theory can take on a descriptive or a normative position. Psychological egoism takes a descriptive approach to describe how individuals must behave, whereas ethical egoism is prescriptive and instructs how a person ought to behave.[225]

Psychological egoism takes the view that individuals are always motivated out of self-interest,

[223] Duska, Duska and Ragatz, above n 60, 51.
[224] Adam Smith, *The Theory of Moral Sentiments* (Prometheus Books 2nd Ed reprint, 1854) I i.i.1.1.
[225] Duska, Duska and Ragatz, above n 60, 55.

and that each person's goals are driven by their own welfare. The approach provides a factual theory of human motivation to explain human conduct rather than justify it. Under the theory, people will always do what pleases them most, and do whatever is in their interest.[226] Psychological egoist theory discards altruistic behaviour as being relevant to the model. Pure altruistic motivation is rejected under the approach as it would be absurd to make sacrifices for others while at the same time being required to act out of self-interest.

In comparison, ethical egoism is a normative theory about what people ought to do. According to ethical egoism, people always ought to act out of self-interest. If ethical egoism was however the prevailing theory of proper conduct in society, anarchism and chaos would most likely result unless preventive measures were adopted. This type of dysfunctional environment was considered by the philosopher Thomas Hobbes who described an egotist world with limited resources, where persons are approximately equal in their ability to harm one another, and where each person acts exclusively in his or her interest. Hobbes argued that in such a world, everyone would be at everyone else's throat, and society would be plagued by anxiety, violence, and constant danger. Hobbes visualised that life in this environment would be solitary, poor, nasty, brutish and short.[227]

Those who reject egotist theory point to compelling examples of altruistic and sacrificial behaviour found in everyday life that do not fit within the model. Even though unselfish actions are commonplace, the egoist will still find that behaviour to be motivated out of self-interest. Egoists maintain that those who help others by promoting fairness and general welfare, or risk their lives for the welfare of others act only to promote themselves. Those people avoid social ostracism by following society's moral and legal codes. Egoists further argue that the desire behind an action in all cases is self-regarding no matter how self-sacrificing it may seem. The true character of an action depends on the motivation of those who act it out. According to the egoist, agents may wish to appear altruistic and not selfish, as that appearance will best promote their interests in the long term. The fact that some sacrifices

[226] Beauchamp, Bowie and Arnold, above n 216, 14.
[227] Ibid 16.

are made in the short run does not count against egoism ideals.[228]

Under the egotist theory, an individual has no moral obligations to others aside from those obligations they voluntarily assume out of self interest. Each person must only accept moral rules and assume specific obligations when doing so will promote self-interest. In this regard, compliance with state laws may offer some protection or create a personally advantageous communal living situation. An individual must however withdraw from these types of obligations under the egotist approach if compliance with them is not to his or her long term advantage. So, when forced to question the trustworthiness of a colleague or faced with incompetent administration, an egotist is no longer obliged to obey the law, fulfil contracts or tell the truth. These obligations are only assumed for as long as doing so promotes self-interest.

In practice, only an excessively narrow conception of self-interest will make an egoist unwilling to observe conventional rules of justice. This is because these arrangements (whereby everyone acts according to fixed rules under conventional moral and legal systems) can produce a desirable state of affairs under egoistic theory. Rules of moral and legal principles and justice arbitrate conflicts and make social life more agreeable, secure and stable.[229] An egoist understands these benefits, and that their interests are best served by accepting binding social arrangements that can resolve personal conflicts through courts and other peaceful means.

3.4.1.1 Criticism of Egoism

All choices involve, or should involve, self-interest as the sole objective under the egoist theory. Personal goals and obligations must be founded on self-promotion, and no sacrifice or obligation is owed to others. Most people who encounter these egotist principles believe them to be unethical given that they promote selfishness. Most members of the community would understand that the pursuit of individual interest often leads to selfishness, and selfishness is immoral. Egotists in the main would oppose this view and object to moralists

[228] Shaver, above n 26.
[229] Beauchamp, Bowie and Arnold, above n 216, 16.

who prioritise altruism before self-interest. They claim the pursuit of self-interest is not necessarily a bad objective as it is healthy for an individual to pursue his or her interests. Self-love, self-esteem, and the pursuit of personal projects and dreams are important to self-worth.[230] In fact, a good reason for doing something is that it will be good for you. A problem will however arise if the pursuit of self-interest can only be undertaken at the expense of others, so that the principle to always act in your own interest will bring about selfish and immoral behaviour in those circumstances.

Given that selfish behaviour is generally perceived as unethical, the egotist approach to ethics is incompatible with business activity and professional relationships where one person acts as agent for another. Egotist theory is unsuited to advice giving and is thereby rejected by this thesis as an acceptable ethical theory for reference by the accounting profession. The egotist approach cannot be applied to solve questions of professional ethics, but more deeply concerning is that it may encourage conflicts of interest where accountants accept responsibly to serve in the public interest as company auditors.

3.4.2 Normative Ethical Theory

This section now examines two influential ethical theories in detail. The utilitarianism and Kantianism theories dominate the literature in this field. Particular attention in this section is given to the principles prescribed under these approaches and their relevance to ethical problem solving for the accounting profession.

3.4.3 Utilitarian Theory

Utilitarian theory argues that the moral worth of an action or practice is determined by its consequences. An action or practice is morally right if it maximises good consequences over bad consequences for all parties affected by it. In adopting this perspective, utilitarians believe that a function of ethical theory is to promote human welfare by minimising harms

[230] Shaver, above n 26.

and maximising benefits. Utilitarianism thereby supports those actions that bring about the greatest good for the greatest number of people. The principal maxim of utilitarianism was expressed by John Stuart Mill as:

> Actions are right in proportion as they tend to promote happiness, wrong as they tend to produce the reverse of happiness.

John Stuart Mill's work is representative of the classical utilitarian approach. Mill's[231] teachings on utility espoused the 'greatest happiness principle' as the foundation of normative ethical theory. Actions are right in proportion to their tendency to promote happiness or promote the absence of pain, and wrong insofar as they tend to produce pain or displeasure. According to Mill, both pleasure and freedom from pain are desirable ends, that is, all things are desirable either for the pleasure inherent in them, or as the means to promote pleasure and prevent pain.[232]

Utilitarianism is a powerful and persuasive normative approach to ethics. The morally right action will produce the most good under the utilitarianism view. Although an egotist will also focus on outcomes, utilitarianism is distinguished from egoism by the scope of consequences taken into account. Under the utilitarianism approach, the consequences used to judge the worth of an action are not those of the agent, but the consequences of all those affected by an action including the agent him or herself.[233]

Utilitarianism theory is thereby a form of consequentialism because the morally right action is judged entirely in terms of the consequences that flow from it. Good consequences make a good action, while bad consequences make a bad action. A utilitarian will justify or condemn an action by computing the benefits and harms of consequences for all those affected. A justified action brings about more total happiness than unhappiness for more people.

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[231] See John Stuart Mill, 'Utilitarianism' in Robert Solomon, Clancy Martin and Wayne Vaught (eds), *Morality and the Good Life: An Introduction to Ethics Through the Classical Sources* (McGraw-Hill, 5th Ed. 2009).
[232] Beauchamp, Bowie and Arnold, above n 216, 20.
[233] Duska, Duska and Ragatz, above n 60, 58.

Utilitarianism in this sense is the ethical theory that uses a cost benefit approach. A wrong action brings about more total unhappiness for more people.

3.4.3.1 The Features of Utilitarianism

There are three essential features of utilitarian theory, which are:

1. The goal to maximise good and minimise harm and evil.

Society must aim to produce the greatest possible positive value (or minimum disvalue) for all persons affected by an action. This goal is aligned to the everyday business objectives of efficiency and effectiveness. When an enterprise carries on business operations, greater efficiency can result in greater profits by lowering costs or maximising production from the limited economic resources available to it. The utilitarian commitment to efficient and optimal productivity is an essential element of traditional business practices. It is well suited to the capitalist economic system based on private ownership as the means of production, and the creation of goods or services for profit.

Given the focus on outcomes and profits in the modern day Australian business activity, much of business and public policy is formulated on fundamental utilitarian concepts. Many businesses and government agencies use tools and procedures to carry out risk assessments to deliver objectives which are designed around and aligned to utilitarian teachings. For example, cost benefit analysis employs utililitarian judgment to analyse the costs and benefits associated with making a resource change or incurring discretionary expenditure. Unpopular short term adjustments made using utilitarian principles can be justified where they bring about improvements in the long run. [234]

The consequences (ends) justify the actions (means) from a utilitarian perspective. Thereby, the ends must be pursued even where the means needed to achieve them may be immoral. In

[234] Beauchamp, Bowie and Arnold, above n 216, 20.

these circumstances, a problem of illicit means will result. History offers up many examples of immoral actions performed for the sake of bringing about some desirable end. These actions are viewed as immoral by those not in favour of the utilitarian approach despite the good consequences they may bring about. Utilitarians who justify an action by citing the good consequences that come from it often dismiss an important element of ethics, that some actions are wrong in principle no matter what consequences flow from them.

2. A theory of good consequences.

Utilitarians believe that consequences must be 'good' in themselves to be justified, but disagree on the range of things or states that qualify as a 'good'. Bentham and Mill as hedonists believed that only pleasure or happiness can intrinsically be good. As hedonistic utilitarians, they considered that only those acts or practices that maximise pleasure are correct. Later utilitarian philosophers contended that values other than pleasure and happiness have intrinsic worth and must also be taken into account, for example, friendship, knowledge, courage, health, and beauty. Those utilitarians who included multiple types of intrinsic values in their approaches are referred to as pluralistic utilitarians.[235] Neither the hedonist nor the pluralist approach has prevailed over time, and neither has been particularly helpful in objectively stating what amounts to be a good consequence for the purpose of solving an ethical dilemma.

In addition to this disagreement on what is a good consequence, whether in fact any utilitarian representation of value (for example happiness) can be actually be measured and analysed adds to the difficulty in applying the theory in practical situations. Accurate measurements of goods or preferences must be made in order to determine which action is to be taken amongst the alternatives on offer. In everyday commercial matters such as purchasing supplies, administering business, or making legislative decisions, there will be limited knowledge of the consequences that will flow from an action.[236] That inability to predict future events and perform a calculation of the total good creates undesirable

[235] Ibid 23.
[236] Ibid 24.

externalities, and thereby renders the utilitarian theory to be of restricted value.

3. Measurement and comparison of good consequences.

The hedonistic utilitarian theory requires the measurement of the pleasurable state or painful state which flows from an action. Comparisons must then be made between these results so as to decide which is dominant. Bentham used a measurement device called the hedonic calculus to perform this calculation. This involved adding quantitative units of individual pleasure and subtracting units of individual displeasure to arrive at a total measure of pleasure or happiness. Bentham claimed that this approach could determine whether an act or practice would provide the greatest happiness to the greatest number of people, to ultimately allow the making of an ethical decision.

Bentham's hedonic calculus was however proven to be of limited practical value. Taking a different approach, Mill sought to measure and compare goods using a panel of experts who had requisite experience and knowledge of the good consequences to be measured. Mill believed that some pleasures were of a higher order than others, so that a measurement of which pleasures were superior must also be assessed. Under the Mill approach, the panel experts would decide on that superiority by performing an analysis and making comparisons. Like the Bentham model, Mill's measurement approach turned out to be of limited practical value given the complexity involved in its application and the problems encountered when sourcing suitably qualified panel members.

3.4.3.2 Some Criticisms of Utilitarianism.

The utilitarianism theory has been criticised because it ignores non utilitarian factors which are essential to making a moral decision. W.D. Ross identified the essential defect of utilitarianism:

> The essential defect of utilitarianism is that it ignores, or at least does not do full justice to, the highly personal character of duty. If the only duty is to produce the maximum of good, the

> question who is to have the good — whether it is myself, or my benefactor, or a person to whom I have made a promise to confer that good on him, or a mere fellow man to whom I stand in no such special relation — should make no difference to my having a duty to produce that good. But we are all in fact sure that it makes a vast difference. [237]

In addition, a distribution problem will arise when the action that produces the greatest balance of value for the greatest number of people, also brings about an unjustified treatment of a minority. A problem of distributive justice exists under the utilitarianism approach which is linked to how the goods and the burdens of the world are distributed.[238] This problem is countered by utilitarians who argue in favour of free enterprise and claim that capitalism has produced the highest standard of living in the history of mankind. Although likely to be true, the goods that created that high level of living standards are not evenly shared. Critics of capitalism thereby claim that although the capitalist economic system may have created the greatest amount of material goods in history, it does not distribute those goods fairly to the greatest number of people.

3.4.4 Kant and Deontology

The word deontology is derived from the Greek words for duty (deon) and science or study (logos). In contemporary moral philosophy, deontology is a type of normative theory that directs the making of a moral choice. Deontology falls within the domain of those moral theories that guide choices on what an individual ought to do when making an ethical decision.

Deontologists oppose consequentialist theories. Deontological theories judge the morality of choices rather than the consequences that a choice may bring, and maintain that some choices cannot be justified by their outcome. No matter how morally good the consequences, some choices are morally forbidden. For deontologists, the right choice will be compliant

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[237] William David Ross, *The Right Good* (Oxford University Press, 1930) 60.
[238] Julian Lamont and Christi Favor, "Distributive Justice", *The Stanford Encyclopedia of Philosophy* (Spring 2013 Edition), Edward N. Zalta (ed.) <http://plato.stanford.edu/archives/spr2013/entries/justice-distributive/>.

with a moral norm, where such norms must be obeyed by each moral agent. In this sense, the right action has priority over a good consequence, and that action must be undertaken no matter the good (or otherwise) it may produce.

3.4.4.1 Deontological Theory

Immanuel Kant's principles are central to deontological theory. For Kant, the moral quality of an act is determined by the principles or the maxims upon which an agent acts, rather than how the action may affect others. [239] Supporters of Kant's deontological principles find utilitarianism to be a misguided theory given that its focus on consequences fails to take moral duty into account.

Deontology in practice calls for a sense of moral obligation rather than action by inclination or desire. Humans act on a moral level that transcends animal instincts and inclinations. That sense of morality makes people moral, and gives them dignity and rights. According to Kant, human beings have inclinations and tend to pursue the things they want. However, humans can choose between alternative means or ways of achieving their goals and are free to set aside their inclinations to act out of a higher motive. The fact that humans can act against their inclinations for the sake of duty is particularly significant. Kantianism thereby focuses on the ethics of duty rather than the ethics of consequences. According to Kant, the ethical person acts according to the right intentions. Kant described the three fundamental principles of ethics as:

- act only on principles which you know to be universally morally permissible;
- always treat the humanity in a person as an end, and never as merely a means;
- act as if you are a member of an ideal kingdom in which you are both subject and sovereign at the same time. [240]

[239] Immanuel Kant, 'Kant: Groundwork of the Metaphysics of Morals' (Mary Gregor (ed), Cambridge University Press, 1998) 13-14.
[240] Duska, Duska and Ragatz, above n 60, 63.

These principles teach respect for others, and require that all people be treated as independent agents and not purely as a resource for production. To do otherwise is to reject a person's considered judgments, ignore their concerns and needs, and in effect deny them liberty to act on those judgments. Under the Kantian theory, respect for human beings is necessary and not discretionary. Human beings possess moral dignity and should not be treated as if they have conditional value. Kant's teachings did not however entirely prohibit the use of human resources as means to the ends. He instead argued only that one person must not treat another exclusively as a means to their ends. Even within hierarchical organisations, an employer can manage performance without exploiting an employee, provided that the employee has freely entered into that work relationship. [241]

Under these principles, Kant taught that all persons must act for the sake of obligation and not merely in accordance with an obligation. A person's motivation to act requires that he or she must firstly recognise a duty to act. Deontological morality offers a rational framework of principles and rules that constrain and guide personal goals and preferences. Kant believed that considerations of utility and self-interest must be secondary because the moral worth of an agent's actions depends exclusively on the moral acceptability of their acts.[242] When deciding if a person has made the right decisions for the right reasons, the motivation that caused the action to be carried out is of greatest importance under Kant's teachings. If a person is honest only because they believe that honesty will reward them, their actions are not honest at all, they only appear honest. For example, a corporation that does the right thing because of the good publicity it may bring and the likely increased earnings that may result has made a prudential decision rather than a moral choice.

3.4.4.2 Some Criticisms of Kantianism.

Kant's theories have been criticised as irrational given the duties and permissions espoused under the deontological approach may in fact make a position morally worse. Kant's theories

[241] Alexander and Moore, above n 23.
[242] Beauchamp, Bowie and Arnold, above n 216, 27.

are also said to be too narrow, and that they do not factor in the problems of moral life. A conventional interpretation of Kant's work finds it to broadly cast the requirement of impartiality and not adequately account for those parts of a moral life that involve intimate and special relationships.[243] These critics think that Kant placed too greater emphasis on universal obligations for all people rather than formulating a response for obligations found in relationships at a more personal or practical level.

Other gaps in Kant's principles are found in their inability to manage conflicts between rights and duties should they arise. Although Kant proclaimed that conflicts between duties are inconceivable,[244] a deontologist will indeed face conflicted duties and rights in a practical setting. Often justice for one individual will conflict with the liberty of another. It is simply not enough to say that liberty and justice must be provided for all. A criterion for adjudication is needed in these cases where conflicts between duties exist. Ironically, a utilitarian approach may be needed to provide answers in these circumstances, that is, the consequences of keeping a promise based on the least harm caused is referred to as the deciding factor.[245]

In addition, a paradox of relative stringency may arise under the deontological approach. Deontological duties are categorical and must be followed no matter the consequences. This strict application creates inconsistent outcomes when conflicted duties are faced. Although some duties appear more stringent than others, there cannot be degrees of wrongness in terms of fundamentally wrong acts.[246] The need to assess degrees of wrongness is thereby forced upon the deontologist in these circumstances. When faced with a conflict, the duties under consideration must be weighed against each other according to which is the more stringent. In addition, wrongs punished in violation of deontological duties are not always punished equally, that is, the greater the wrong the greater the punishment deserved. The relative

[243] Ibid 29.
[244] Immanuel Kant, in J Ladd, *The Metaphysical Elements of Justice: Part I of the Metaphysics of Morals* (1780), Trans (Hackett Pub. Co, 1965) 25.
[245] Duska, Duska and Ragatz, above n 60, 66.
[246] R. G. Frey, 'Intention, Foresight, and Killing' in *Intending Death*, Tom. Beauchamp (ed.) (Prentice-Hall 1995) 78.

stringency of the duty violated or the importance of the rights in question help determine which is the greater wrong, and then what level of punishment is appropriate.

3.5 Challenges to the Dominant ethical Theories

Utilitarian and Kantian theories incorporate a range of moral considerations in their frameworks which can be used to assist ethical decision making for the professions. They affirm the idea of a moral life oriented around universal principles and rules. Notwithstanding their dominance, they are not the only ethical theories for guidance and reference, and some attention has been drawn to defects put forward by critics against these theories. Several alternatives to the utilitarian and Kantian models have been promoted, including rights theories, virtue theories and common morality theories. The suitability of application of these theories to ethical issues found in the professions and accounting practice in particular is now examined.

3.5.1 Rights Theories

Many of the most challenging ethical issues found in the professions, business, and public policy centre on rights, for example, property rights, work and privacy rights. Rights theories offer a distinctive character to ethical theory, and provide a contemporary approach to dealing with ethical issues. In recent years, a public shift to protect vulnerable persons has taken place which typically is stated in terms of human rights that transcend national boundaries. Unlike legal rights though, human rights are independent of the state or social group membership, and are often defined to include:

- the recognition and respect of people's dignity;
- a set of moral and legal guidelines that promote and protect the recognition of personal values, identity, and the ability to ensure an adequate standard of living;
- the basic standards by which inequality and fairness can be identified and measured;

- those rights associated with the *Universal Declaration of Human Rights*. [247]

Rights theories have evolved from the notion of natural rights, and the claims of individuals against the state. Initially, natural rights were thought to consist primarily of the right to liberty and the right to be free of state interference. Proclamations of rights to life, liberty, property, a speedy trial, and the pursuit of happiness have subsequently been at the core of major western political decision making and legal developments. These rights have come to be understood as powerful assertions for all individuals. They give both respect and status such that a state which does not honour these rights will have its legitimacy called into question.

Although moral rights theories have not traditionally focused on the ethics of business or the profession's, this lens has been broadened given that human rights concerns have taken on greater relevance for ethical decision making in recent times. Theories of employee, consumer, and shareholder rights now provide frameworks for debates about rights in business ethics and the ethics of the profession's more broadly. [248]

3.5.2 Virtue Ethics

The forgoing discussion on utilitarian, deontology and rights-based theories have centred on obligations and rights. These theories do not however focus upon the agents or actors who must follow the theoretical principles they espouse. In recent years, calls have been made for ethical theory to redirect its attention from a preoccupation with principles of obligation, directive rules, and judgments of right and wrong, to instead place focus on the character of the person making the decision. This approach emphasises the importance of the virtuous persons of good character. Virtue ethics is a normative approach to ethics, and is characterised by the importance it places on virtues and moral character.[249] The ethical

[247] See UN General Assembly, *Universal Declaration of Human Rights*, 10 December 1948, 217 A (III), <http://www.unhcr.org/refworld/docid/3ae6b3712c.html>, see also *Australian Human Rights Commission Act* 1986 (Cth) s 3 which contains a limited definition of human rights for the purposes of that Act.
[248] Beauchamp, Bowie and Arnold, above n 216, 31.
[249] Rosalind Hursthouse, 'Virtue Ethics', *The Stanford Encyclopedia of Philosophy (Summer 2012*

practices and attributes of this ethical theory are sometimes labelled habits given that are part of an individual's character. This emphasis on habits however leaves the approach open to the suggestion that it is merely reflexive and that it does not fit within the conventional understanding of ethical responsibility.[250]

A virtuous person will recognise an ethical problem and then try to resolve it through honest deliberation in order to reach a principled and defensible conclusion. A person's character is critical to that deliberation. A virtuous person is disposed to honesty and generosity, and is expected to be guided by those tendencies when giving answer to an ethical question. Virtuous acts are not however by themselves sufficient to demonstrate a virtuous character. A person who is not disposed to honesty and generosity, but who on occasion acts with honesty and generosity cannot be characterised as a virtuous person. For example, a utilitarian may also act with honesty and generosity to achieve their purpose, but is not expected to respond in a virtuous manner in all situations.

Virtue ethics centres the on attributes and dispositions of the decision maker, and is thereby well suited to accounting practice. The self-governing aspects of professional cultures and the sense of pride borne from membership of a profession are characteristic of the ideals that underpin virtue ethics. Even though regulation and codes can govern the accountability and responsibility of the members of a profession, these imperatives cannot preside over the dispositions of the membership. These rules add value to professional practice, but only where virtuous practices are present and not made redundant or overwritten by regulation and rule making. In this context, Alan Greenspan stated:

> [A] market economy requires a structure of formal rules – a law of contracts, bankruptcy statutes, a code of shareholder rights – to name but a few. But rules cannot substitute for character. In virtually all transactions, whether with customers or with colleagues, we rely on the word of those with whom we do business. If we could not do so, goods and services could

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Edition), Edward N. Zalta (ed.) <http://plato.stanford.edu/archives/sum2012/entries/ethics-virtue/>.
[250] Duska, Duska and Ragatz, above n 60, 67.

not be exchanged efficiently.[251]

Virtue ethics is also relevant to ethical dealings in business. A morally good person with the right desires and motivations is more likely to act according to those moral ideals. Following on from this view, Australian company auditors might ordinarily be trusted by the business community because of their ingrained motivation to act appropriately and make morally appropriate decisions. Notwithstanding that perception of an auditor's character, an auditor who simply follows rules and exhibits no special moral character is not necessarily trustworthy. It is not the rule follower but rather the person whose character is generous, caring, compassionate, sympathetic and fair, who should be recommended, admired, praised, and held up as a moral model. [252]

Several objections have been raised against virtue ethics by its critics. Some people argue that the task of ethical theory is to establish a code of universal rules or principles to guide decision making and ensure that the correct action will be taken. Those guiding rules must be stated in terms so that a non-virtuous person can understand and apply them. The virtue ethics approach cannot satisfy this requirement given that it cannot be expressed in codified principles. As such, an application problem exists under the theory. Further problems in a practical sense exist. Different cultures embody different virtues, so that rules of virtue ethics must then determine a right or wrong action relative to a particular culture. In addition, virtue ethics cannot effectively resolve dilemmas where several competing virtues are in conflict. The opposing demands of each virtue must be identified, and a decision then made on which outranks the others.[253]

3.5.3 Common Morality Theories

Common morality is the set of norms shared by all persons who are committed to achieving the objective of morality. Common morality applies to all people in all places, and all human

[251] Alan Greenspan, 'Corporate Governance' (presented at the 2003 Conference on Bank Structure and Competition, Chicago, May 8, 2003) 2.
[252] Beauchamp, Bowie and Arnold, above n 216, 35.
[253] Alexander and Moore, above n 23.

conduct is judged by its standards. According to this approach, virtually all people in all cultures understand the basic requirements of morality. Its norms are familiar and unobjectionable to those who are deeply committed to a moral life. Philosophers including Thomas Hobbes and David Hume pointed out that the human condition tends to deteriorate into misery, confusion, violence, and distrust unless the norms of the common morality are observed. [254] Supporters of common morality maintain that no philosophical ethical theory takes precedence over common morality; and that all philosophical theories are founded on an understanding of common morality.

Most professional codes of ethics include standards of ordinary morality at a high level (for example honesty),[255] with more detailed rules of ethical behaviour then used to expand upon these general morals. The ethical standards required of professionals are in practice more elevated than ordinary morality standards, given that professionals are expected to exercise higher standards of behaviour. Many examples of specific norms can be found in codes of professional practice, institutional codes of ethics and government regulations in Australia. In the case of auditors, the level of honesty required goes beyond ordinary morality and the standards required of people in business more generally.[256] In this context, the code of ethics for accountants in Australia [257] is reflective of common morality, while also being rich in content that comprehensively prescribes rules of ethics for the accounting profession.

3.6 Descriptive Ethics - Ethical Standards and Codes

Professional codes and moral standards represent the acceptable ethical standards for the members of an occupational group. Codes of ethics are those morally permissible standards that members of a professional collective must follow. Ethics in this sense applies to members of a group simply because of their membership. These professional ethical standards are important for those who consume professional services. They promote business confidence

[254] Beauchamp, Bowie and Arnold, above n 216, 37.
[255] *APES 110, Code of Ethics for Professional Accountants,* paras 100.5, 110.1, 150.2, 250.2, 320.1
[256] Michael Davis, 'Integrating Ethics into Technical Courses: Micro-Insertion' (2006) 12 (4) *Science and Engineering Ethics* 717, 718.
[257] *APES 110, Code of Ethics for Professional Accountants*.

and capital market efficiency more broadly. This reliance is discussed in Chapter 7 in the context of Australian registered auditor conflicts of interest, and how increased capital costs are factored into funding a company where breached auditor independence is evident.

Codes of ethics, their nature and their effectiveness have dominated contemporary conversations on professional ethics. A profession is a voluntarily organised occupational group. Members of the collective seek to earn a living by openly serving moral ideals in ways beyond that which the law, capital markets, ordinary morality, and public opinion require of them**.** Professional groups typically prescribe morally permissible standards of conduct for their members by way of codes of ethics. Ethical standards and codes of conduct define cooperative practice for the membership of a group. They hold moral status similar to that of a binding promise requiring compliance of those who participate in the occupational practice. To act against these standards is a breach of a moral rule by a member, morally wrong and unethical from a professional viewpoint. [258]

Although an organisation may adopt a code of ethics, that group or enterprise may not be a profession and never achieve professional status merely because of those rules. For example, a business may have a code of ethics to serve a moral ideal, but is also organised for the primary purpose of generating income. In these circumstances, those who earn their living from the business are employees and not members of a profession. The owners or principals who earn profits from business operations are also not members of an occupational group even though they may comply with the business entity's code of conduct.[259]

The standards that constitute the ethics of a profession and formulated as its code of ethics are formal rules of conduct. Although informal practices of moral behaviour are not included in these codes, these practices are generally passed down by experienced members of the profession to those members who have more recently joined or may require counsel. The role of ethics for the professions is just as important as the technical knowledge that their membership possess, and this is particularly true in the case of accountants who act as

[258] Davis, 'Integrating Ethics into Technical Courses: Micro-Insertion', above n 256, 719.
[259] Ibid.

registered company auditors in Australia. An auditor must know the ethical rules of the accounting profession and apply them in practice. Non-compliant auditors are more likely to act unethically and make mistakes in their professional practice and auditing activities.

3.7 Conclusion

Concepts of good and evil, right and wrong, virtue and vice, justice and crime are common matters for ethical consideration. There is disagreement about the exact nature of ethics, however it is generally understood that ethics comprises a mix of ethics as morality, rules of ethical behaviour, and ethical theory.

Many people tend not to see the ethical landscape in its entirety and are ill-equipped to solve an ethical problem. They have little option but turn to ethical theory for direction when faced with an ethical dilemma. Ethical principles can be used to resolve moral problems that arise in the professions and applied to practical situations across all professional fields. The theories discussed in this chapter explain several ethical approaches which are relevant to the professions. Although elements of these ethical theories are found in accounting and audit practice, no single theory can give complete instruction and direction to accountants. Amongst those theories, normative ethics is commonly used to treat moral problems faced in accounting practice such as conflict of interest situations or the improper disclosure of information.

Not all ethical theory is suited to the accounting practice. There are situations where strict deontological norm compliance will bring about a disastrous consequence. In addition, egoism is based on a distorted egocentric and limited view of the universe, where the decision maker is the most important person in his or her life. A moral viewpoint demands that an accountant must look further than this self-interested approach. Virtue ethics is well-suited to the accounting profession it is more difficult to prescribe in practical situations. From a virtue ethics perspective, accountants must respond truthfully to be excellent accountants. But an accountant may have several goals and conflicting virtues. The virtues developed and used by him or her may prove dysfunctional in these circumstances,

for example, loyalty is often viewed as a virtue which may be incompatible with independent auditing practices.

Co-operation between all members of society calls for the practical application of rules and principles. Within such a collaborative environment, individuals are obliged to follow implicit and explicit arrangements and agreements under which they must co-operate or abstain from interfering with others. Ethical standards and codes of conduct are examples of such rules. These professional standards must evolve with social change to ensure they are aligned to societal expectations and remain relevant. Codes of ethics must not stay fixed or cling to historical traditions. The accounting profession in Australia has taken a descriptive approach to ethical rule making and adopted a code of ethics for its members. Although, members of the accounting profession in Australia are bound by the rules of APES 110, this thesis concludes that they must not only follow the rules but also act with altruistic intent in favour of their clients and society more broadly. Although APES 110 offers useful guidance, the profession must not let itself become regarded simply as an enterprise association from which users consume accounting and audit services. As members of a profession, individuals who practice as accountants must demonstrate a practical commitment to being ethical, and doing that which is right and good. They must apply an ethical attitude towards the rules of public practice even when they appear straightforward.

There is a place for ethical standards and rules for the professions, as these regulations express the ethical expectations of a collective and can be applied in a relatively uniform way by different people. Rules following also offers predictability for capital markets needing to rely upon the independent reports of company auditors to make funding decisions. Rule effectiveness requires the willing compliance of accounting practitioners, rather than challenges from them to test the limits of rules for personal advantage. Ultimately, ethical decision making requires that a professional practitioner look beyond a framework of rules imposed upon him or her, and to act in the interests of the community that granted professional status to their occupational group. This thesis now discusses the nature of accounting as a profession, to further develop the significance of ethical behaviour for that

collective and its importance to the memberships continued professional status.

Chapter 4: The Rise of Accounting as a Profession

4.1 The Professions

The professions dominate our world. They heal our bodies, measure our profits, save our souls, yet we are deeply ambivalent about them. [260]One broadly accepted definition of the term profession makes reference to:

> … a group of men pursuing a learned art as a common calling in the spirit of public service - no less a public service because it may incidentally be a means of livelihood. Pursuit of the learned art in the spirit of public service is the primary purpose.[261]

This definition distinguishes a profession as having a specialised body of knowledge, commitment to social good and having high social status. It projects the idea that professionals make a bargain with society under which they promise to conscientiously serve the public interest which at times may be at their expense. In return, society allocates certain privileges and special status to professions which generally include the right to self regulate and the exclusive right to perform particular functions for economic reward. These privileges are given on the condition that members of the profession must work to improve the common good and meet societal expectations.

Adam Smith once warned that:

> People of the same trade seldom meet together, even for merriment and diversion, but the

[260] Andrew Delano Abbott, *The System of Professions: An Essay on the Division of Expert Labor* (University of Chicago Press 1988) 1.
[261] Dean Roscoe Pound in the Editorial 'The Line', (January 1966) 52, *American Bar Association* 51,51.

> conversation ends in a conspiracy against the public, or in some contrivance to raise prices. [262]

This tendency holds true for the accounting profession in Australia. This chapter considers the concept of occupational authority under which professions are characterised as occupational groups that oversee particular domains. It examines the collective social mobility used by accountants to achieve occupational authority and expand the audit function to control the market for those services. It will be seen that this strategy to take market control is the type of contrivance envisaged by Adam Smith. That domination of audit services by the accounting profession has allowed conflicts of interest to arise and breached auditor independence to manifest in client relationships. The problem of auditor conflicts is examined in detail in later chapters of this thesis, which culminates in a proposal for financial statement insurance ('FSI') as a solution to breached independence in Chapter 8.

4.2 Professions, Their Nature, Roles and Responsibilities

Professions are occupation-based structures of authority with vested responsibility to oversee specific domains within society. The justification for the endowment of this authority is founded on the exclusive and specialised expertise that an occupational group possesses, and the group's commitment to apply that expertise responsibly. The requirement for professional knowledge is central to professional recognition, and specialist expertise is universally accepted as a distinguishing feature of a profession.

The grounding of professions in professional knowledge is emphasised in Whitehead's *Adventures of Ideas*:[263]

> …the term profession means an avocation whose activities are subjected to theoretical analysis, and are modified by theoretical conclusions derived from that analysis. . . . Thus

[262] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, (University of Chicago Press, originally published 1776, 1952 ed) 55.
[263] Alfred North Whitehead, *Adventures of Ideas* (Cambridge University Press, 1933) 72-3.

> foresight based upon theory, and theory based upon understanding of the nature of things, are essential to a profession.... The antithesis to a profession is an avocation based upon customary activities and modified by the trial and error of individual practice.

The main studies of the professions to date have been definitional and explanatory. Focus has centred on what professions are and how they have achieved their status. This can be seen in trait-based models which list the ingredients needed to make up a profession. Later studies guided by Weberian and Marxist perspectives then employed ideas of market control in their construction of the professions. These writers concerned themselves more with what professions do in everyday life in order to negotiate and maintain their special position.[264]

The earliest views of the professions were idealised portrayals and generally reverential in their tone and descriptions.[265] The *Acquisitive Society* by Tawney [266]stresses the altruistic nature of professional service:

> The difference between industry ... and a profession is, then, simple and unmistakable. The essence of the former is that its only criterion is the financial return which it offers to its shareholders. The essence of the latter is that, though men enter it for the sake of livelihood, the measure of their success is the service which they perform, not the gains which they amass. They may, as in the case of a successful doctor, grow rich; but the meaning of their profession, both for themselves and for the public is not that they make money but that they make health, or safety, or knowledge, or good government or good law.

This ideal view sees the professions accepting moral and ethical responsibility, and envisages the continued and deserved elevation of their roles.[267] On that basis, the professions are considered to be permanent groups to which individual members have a strong attachment and devote their life.

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[264] Larson, *The Rise of Professionalism: A Sociological Analysis*, above n 19, xii.
[265] West, above n 28.
[266] Richard Henry Tawney, *The Acquisitive Society* (Harcourt, Brace and Company, 1920) 94.
[267] Emile Durkheim, *Professional Ethics and Civil Morals*, trans. C. Brookfield (Routledge, 1957) 96-7.

4.2.1 Trait Model of Professions

One simple approach finds the typical profession to possess a set of characteristics that define its nature. These characteristics are used to define professionalism under the trait model of the professions. Cogan's[268] definition is representative of this approach, and describes the characteristics that distinguish a profession from non-professional occupations to be:

> A profession is a vocation whose practice is founded upon an understanding of the theoretical structure of some department of learning or science, and upon the abilities accompanying such understanding. This understanding and these abilities are applied to the vital practical affairs of man. The practices of the profession are modified by knowledge of a generalized nature and by the accumulated wisdom and experience of mankind, which serve to correct the errors of specialism. The profession, serving the vital needs of man, considers its first ethical imperative to be altruistic service to the client.

Others have offered more explicit collections of attributes by listing discrete features rather than an integrated definition of professional occupations. For example, Greenwood [269] listed systematic theory, authority, community sanction, ethical codes, and a culture as five characteristics that all professions must possess. [270]

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[268] Morris L Cogan, 'Toward a Definition of Profession' (1953) 23(1) *Harvard Educational Review* 33, 49.
[269] Greenwood, above n 122, 10.
[270] See Geoffrey Millerson, The *Qualifying Associations: A Study in Professionalization*, (Routledge and Kegan Paul, 1964) 4. As noted by West, attempts to define professions by reference to a checklist of attributes reached their pinnacle with Millerson's 1964 survey. The following six 'essential features' of a profession were nominated:

(a) A profession involves a skill based on theoretical knowledge.
(b) The skill requires training and education.
(c) The professional must demonstrate competence by passing a test.
(d) Integrity is maintained by adherence to a code of conduct.
(e) The service is for the public good.
(f) The profession is organized.

Some attempts to define the professions using a checklist have caused confusion and disagreement about the fundamental occupational characteristics particular to all professions. In addition, more expansive lists of factors have been offered including an example provided by Behrman whose compilation identified ten characteristics that differentiate a profession from other forms of employment as follows:

1. A clearly defined field of expertise, which distinguishes members from all other careers;
2. A period of prescribed education or training which precedes entry into membership;
3. A selective process of entry, restricting membership to those qualified;
4. A procedure for testing and licensing;
5. A dedication to social services, meeting obligations to society and performing services other groups are not capable of offering;
6. Correlatively, substitution of service for income and wealth as the primary motivation for members, plus high quality service regardless of fees received;
7. Provision of adequate services for the indigent or those in extremis;
8. The application of differential fees for the same service according to circumstances or ability to pay;
9. A set of self-governing rules, inculcating a high code of ethics;
10. Means of self-surveillance and application of penalties for misbehaviour or negligence of members. [271]

A professional person's obligation to serve in the public interest and accept public responsibility stands as a distinguishing mark of all profession and is common to most trait models. Financial statement users rely on the objectivity and integrity of accountants to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on accountants to ensure the wellbeing of the community and those institutions the profession serves. As such, a professional practitioner must possess a spirit of loyalty to his or her fellow practitioners, helpfulness to the common cause of the profession,

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See West, above n 28,17.

[271] Jack N. Behrman, *Essays on Ethics in Business and the Professions* (Prentice Hall, 1988) 97-98.

and not allow unprofessional acts bring shame upon their profession. [272]

4.2.2 The Structural - Functional Model of Professions

Professional institutions lay down the standards for admission to membership. Members then acquire the norms and values of the group by undertaking prescribed training, and internalising the collective's social control strategies through peer association and engagement. Those norms and values are an important reference point for members when faced with opportunities to exploit others in the course of their practice.

The structural - functional model of the professions emerged out of claims that the existence of the professions is evidence enough of their social utility. [273] The structural-functional interpretation finds professions to be party to a social contract.[274] Here, the professions strike a bargain with society under which they exchange competence and integrity for client and community trust, the relative freedom from lay supervision and interference, protection against unqualified competition, higher levels of remuneration, and social status.[275]

The structural - functional model places emphasis on the characteristics a profession needs to support its social contract undertakings. For example, codes of ethics cease to be a benign checklist used to evaluate occupational status, and become a necessary social control device under the model. They are used to balance the unequal relationship between the supplier of a professional service and his or her client. [276]

Some commentators oppose the structural - functional model given the tension that exists between the values adopted by a profession in its business dealings and those of wider society. Professional groups control their body of expert knowledge and apply that

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[272] Wilbert E Moore, *The Professions: Roles and Rules* (Russell Sage Foundation, 1970) 5-6.
[273] Elliott, above n 32,11.
[274] West, above n 28, 17.
[275] Rueschemeyer, above n 34, 41.
[276] West, above n 28, 18.

knowledge to perform specialised tasks. Problems of social control may arise given the unbalanced nature of the relationship between the professional person holding knowledge and his or her less skilled client who receives it.

4.2.3 Professionalism and Theories of Action

The trait model and structural-functional model of the professions have been challenged given that the interests of service users are sometimes placed second to business ambition and running a successful professional office. This aspect is largely ignored under these models. The legitimacy of privileges enjoyed by the professions and the motivations of professionalisation strategies used by them to access those privileges has also gone largely unquestioned and unchallenged. In addition, the source of power and authority of the professions requires more explanation then that offered by these models.

In particular, the attribute-based model of professions has been criticised on the basis that it does not focus on the professionalisation process but rather on the product produced by it. To focus on professional attributes alone is likely to bring about a list contaminated with a group's principles and hopes rather than an independent assessment of what the collective achieves in practice. The trait model is problematic given that a profession can enhance its standing relative to other occupations by simply increasing its list of attributes to then claim greater financial reward. Comparisons made between occupations according to the scale of features they have is not appropriate given that this analysis draws attention away from the problems caused by professionalisation. Focus should instead be placed on the avoidance of public accountability by the professions, their manipulation of political power to promote monopoly control, and the restriction of services by members to create scarcities and increased costs.

Theories of action provide an alternative approach to understanding the professions. This theory explores the dynamics of professionalisation (that is, the process by which occupational groups ascend the occupational hierarchy) to explain the nature of professional

occupations. The enquiries made under this approach place focus on how and why certain occupations have gained ascendancy and achieve enhanced status and privileges while others have not.[277]

At its most simple level, the acquisition of professional status is associated with the accumulation of particular traits. Building upon this idea, professionalisation can be viewed as a consequence of social progress and natural line of development which is made possible by an industrialising and professionalising society.[278] The professionalisation of an occupational group follows a sequence of steps. It proceeds according to an invariant progression of events that paves the way to professional status.[279] That sequence typically comprises the establishment of a professional association, changing the name of the occupation, promulgation of a code of ethics, the conduct of political agitation, and development of training facilities controlled by the occupational group. This process is typically used by occupations to stake out a jurisdiction claim, to then establish a professional association and close the market for the services it provides.[280]

The theories of action interpretation of the professions has radically changed the way in which professionalisation is viewed. Previously recurringly sentiments of altruism, ethical service and self-regulation have been replaced by the professions now portrayed as self-interested collectives that use strategies of closure and collective social mobility. Under this theory, the closure of a profession is achieved through a process of mobilising power to enhance and defend a group's share of rewards and resources.[281] Collective social mobility operates to attach status and social standing to occupational roles.[282] The rise of the accounting profession in Australia is one such example of a professionalisation project;

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[277] Paul Halmos, 'Introduction' in P. Halmos (ed.) *Professionalization and Social Change* (University of Keele, 1973) 6.
[278] William J. Goode, 'Encroachment, Charlatanism, and the Emerging Profession: Psychology, Sociology, and Medicine' (1960) 25(6) *American Sociological Review* 902, 902.
[279] Harold L. Wilensky, 'The Professionalization of Everyone?' (1964) 70(2) *The American Journal of Sociology* 138, 142.
[280] Ibid 145-6.
[281] Murphy, above n 31, 548.
[282] Larson, *The Rise of Professionalism: A Sociological Analysis*, above n 19, 66.

where accountants have successfully translated their scarce resources of special knowledge and skills into social and economic rewards.[283] The key to extracting these rewards lies in the ability of a profession to exert market control and maintain scarcity over its resources. Where successful, this process creates a monopoly of expertise and market recognition for the profession and the services it provides.[284]

Some commentators argue that collective mobility and the professionalisation outcomes that result from it is not a natural and inevitable form of occupational development. That is, professionalisation is a project aimed at achieving social and economic ascendancy. Duman explained this development in nineteenth-century England as: [285]

> …a unique ideology based on the concept of service as a moral imperative. This provided doctors, lawyers, clergymen and the members of an ever growing number of other occupations with an article of faith with which to justify their claim to superior social status and special privileges, such as self-discipline. The ideal of service allowed the professions to reconcile the concept of the gentleman with the necessity to work for a living and to formulate a definition of their relationship with clients and with society.

The theories of action approach thereby looks beyond the attributes used to define a profession's character to place greater emphasis on presumed motivations, namely the professions desire to achieve elevated class and economic status. This shift in understanding the professions finds them to be self-interested collectives. Many of the traits commonly associated with professions (for example codes of ethics, formal associations and public interest affirmation) are not understood as naturally occurring features under the model, but as tools used in the pursuit of enhanced status. Under this view, professions are established through social and political processes and their development is motivated out of membership self-interest.[286]

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[283] Ibid xvii.
[284] Ibid vii.
[285] Daniel Duman, 'The Creation and Diffusion of a Professional Ideology in Nineteenth Century England', (1979) 27(1) *The Sociological Review* 113, 114.
[286] Paul Boreham, 'Indetermination: Professional Knowledge, Organization and Control' (1983)

It can be seen that under the theories of action point of view, the existence of the professions is not universally believed to be socially desirable. Society is not always presumed to have made the right choice by elevating particular occupations to the status of a profession because of the special qualities it may possess. Some critics instead claim that professions are formed through the pursuit of elevated economic and social status, and that professionalisation does not necessarily yield social benefits but rather secures benefits for members of the professional group. [287] In these cases, acceptance of a group's professional status may be a choice mistakenly made by society.

After considering these alternative views of the professions, it can be concluded that there is no common understanding of the nature and roles of these collectives. Professions have been praised as the altruistic saviours of modern society but at the same time depicted as self-interested cartels far more concerned with furthering the economic and social status of their members. [288] Professionalisation is regarded by some as an occupational strategy used by social groups to control their place within a market. [289] Instead of merely responding to market dynamics, some occupations go beyond this to seek out control of market conditions. Those occupations which turn out to be especially successful at market control are the professions. That market control may then become distorted over time and go on to create an environment infected with conflicts of interest. This condition is particularly evident in the accounting profession, where its members have exclusive authority to conduct audits of public Australian companies. This thesis examines the problems of breached auditor independence and proposes a market driven solution to remedy conflicted auditor behaviour in later chapters.

4.2.4 Professions and Occupational Authority

11(4) *The Sociological Review* 693, 694.
[287] West, above n 28, 31.
[288] Ibid 25.
[289] Bryan S Turner, *Medical Power and Social Knowledge*, (Sage Publications, 2nd edn 1995) 139.

Members of the professions are vested with enhanced levels of authority which typically comprise the exclusive right to perform certain tasks and define the nature of those tasks. Those occupational groups have the capacity to influence the governance of their particular fields as a professional class. As such, the members of professional occupations have significant authority within the domains in which they operate. The provider of professional services has primary and often exclusive authority to supply certain services and define the nature of those services.

A chief justification for the authority given to an occupational group is founded on the collective's contribution to enhancing social order. The level of occupational authority enjoyed by a profession is determined by the extent to which its authority is relied upon as a mediating mechanism within a particular field. For example, the registration of accountants as company auditors in Australia restricts the provision of this service to members of professional accounting bodies.[290] Because of this limitation, the reliance placed on accountants to mediate the interactions within the field of audit knowledge has elevated their occupational authority.[291]

An occupational group's knowledge base is central to its authority. A prerequisite for the proper functioning of a profession is that its members possess that level of special knowledge and skills to justify their authority. This qualifies them to carry on a business as a professional person and properly discharge their responsibilities. Professionalism is therefore characterised by the self-directed application of knowledge that serves a particular human need, together with ongoing research on how those needs might be better satisfied into the future.[292] A fundamental responsibility of a professional group is to ensure that its practices are technically sound, serviceable and fit for their purpose.

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[290] See *Corporations Regulations 2001*(Cth), Regulation 9.2.03, *Prescribed courses (Act s 1280 (2A))* and Regulation 9.2.04, *Prescribed bodies' (Act s 1282(2)).*
[291] West, above n 28, 42.
[292] Ibid 34.

4.2.5 Professional Knowledge

As touched on in the previous section, it is generally agreed that the occupational authority enjoyed by professional bodies has been achieved and is justified by the possession of specialised knowledge. Exclusive expertise and knowledge plays an important role in the professionalisation process as it binds practitioners together to form a distinct group. It provides the foundation for the professions to procure authority and negotiate state-endowed privileges.

The ownership of specialised knowledge by a profession may however create an asymmetry of knowledge and asymmetry of power. A dependent relationship may evolve where a person who lacks knowledge must depend on the word and advice of an expert. This asymmetry of knowledge creates potential for a profession person to abuse his or her position of power and take advantage of those seeking advice. It is unethical for those holding superior knowledge to gain an unfair advantage from it. Thereby, a professional person must abandon his or her strictly selfish commercial view and follow ethical principles when supplying a service, and not misuse his or her knowledge against unknowing persons. [293]

Elevated occupational authority is a product of an occupational professionalisation project. As a consequence of gaining that control, the members of professionalised occupations enjoy exclusive authority to supply certain services and define the nature of those services. [294] Given this ability to control supply, the community expects that the authority vested in professional groups will be used to enhanced social order and help the community more broadly. In the field of accounting services, the technical quality of accounting information produced is of primary concern to users. The public interest is best served (and accountant professional authority is justified) where the accounting function operates as a reliable

[293] Duska, Duska and Ragatz, above n 60, 72.
[294] West, above n 28, 40.

financial instrument. [295]

The accounting profession routinely claims that accounting is a knowledge-based profession which encompasses a specialised body of knowledge. Accounting is a complex discipline requiring formal study in order for an individual to become a competent expert. A professional accountant must be competent and hold the necessary knowledge of the art and science of accounting. That level of competence is achieved through education and work place experience. As such, a professional accountant is expected to be committed to learning and personal improvement throughout his or her professional life.

The expanding nature and growing sophistication of business activity in Australia has demanded that accountancy practice also become increasingly complex. Notwithstanding that evolution, most aspects of accounting knowledge needed to service these business requirements are also found to exist in other occupations. Bookkeeping, company law, insolvency, taxation, and trust accounting can be carried out by lawyers, company secretaries, bookkeepers and clerks with only modest qualifications. The professional accounting bodies rest their claim to professional knowledge on the basis that they are the only group able to perform all of these services. Below its surface, accounting professional practice has come to entail a mysterious collection of knowledge topics and areas, rather than a single basis of knowledge. This perspective denies that a body of unique accounting knowledge exists given that the individual elements of accounting expertise are broadly known to and shared amongst others. Some also argue that the vague and inconsistent nature of accounting practices has diminished public confidence in accountants and the legitimacy of their professional status more generally. The following sections of this chapter will consider if accounting can in fact lay valid claim to professional status, and how it has used its power and influence for more commercial, and less altruistic pursuits.

4.3 Professionalism and the Accounting and Audit Functions

[295] Ibid.

The elevated occupational authority enjoyed by accountants is reflective of the range of occupations commonly described as the professions. The authority vested within the professions is a particular form of social control. Professions are relied upon to act responsibly when delivering their specialist services, and must have proper regard for the public interest when doing so. In the case of accountants, professionalism involves members acquiring and applying their specialist knowledge to improve the serviceability of accounting information. To achieve this, the accounting profession continually seeks out reliable financial measurement and informative control systems. The audit function is also aligned to this goal, as it expands the range of auditable objects alongside these new accounting systems to make organisations more auditable. The construction of systems receptive to audit has allowed audit to develop and flourish as a constitutive principle of social organisation.

The history of accounting in Australia features the development and proliferation of accounting standards and technical regulatory statements. Early bookkeeping manuals contained qualitative accounting standards as a basis to keep accounts for public bodies and the financial affairs of business.[296] Today, the Australian Accounting Standards Board issues and maintains Australian Accounting Standards and related pronouncements. There are currently more than fifty Australian Accounting Standards Board ('AASB') standards issued on matters as diverse as AASB 141, *Agriculture* and AASB 129, *Financial Reporting in Hyperinflationary Economies*.

The confused and incoherent nature of Australian accounting standards was discussed in Chapter 1. Although accounting rules are claimed to improve the quality of accounting information, doubts have been expressed as to whether they have achieved that end. A preoccupation with accounting rule making and rule compliance is instead claimed to distract attention from the primary goal of accounting practice, that is to produce quality

[296] Raymond J. Chambers Peter W. Wolnizer, 'A True and Fair View of Position and Results: the Historical Background' (1991) 1(2) *Accounting, Business and Financial History*, 197, 198.

financial reports.[297] Qualitative standards do not of themselves ensure the serviceability of financial reports. That outcome requires technical practices to be both specified and enforced. This responsibility has been substantially been placed in the hands of accounting practitioners. Both individually and through their formal associations, accountants play the primary role in designing accounting procedure by issuing standards and ensuring they are applied by the membership. Accountants as an occupational group have exercised significant authority in connection with all technical aspects of accounting practice. This is evidenced by the success of accounting associations in obtaining the exclusive right to carry out the public company audit function in Australia, and report on the truth and fairness of company financial statements.[298]

In addition, the audit function has expanded to new areas in more recent times. The audit product has extended beyond the financial statement audit ('FSA') of public companies to encompass new opportunities including environmental audits, management audits, quality audits, forensic audits, data audits, intellectual property audits and medical audits. Audit has thereby become a constitutive principle of social organisation. Audit now represents a managerial rationality which is capable of reorganising social, business and government relations. The significance of the modern audit product is not centred in its role and operational practices, but rather how new audit opportunities are appropriated and mobilised.[299] Over time, accountants have used strategies of closure and collective social mobility to enhance their power and defend the rewards and resources they have gained. The advancement of audit into new areas is a good example of this.

As business practices grow in scale and complexity to cause problems of resource control, the audit function has sustained that control by displacing costly inspection technologies with more distant audit review activity. Audit differs from traditional managerial control. It functions as a control of organisational controls, to replace direct control practices of

[297] West, above n 28, 69.
[298] West, above n 28, 4.
[299] Power, *The Audit Society: Rituals of Verification*, above n 119, 300.

supervision and real time inspection.[300] Notwithstanding that important assurance and support role, accountants have branched out to supply other products, to develop and expand the audit function as a self-interested collective. They have achieved this by employing professionalisation strategies to control the market for audit services in Australia as registered company auditors, and then have looked beyond this to establish new areas for audit product and business development.

4.3.1 Accounting Professional Occupational Authority

The nature of professional services is in substance determined by professionals themselves rather than the preferences of their consumers or the directives of external agencies. Professions are characterised as occupational groups that enjoy largely unchallenged authority in connection with the technical aspects of the services they supply. This understanding of the accounting profession and accounting process is not however accepted by all, with questions having been raised about the quality of the accounting product. It has been said that:

> Their product, the financial report, is a costly mess; their …..accounting principles in chaos; their signatures on audit reports …..and training considered unacceptable. Some degree of indeterminacy in professional knowledge has been said to provide a means of accentuating professional authority as it allows secrecy and means that control over ... professional skills remains in the hands of practitioners.[301]

The extent to which the accounting occupation is characterised by professional authority is now considered by examining its historical development. It will be seen that accountant occupational authority was helped by a range of social and environmental factors which enhanced the social status of accounting work and inferred broader occupational credibility on it. This review will show the standing of accounting as a professional collective to have a predominantly social origin rather than cognitive origin.

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[300] Ibid.
[301] Robert W. Perks, *Accounting and Society* (Chapman and Hall, 1993) 13.

The history of the accounting profession finds accountants to individually and collectively hold themselves out to exercise authority over accounting related tasks, and lay claim to an established, recognised and highly regarded profession.[302] Accountants have claimed broad social recognition, and regard themselves as professionals and equal in every respect to those professions regarded by society as deserving of that appellation, including law, medicine and theology. Some critics however oppose the assertion that accountants are entitled to professional standing.[303] Rather than challenge the notion that accounting is widely recognised as a professional occupation, doubt has been cast on the extent to which accountants have met the expectations of those entitled to claim professional status. Those reservations typically point to the questionable meaning of reported accounting figures, inconsistencies in accounting rules, education orientated solely to training for current practice, a lack of research on accounting practice, and mismanaged ethical behaviour of practitioners.[304]

This chapter has shown that occupational authority is both a significant and discriminating feature of professionalised occupations. Professions are occupational groups with authority to perform certain tasks and define the nature of those tasks.[305] Evidence of accountant occupational authority is found in legislative provisions that restrict the performance of particular accounting tasks to members of the profession. In addition, accounting associations have successfully acquired the exclusive right to perform a number of accounting related tasks for their members. This exclusivity includes the audit of company financial statements in Australia. The *Corporations Act 2001 (Cth)* (‘*Corporations Act’*) mandates that certain companies must appoint an auditor to report on the truth and fairness of their accounts.[306] The regulation also lists membership of a prescribed accounting

[302] Robert Jeffery, ‘From the President’, (1995) 65(2) *Australian Accountant* 3, 3.
[303] Floyd W. Windal, and Robert N. Corley, *The Accounting Professional: Ethics, Responsibility and Liability* (Prentice Hall, 1980) 8.
[304] Tom Lee, ‘A Review Essay: Professional Foundations and Theories of Professional Behaviour’ (1991) 18(2) *The Accounting Historians Journal* 193, 193.
[305] West, above n 28, 44.
[306] *Corporations Act* s 301.

association as a criterion for registration as a company auditor.[307] The accounting profession's ability to influence the technical aspects of audit practice has been assisted by this restricted supply of audit services for its members.

Financial statement audit has been described as a quality control function given that an auditor examines the quality of information used by managers, investors and creditors to make judgements about the performance and prospects of a company.[308] Substantial authority is vested in registered auditors as the exclusive purveyors of that control. That authority is further accentuated given that auditors carry out their work almost entirely free of externally imposed regulatory requirements on how the audit is to be conducted. The *Corporations Act* does specify the expected outcomes of an audit. Section 308 of the *Corporations Act* requires that an auditor express an opinion on whether a company's financial report provides a true and fair view of its financial position and performance, and if it complies with the law and applicable accounting standards. However, the legislation is silent on the procedures to be used when an auditor forms this opinion, and equally importantly, the meaning of 'true and fair'. Any decisions on technical issues made during the course of an audit (including the nature and level of sufficient appropriate audit evidence to be gathered, and the interpretation of 'true and fair') is largely left to those providing audit services and their professional associations.[309]

The accounting profession exercises substantial authority over the technical aspects of financial reporting practice. In Australia, the professional accounting associations have achieved a dominant position in the regulation of external financial reporting through their

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[307] *Corporations Amendment Regulations 2004* (Cth), Regulation 9.2.03 sets out 'prescribed courses' for s 1280(2A) (c) of the *Corporations Act*. It provides that, before registering a person as a company auditor, ASIC must be satisfied that the applicant has satisfactorily completed a course in auditing prescribed by the regulations for the purposes of that paragraph. This regulation prescribes courses in auditing offered by, or conducted on behalf of, CPA Australia, The Institute of Chartered Accountants in Australia and the National Institute of Accountants.

[308] Raymond J. Chambers, *Securities and Obscurities: A Case for Reform of the Law of Company Accounts* (Gower, 1973) 144.

[309] West, above n 28, 45.

involvement in accounting standard setting.[310] This authority is further supported by the professions influence on audit standard development. These standards are then used by auditors to examine auditee performance and report on it.

In Australia, there are three recognised local professional accounting bodies. These consist of the Institute of Chartered Accountants of Australia, CPA Australia and the Institute of Public Accountants. Each has their own requirements for membership. Until recently, Australian accounting and audit standards and the rules for auditor independence were developed and issued by a self-regulated accounting profession. Under self-regulation, audit firms and individual auditors were subject to the governance of the professional accounting bodies. Large accounting practices dominated the profession and blurred the practical distinction between the accounting firms and the accounting bodies. This was perceived by some as a conflicted situation. To address the problems of self-regulation, the Auditing and Assurance Standards Board ('AUASB') was established as an independent Australian Government statutory board under section 227A of the *Australian Securities and Investments Commission Act 2001* to oversee standard setting in Australia. [311]

Although the AUASB takes a broad societal view when setting standards for the accounting profession, it is influenced by lobby groups which include the accounting profession. As such, the accounting profession may press for rules and standards that do not necessarily bring about a social benefit. Even though the board is held out to be an independent body, its membership is heavily represented by the accounting profession including the large four accounting firms. These individuals are well positioned to influence the direction of audit standard setting in favour of the accounting profession. The direction offered by these

[310] K Cooper 'From Charlatan to Doyen: the Legitimization of Australian Accountancy', in A.J. Richardson (ed.) *Disorder and Harmony: 20th Century Perspectives on Accounting History* (Selected Papers from the 7th World Congress of Accounting Historians) Vancouver: CGA-Canada Research Foundation (1996) 179.

[311] The AUASB's functions include:

(a) making auditing standards under section 336 of the *Corporations Act 2001*;
(b) formulating auditing and assurance standards for other purposes; and
(c) formulating guidance on auditing and assurance matters.

members thereby continues to be perceived as biased in favour of accounting profession objectives. This potential moral hazard is however less problematic under the current accounting and auditing standard setting administration, given that the regulation of auditors is now shared between the professional bodies and Federal Government. [312]

The rise of the accounting associations has seen them become legitimising institutions with legitimising powers. Accounting provides legitimation through the development of accounting theory and applying that theory in practice. [313] The profession has gained prominence as a necessary means of regulating many aspects of our lives. Accountants are vested with the authority to control financial reporting quality and prescribe the form and content of those reports. They enjoy significant authority in determining what is right, wrong, acceptable and unacceptable in the field of accounting. The accounting occupational group continues to expand its substantial authority over accounting related matters, financial reporting practices, and the supply of audit services.[314]

4.3.2 Occupational Authority and Market Closure

The history of the accounting profession in Australia helps to explain the origin of the profession's elevated occupational authority. Official accounting histories assume that the accounting function is a necessary social institution, and that the success of accountants is largely attributed to the formation of their professional associations to control accounting business activity.

The origin of accounting as a profession features a mix of complex and divergent strategies, influences and circumstances. Early professional accountants were exclusively male and

[312] Tom Campbell, 'Introduction: The Ethics of Auditing' in Tom Campbell and Keith Houghton (eds), *Ethics and Auditing* (Australian National University, 2005) xxix.
[313] Tom Lee, 'Education, Practice and Research in Accounting: Gaps, Closed Loops, Bridges and Magic Accounting' (1989) 19(75) *Accounting and Business Research* 237, 249.
[314] Paul D Montagna, 'Accounting Rationality and Financial Legitimation' (1986) 15(1/2) *Theory and Society* 103, 104.

generally from privileged social backgrounds.[315] They were politically astute, had connections to powerful institutions such as the legal profession, and were found to denigrate and exclude others from seeking to share in the activities claimed to be their own. Legislative change and expansion, economic growth and development, and greater complexity in business activities have over time rendered accounting work increasingly important. These factors have combined with professionalisation strategies to construct elitism, facilitate closure of the accounting services market, and elevate accounting within the occupational continuum.

A profession is however not created by merely by forming an association. Collective mobility and closure must also be present. The members of an occupation must elevate the social standing of their field of work to achieve privileged status within the market for their services. The processes used by accountants to achieve closure demonstrate how professionalisation strategies can be employed to attain professional status. In this case, social, political and ideological factors appear chiefly responsible for the status achieved by accountants rather than the possession of accounting knowledge. Factors including social class, gender and the political perception of aspiring professional accountants have all contributed to that success.[316]

Political struggle was also central to the professionalisation of the accounting occupation. From a broad perspective, professional associations are political bodies whose purpose is to define, organise and advance the interests of their members.[317] The success of a professionalisation project thereby depends on the strength of a profession's relationship with both with the consumers of its services and those agencies empowered to legitimate and extend its occupational domain and control. The resulting success of any professionalisation

[315] Robert Linn, *Power, Progress and Profit. A History of The Australian Accounting Profession* (Australian Society of Certified Practising Accountants, 1996) 134.
[316] Thomas Tyson, 'The Archivist Responds to the New Accounting History: the Case of the US Men's Clothing Industry' (1995) 5(1) *Accounting, Business and Financial History* 17, 17.
[317] Hugh Willmott, 'Organising the Profession: a Theoretical and Historical Examination of the Development of the Major Accountancy Bodies in the U.K.' (1986) 11(6) *Accounting, Organizations and Society* 555, 556.

activity is gauged by advancement in social identity of the association's membership.[318]

Effective engagement with the state and government bodies was an important element of professionalisation for accountants in Australia. This required positive government relationships be established, the cultivation of strategic alliances with existing social institutions, and action taken to denigrate those who sought to take away business that accountants claimed as their own. The successful pursuit of professional status by accountants depended on state given power granting that status, for example the Royal Charter of the Institute of Chartered Accountants in Australia[319]and the legislative privileges enacted to create a monopoly for registered company auditors.[320]

Success in holding on to professional status and elitism requires that potential competitors be denigrated and excluded, and the suppression of internal political struggles. The accountant professionalisation process in Australia sought to establish professional organisations of high standing which were intended to dominate the practice of their vocation.[321] As a result of those strategies, accountants now exercise substantial authority over accounting matters. As registered company auditors, accountants are vested with exclusive authority to attest to the truth and fairness of financial reports under the *Corporations Act*. In addition, accounting standard setting and the development of technical regulations that govern financial reporting are significantly influenced[322]by accounting associations. Audit technical procedures are also in the main determined by auditors. These factors are representative of the elevated occupational authority enjoyed by a profession.

While it is clear that accountants exercise substantial authority with respect to accounting

[318] Ibid 561.
[319] The Institute of Chartered Accountants in Australia was constituted by Royal Charter in 1928. It operates under a Supplemental Royal Charter granted by the Governor-General on behalf of Queen Elizabeth II on 19 August 2005.
[320] Registration as a registered company auditor requires an auditor to satisfy the requirements of section 1280 of the *Corporations Act*. Audit Company registration is covered by section 1299B.
[321] Stephen. P. Walker, 'The Defence of Professional Monopoly: Scottish Chartered Accountants and "Satellites in the Accountancy Firmament" 1854-1914' (1991) 16(3) *Accounting, Organizations and Society* 257, 281.
[322] West, above n 28, 62.

matters, it is less clear whether the origin of that authority is founded on cognitively based expertise. There is ample evidence suggesting that a social process surrounded and supported the professionalisation of accounting as a profession. This social process shows that the social class, gender and the political acuity of early accountants contributed to the elevation of accounting. In addition, professional status was assisted by favourable legislative change and increased economic activity that demanded accounting and audit services be supplied to meet these needs. In comparison, accounting knowledge is less easily identified as an explanatory factor. [323] On this basis, accountants can be shown to have closed the profession to others through a process of mobilising their power in order to enhance and defend the group's share of rewards and resources.[324]

4.3.3 The Rise of Professionalism and Accounting Practice

Many advocates of the free-market system argue that the only responsibility of business is to increase profit. This view however distorts the position taken by Adam Smith who championed the capitalistic free market economy. Smith held that significant good comes from a system that allows people to pursue their own interests. This view became the theoretical foundation and justification of the capitalist free-market economic system. Smith did not however adopt a strictly commercial view, but instead insisted that the pursuit of self-interest be constrained by ethical considerations of justice and fairness.[325] Smith stated that:

> Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or order of men. [326]

In a similar vein, the *New Testament* teaches that we love our neighbour as ourselves, so that society is best served by healthy self-love and self-interest. However, to adopt a strictly

[323] Ibid 63.
[324]Murphy, above n 31, 548.
[325] Duska, Duska and Ragatz, above n 60, 71.
[326] Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, above n 262, 208.

selfish commercial view will encourage the pursuit of self-interest and lead to selfish behaviour. On that basis, the actions of those who pursue self-interest at the expense of others are unethical. There are occasions when people must sacrifice their own interests for others or the common good, and abandon a selfish profit-making approach[327] to their business affairs.

Members of the professions are expected to have due regard for their client's interests, and for those of the public more generally. Altruistic behaviour is a central ethical consideration of the professions and distinguishes a profession from other types of businesses activity, so that professional practice ideals must be expressed in non-market driven terms. Profit motivation is displaced by altruistic intent to serve the needs of man.[328] A supplier of professional services must thereby supply his or her services without selfish intent and not seek to take competitive advantage. To support this behaviour, codes of ethical conduct often endorse anti-competitive sentiments and forbid economic activity such as competitive price bidding.[329] Competitive advertising and advertising fees may otherwise allow clients to discriminate between competing suppliers and competing forms of professional service. For example, APES 110.250[330] provides instruction for members of the professional accounting bodies when marketing their professional services.

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[327] Duska, Duska and Ragatz, above n 60, 72.
[328] Greenwood, above n 122, 17.
[329] Eliot Freidson, *Professional Powers: A Study of the Institutionalization of Formal Knowledge*, (University of Chicago 1986) 113-14.
[330] Section 250, Marketing Professional Services provides that:

> 250.1 When a Member in Public Practice solicits new work through Advertising or other forms of marketing, there may be a threat to compliance with the fundamental principles. For example, a self-interest threat to compliance with the principle of professional behaviour is created if services, achievements, or products are marketed in a way that is inconsistent with that principle.
>
> 250.2 A Member in Public Practice shall not bring the profession into disrepute when marketing Professional Services. The Member in Public Practice shall be honest and truthful and not:
>
> (a) Make exaggerated claims for services offered, qualifications possessed, or experience gained; or
>
> (b) Make disparaging references or unsubstantiated comparisons to the work of another.
> If the Member in Public Practice is in doubt about whether a proposed form of Advertising or marketing is appropriate, the Member in Public Practice shall consider consulting with the relevant professional body.

The ideal portrayal of a professional association presumes the group to have collectively developed their expertise, unfettered and unchallenged by regulatory agencies. That autonomy ensures that members of a profession are positioned to control the development and application of the body of generalised knowledge which they alone are expert. Professional freedom and autonomy then allows members to offer services and advise free of the direction and influence of others.[331] Independent judgement must be exercised in the course of supplying a professional service where members are independent and are seen to be independent. In particular, members of the accounting profession must not be under the influence of persons or circumstances that can interfere with their judgement. [332] Benevolent autonomy must characterise a professional person's work, so that they are not subject to client directives but rather free of normal commercial pressures. Although exploitive potential may exist within a practitioner's relationship with his or her client, those influences must be suppressed by altruistic intent that displaces the pursuit of profit and competitive advantage.[333]

This idealised portrayal of professional practice has been challenged in the case the accounting profession in Australia. That professional accounting practice has not evolved to protect consumer interests but rather protect and enhance the interests of practitioners. In keeping with this view, it has been argued that professionalism arose to give security against capitalist employment instability rather than protect professional services users. [334] The professions serve as a means to achieve a gentlemanly life and acceptance as a member of the social elite.[335] The altruistic service ideal is in fact a strategy used to sustain public belief in professional ethicality. It allows anti-market and anti-capitalist principles to enter the market

[331] H Benson, 'The Professions and the Community' (1981) 51(4) The *Australian Accountant* 239, 240.
[332] The importance of independence for Australia registered auditors is further discussed in detail in Chapter 7 of this thesis.
[333] Elliott, above n 32, 104.
[334] Abbott, above n 260, 132.
[335] Duman, above n 285, 115.

in favour of the profession without uncomfortable questions being asked of its members.[336]

Anticompetitive professionalisation ideals can also assist the materialistic intents of already established practitioners. For example, the use of advertising restrictions may stop new entrants from establishing an accounting practice. Similarly, the entry requirements for professional membership are formulated to restrict the supply of qualified practitioners rather than provide an objective assessment of competence.[337] Rather than serve the interests of professional services users, these conventions have shaped and maintained professional accounting practice, protected practitioners through reduced competition, and allowed them to escape the vagaries of the marketplace.

4.4 Professionalism and the Expansion of the Audit Product

Nowadays, the word audit defines an expanding list of assurance and accountability activities which are generally carried out by the accounting profession. Audit has become a constitutive principle of social organisation. Audit represents a distinctive managerial and government rationality which is able to reconfigure social and organisational relations. The significance of audit is not founded in its definition or what audit practice amounts to in an operational sense, but rather how the idea of audit is appropriated and mobilised.[338]

Problems of organisational control have grown in scale and complexity in Australia alongside growth in modern business practices. The audit function has sustained organisational control by allowing the otherwise costly inspection of operations to be displaced by audit as a more distant review. Audit is a control sub-system that oversees organisational internal controls through testing and checking. In place of traditional direct managerial controls including supervisory and real time inspection, the audit function stands independent and distant from organisational processes. Audit has grown and developed as an

[336] Larson, *The Rise of Professionalism: A Sociological Analysis*, above n 19, 63.
[337] Randall Collins, *The Credential Society: An Historical Sociology of Education and Stratification* (Academic Press, 1979) 146.
[338] Power, *The Audit Society: Rituals of Verification*, above n 119, 300.

administrative rationality despite its lack of procedural transparency. The audit function is relied on by financial statement users despite the fact that audit procedure remains largely invisible from the public eye.

The accounting profession actively employs strategies to construct auditable subjects to make accounting environments auditable. In this sense, accounting systems and internal controls have been designed to require monitoring by auditors. This process is a further example of accountants seeking to control the market for their services and achieve closure through collective mobility. This thesis finds that control of the audit services market by accountants has allowed conflicts of interests to develop in their client relationships. Breached auditor independence has become common place as a consequence. The solution to the problem of conflicts and breached independence put forward by this thesis is to open the market for audit services. FSI is nominated as one means to achieve this. FSI is discussed in detail in Chapter 8 as one way to tap into those market forces that drive both insurance and the supply of assurance services.

4.4.1 Auditing and Accountability

The audit function is traditionally understood to be a means for ensuring quality control over an auditee's financial accounts. The auditee is visible throughout the periodic inspection of its books and records by an independent auditor. The word audit is derived from the Latin word audire, to hear. Early characterisations of the audit process required the party being held to account to defend their actions in person to an audience. The auditee was often visible throughout this aural defence, and the intimacy of that practice was similar to present day judicial conceptions of a hearing. This aural intimacy has been displaced by more distant approaches used in modern audit practice which now stand largely disengaged from these judicial origins.[339]

Agency relationships do not always allow for direct verification of an agent's activities by

[339] Ibid 301.

others. Agents are favoured by information asymmetries. A deviant agent may use the information that he or she controls to act against their principal's interests. In these circumstances, audits are monitoring technologies which arise naturally under conditions where agents can expose their principals to moral hazards. A rational auditee will voluntarily submit to an independent audit to make good offices visible. In the case of Australian public companies, laws are in place to regulate the relationship between company officers and shareholders including the requirement that an audit be performed. [340] An auditor is engaged in these circumstances to decide if the assurance and accountability requirements imposed on company officers have been discharged.

Notwithstanding that audit supervision can effectively watch over the principal and agent relationship, the audit process can also encourage problems of accountability rather than resolve them. Rather than acting as a natural response to the problems of accountability, the audit process itself may take a lead role in reinforcing the existence of the agency arrangements which it oversees. The range of audit subject matter has been expanded by accountants having discovered new problems in the relationship between company management and those who fund the company. This strategy is used by accountants to expand audit opportunities. It is also reflected and reinforced by economic theories of the corporation that depict a world in which action cannot be coordinated by trust alone. In this sense, audit can be regarded as a technology of mistrust that employs independent outsiders to restore trust. The audit of financial statements then gives a message of credibility to produce trust, while also generating a demand for yet more audit examination. Financial statement users have come to trust auditors more than the operatives they employ to manage business operations, and value auditor independence as much as the technical expertise that auditors possess.[341]

Financial statement audit has developed over time as a regulatory by-product of capitalism.[342] Audit processes have developed as a mobile technology across different organisational contexts. Audit has secured a role in Australian's economic systems that links

[340] *Corporations Act* s 301.
[341] Power, *The Audit Society: Rituals of Verification*, above n 119, 302.
[342] Montagna, above n 314, 104.

organisational internal workings to macroeconomic goals such as the smooth functioning of capital markets. The operational ambiguity and variability of audit processes has also assisted the expansion of the audit product to new areas of business. That inherent vagueness helps auditor service providers attach themselves to newly constructed auditable objects. The suitability of audit process to these new areas is then difficult to question or criticise. The audit product has become an all-purpose enabling technology which makes diverse regulatory programmes possible by using more distant oversight and assurance processes. [343]

4.4.2 Auditing and the Construction of the Auditable Object

Accountants develop processes and construct systems with the intention that they be audited. Their business model requires that audit activity be mobilised in the first instance as an entrée to future work types, with claims that improved accountability will result. Traditional audit processes require the collection of sufficient appropriate evidence to support conclusions made on the auditee's performance. Auditing standards guide an auditor during the course of this work. This approach assumes verification of an auditee's performance and compliance with reporting regulation is a simple task. In the case of financial statement audits, accounting standards also provide rules that standardise financial reporting which must be taken into account. This regulatory ideal of compliance with both audit and accounting standards is central to audit visibility and legitimacy, although compliance with them may not always be straightforward in practical situations. Officially, the audit function is neutral with regard to these standards; however, this understanding ignores the role that audit profession plays in constructing standards and imposing its definitions of quality within them.

Audit examination does not passively observe an auditee but rather constructs and inscribes the basis upon which an audit can be performed. In many instances, these inscriptions are imposed by legislation. For example, the Australian company law, taxation law and other pronouncements including accounting standards set out the financial reporting rules, and the

[343] Power, *The Audit Society: Rituals of Verification*, above n 119, 303.

requirement that proper books and records be maintained.

The system of audit knowledge in Australia is primarily procedurally based. Checklist compliance is typical of audit procedure. Although some audit practitioners contend that checklists impose unnecessary structure on the audit process and inhibit professional judgement, the checklist remains the norm even if not formally encoded into audit procedure. The ideal checklist inscribes best practice in order to produce complete and visible audit work, and thereby gives audit practitioners a defence against critics of their audit procedure. Over time, audit practice has attempted to link this procedural type knowledge base to higher and more abstract bodies of knowledge, hoping to confer scientific credibility upon audit processes. For example, statistical sampling techniques have been used to place auditing on a more scientific footing. Statistical technologies give audit a more scientific image because of the symbolic importance of sampling. Statistics are relatively unaffected by misapplication and can be used to make rational representations of the audit process.[344]

Audit is a risk management tool that allocates problems to particular classes of experts. New types of markets are created by redefining risk. More broadly, audits are mechanisms by which risk is represented for managerial purposes. Audit subjects are constructed around particular classes of risk, where that risk can be managed by systems of control.[345] Auditors must then test these systems and report on them. The importance of managing risk is further explored in Chapter 8, where a risk based insurance product is proposed as an alternative to the traditional auditor assurance function.

4.4.3 Making New Things Auditable

The financial reports produced by accountants influence business choices and support decision making more generally. Accounting systems in a broader sense function to legitimate individual and organisational behaviour, and support efficient and rational

[344] Ibid 312.
[345] Power, *The Audit Society: Rituals of Verification*, above n 119, 312.

choices.[346] The legitimacy of audited accounting information has been questioned in recent times given that the boundary between auditing and consulting services provided by the same practitioner is sometimes blurred. Breached auditor independence can for example result where an auditor provides non-audit services, a problem not adequately addressed by the accounting profession to date. Chapter 7 of this thesis examines this issue in greater detail in conjunction with a discussion on auditor conflicts of interest.

Auditing plays a leading role in the production of legitimacy and is used to install trust in financial statements. The accounting profession claims that audits produce greater levels of assurance and increased confidence in an audit subject. Audited financial statements are regarded as more reliable, and that this reliability in turn improves the efficiency of capital markets. The trust that financial statement users place in audit practice is just as integral to that assurance process as the technical judgement used to form an audit opinion.[347]

Auditing practice is in effect a self-regulating system which is aligned to economic, regulatory and political pressures. It responds to and facilitates change under the influence of these pressures. Although the conduct of auditing practices is largely predictable, the blueprints, idealisations concepts and definitions of audit practice continually shift to meet new situations. Under this development, audit practitioners create representations of problems to then offer solutions to them which are generally regarded as legitimate. Audit legitimacy is under a constant cycle of reform. During this evolutionary process, audit systems must change to ensure legitimacy of audit practice. Hence, the legitimacy of audit practice is threatened by misaligned expectations about what the audit process delivers. The audit expectation gap is a common term used to describe the gap between the public's expectations of auditor performance as opposed to an auditor's required standard of performance. The phenomenon is discussed in more detail in Chapter 6. Threats against audit product legitimacy bring about pressure to rationalise, formalise and provide greater transparency in auditing. As a consequence, the trend towards writing audit process into

[346] Michael K Power, 'Auditing and the production of legitimacy' (2003) 28(2-3) *Accounting, Organizations and Society* 379, 379.
[347] Ibid 380.

audit standards and technical guidance increases. [348]

The evolving nature of audit practice, the requirement that audit practice respond to new regulation, and the commercial motivations of some practitioners have seen audit practice extend to new areas. Auditing has become a legitimate part of good management practice in a wide variety of activities. The rise of assurance services and risk management are reinvention projects for audit and auditors in which aspects of the audit procedure are reconstructed for new or different purposes and mobilised with different vocabularies. [349] Any new areas of business which fall outside the protection afforded to registered company auditors are faced with competition from other professions and assurance providers. This expansive mix of traditional FSA, assurance type services and other business services creates a conflicted environment when provided at the same time. At a minimum, a solution is needed to control conflicted behaviour with respect to traditional audit services. This thesis proposes that the insurance industry take on the independent assurance role. Insurance providers could offer FSI to public companies as a market driven assurance solution which is free of self-interest, conflicts and breached independence.

The role of auditing and the audit process are not fixed or obvious. They are instead a function of specific political and managerial discourses which rely on legitimate audit practice to bring about change. If this point of view is accepted, then all forms of audit deliver more than a simple attest function. This chapter has discussed new roles for auditors, and the broader functional scope of auditing. The traditional attest function provides an important foothold for new roles that audit practice is asked to play. New objects and practices are made auditable and subject to assurance, as the old ways of managing and monitoring an organisation loose favour. [350]

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[348] Ibid 382.
[349] Brian T Pentland, 'Will Auditors Take Over the World? Program, Technique and the Verification of Everything' (2000) 25(3) *Accounting, Organizations and Society* 307, 308.
[350] Power, 'Auditing and the Production of Legitimacy' above n 346, 388.

4.5 Conclusion

Professions are characterised by a particular kind of authority, where the justification for that authority is founded in the occupational group's contribution to enhancing social order. The elevated occupational authority enjoyed by the professions gives them an exclusive right to define and provide specified services. The collective capability of members of an occupation is then mobilised to preserve that occupational control. Members define their profession together with their standards of work conduct and quality. They also determine the conditions of entry to and exit from practice. Professional service providers are primarily responsible for the suitability of their services given the special knowledge and skills they possess. The authority enjoyed by the professions is not generally given with formal accountability mechanisms by the community, but instead faith is placed in professional expertise and knowledge.

Most in the community presume that accountants possess special and exclusive expertise in connection with accounting matters. The accounting profession has constructed a mystique around accounting knowledge and the mechanisms by which membership is gained without any great state interference in that process. Challenges to accountant claims to a specialist body of knowledge have however become more common place. Against this background, audit has emerged as a principle of social organisation. Many audit practices have delivered new ideals of quality, governance and accountability. While audit technologies support managerial communications about performance, the performance of audit itself remains ambiguous and subject to dispute. While auditors are appointed by a company's shareholders' and report to them, auditors do not take instruction from shareholders. The ability of shareholders and other corporate stakeholders to evaluate the quality of audit services is also restricted. Quite often the only measure of audit quality comes from subsequent events that show whether an audit was performed at a reasonable level. Given this reliance by shareholders and others, confidence in the audit process requires that faith be placed in auditors as trusted experts who find themselves situated at the dead end of accountability

Core values of organisational transparency, quality and accountability are supported by the audit function. The submission of a subject to audit establishes legitimacy regardless of the operational substance of how the audit is performed. The audit product is used by markets, entrepreneurs and regulators given its mobility and diversity of application. Audit practices allow newly perceived difficulties and dangers to be treated and reconciled to managerial and economic practice. But alongside this emphasis on trust in auditing, instances of auditor conflicts of interest persist. Auditors are routinely discovered to have breached the trust placed in them. The profession in these cases has stepped outside the terms of its social contract with the Australian community. Chapter 5 now connects the earlier analysis of ethical theory to the theory of the professions set out in this chapter, to cover off ethical theory in the context of the Australian accounting profession.

Chapter 5: Ethical Behaviour and the Accounting Profession

5.1 The Importance of Ethics for the Accounting Profession

In addition to the import role ethical behaviour plays in business, ethics has a critical function when an auditor is called to attest to truth and fairness of financial statements. The audit product is of greatest use when an auditor conducts him or herself in an ethical manner, and so imputes credibility into financial statements. Ethical conduct within accounting and assurance engagements is essential for financial market operations given that misstated and falsely assured financial reports are unreliable. Participants in capital markets cannot rely on an auditor's attestation if the auditor is perceived to be unethical. As such, an auditor must not only exercise that level of skill and competence necessary to detect financial statement misrepresentations and omissions, but must also possess the ethical qualities required to render an honest opinion.

Questions about the accounting profession's ascendancy are common, together with whether professional status is deserved given these doubts exist. Chapter 4 of this thesis found accounting to be generally accepted as a special profession. Former United States Chief Justice Warren Burger agreed with this view as can be seen in his comments on the special nature of the audit function performed by accountants:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

> The demand for ethical auditors is derived from the demand for truthful financial statements.[351]

Unethical conduct generally involves self-centred behaviour which can inflict economic harm on others. This conduct is characterised by a self-interested individual who prefers a course of action that brings personal benefit while at the same time risking loss or damage to others.[352] Notwithstanding that outcome, elements of self-interest are positively expressed in some economic models constructed around the rational agent of a self-interested individual. In the context of public companies, agency theory is centred on the self-interest of shareholders who seek to maximise the value of their shares. Both audit and accounting products are devices used by company management in their role as shareholder agent to validate their managerial performance.[353] Given the divergent motivations that exist under these agency relationships, the audit of Australian public company accounts is carried out in an environment of self-interest and disparate incentives. Auditor conflicts of interest are fuelled by competition between suppliers of audit and accounting consultancy services, against a backdrop of competing stakeholder's interests.

Investors and others who fund public company operations cannot directly observe the behaviour of officers employed to manage the company's business. They are unable to see if the company directors act according to their fiduciary and contractual obligations. Management will thereby engage registered auditors to attest to the veracity of corporate disclosures given this restricted view.[354] Auditors appointed to that task must decide if material misrepresentations are present in the company's financial statements and report on them as required. Organisations that employ a high concentration of unethical agents will demand a relatively greater investment in external audit resources. An auditor must be

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[351] *United States v. Arthur Young & Co* (1984) 465 U.S. 805, 817-18.

[352] This definition of unethical behaviour is generally articulated or implied in the economic literature; see Kenneth Koford and Mark Penno in Norman E. Bowie et al.(eds) *Accounting, Principal-Agent Theory, and Self-Interested Behavior, in Ethics and Agency Theory* (Oxford University Press, 1992) 127.

[353] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 45.

[354] See also the statutory requirement, s 301 of the *Corporations Act* which mandates that certain companies must appoint an auditor to report on the truth and fairness of their accounts.

without conflict when performing that function, or additional agency costs will be incurred by the organisation.

This chapter expands upon the Chapter 3 discussion on ethical theory, to focus on the ethics of the accounting profession and the audit function more particularly. The ethical framework of *APES 110: Code of Ethics for Professional Accountants* ('APES 110') is also discussed as the moral and ethical standard prescribed for auditors in public practice.

5.2 Ethics and Public Company Management

A principal must be able to rely upon their agent to act in good faith. In practice, agents exhibit varying degrees of ethical behaviour. The ideal relationship between principal and agent in the public company context would allow shareholders to directly observe manager behaviour. The most preferable arrangement is for shareholder and manager incentives to be perfectly aligned. In these circumstances, the interests of the shareholders can be projected across the organisation to influence the conduct of company officers and employees towards shared goals.

If a board of directors believes its management or employees are of low ethical standing, it is forced to direct additional resources towards improving the systems that control and monitor behaviour. This course of action is intended to avert the potential costs of self-interested behaviour by implementing internal controls and surveillance systems. Conversely, higher standards of management ethical behaviour will realise surveillance system cost savings. A corporation showing higher ethical standards will need fewer internal control systems and demand less internal and external audit services to monitor the conduct of management.

AUS 402 Risk Assessments and Internal Controls ('AUS 402') makes reference to the internal control structure of an audit body at paragraph 18, and provides that:

> The auditor should obtain an understanding of the control environment sufficient to assess its effectiveness. When conducting this assessment, the auditor should concentrate on the

> substance of management's policies, procedures, and related actions rather than their form. Management may establish appropriate policies and procedures but not act on them.

Paragraph 19 of AUS 402 gives further assistance. Under that paragraph, an organisation's control environment consists of factors that include management's philosophy and operating style. Management is responsible for devising and maintaining organisational internal control structures. In carrying out its supervisory responsibility, management will ordinarily review the adequacy of internal controls on a regular basis to ensure that all significant controls are operating effectively. Management's philosophy and operating style will greatly influence the control environment. When carrying out an environmental assessment, an auditor must consider management's attitude toward risk-taking, financial reporting and control. Some typical indicators of management's attitude include the manner in which accounting policies are selected, the systems put in place for monitoring and enforcing control procedures, and the conscientiousness with which accounting estimates are developed.

A company's financial accounts are a reflection of management performance. Along with the legislative requirement to report, company management engage auditor capability to attest to the truthfulness of financial statement disclosures and the success (or otherwise) of their performance. An audit must be planned according to Auditing Standard ASA 300,[355] while also taking account of ASA 315, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement* and ASA 240, *The Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report*. Using this guidance, an auditor must form his or her view on the concentration of unethical agents employed by an organisation in the conduct of its business activity. That assessment will then impact upon the level of external audit resources needed to examine the auditee.

Reduced audit sample sizes and less audit testing are more likely where higher levels of management ethical behaviour are found. An auditor who finds the audit body's

[355] Refer to Auditing and Assurance Standards Board, ASA 300 *Planning an Audit of a Financial Report*. (at April 2006).

management morally principled will assess lower levels of audit risk to exist, and thereby expend less effort in forming an audit opinion. In addition, a company perceived by financial markets to be an ethical institution and free of unethical elements will benefit from increased share values. Capital markets assign value to the saved agency costs from reduced levels of internal control oversight and less audit service fees, so that accounting controls and ethical conduct are viewed as economic substitutes.[356] Credible auditor attestation is both objective and neutral. The audit procedures performed to detect misrepresentation must be convincing and apparent to financial statement users. The overarching requirement is that auditors carry out the audit function free of conflicts of interest, the incidence self-interested behaviour, or collaboration with management. These conflicts and types of behaviours would otherwise diminish the audit body's financial statement credibility.

As seen in the examples of accounting irregularity referred to in Chapter 2, some auditors continue to breach their fiduciary duties even though legislative deterrents against conflicted behaviour are in place. There is in fact little evidence that increased fines and imprisonment terms cause any more than a marginal improvement in auditor behaviour.[357] Given the inadequacies of regulatory reform, this thesis proposes that market incentives offer a more effective means to elicit ethical conduct. A market based approach to rectify conflicted auditor behaviour is discussed in Chapter 8, where the concept of financial statement insurance ('FSI') is introduced as a means to assure financial reporting in the Australian context.

5.3 Ethical behaviour and the Accounting Profession

5.3.1 Ethics and the Professions

It is not only philosophers and theologians who develop ethical theory and systems. Other

[356] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 46.
[357] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 47.

groups within society have formed rules of conduct referred to as codes of ethics. The rules of the accounting profession in Australia are contained in *APES 110 Code of Ethics for Professional Accountants* ('APES 110', or 'the Code'). The Code represent one such attempt to systematise the principles of an occupational group engaged in a common activity. The status of codes of conduct was addressed in Chapter 3 [358] in the context of descriptive ethics, while Chapter 4 explored the rise of accounting as a profession in some detail. The nature of professions is now briefly discussed to provide background to APES 110 to give context to the Code's purpose and the key principles it espouses.

One useful definition of a profession is:

> The term refers to a group of men pursuing a learned art as a common calling in the spirit of public service - no less a public service because it may incidentally be a means of livelihood. Pursuit of the learned art in the spirit of public service is the primary purpose.[359]

The spirit of public service aspect of this definition implies that a member of a profession will seek to promote or preserve the public interest. A professional person who moves in the spirit of public service but also harms public interest is thereby open to accusations of insincerity. He or she may be held to account for failing to understand what professional commitment amounts to. A professional practitioner is distinguished from other more commercially minded occupations given that he or she:

> ... must at all times place the responsibility for the welfare, health and safety of the community before their responsibility to the profession, to sectional or private interests, or to other members of the profession.[360]

According to this view, professional status hinges on the notion that professionals make a bargain with society and promise to serve the public interest, even if to do so may at times be

[358] See section 3.6
[359] Pound, above n 261.
[360] Australian Council of Professions, *Professional Services, Responsibility and Competition Policy: a Discussion Paper Prepared for the Permanent Advisory Committee* (August 1993) 1.

at their expense. In return, society allocates certain privileges to the professions which may include the right to self regulate, the exclusive right to perform particular functions, and special status.

A professional person who supplies accounting services must exercise a high degree of technical competence given that he or she owes a duty of care to the client, the community, and to other members of the accounting profession. Notwithstanding that requirement, forces of greed may influence an individual's integrity. Other powerful factors may also threaten ethical conduct which include the desire to carry on a viable accounting practice against competition from other suppliers of professional services. In these circumstances, ethics may become a luxury that no longer can be afforded, particularly if business operations are put at risk. These types of threats cause some practitioners to approach the law as a boundary to be tested. The letter of the law is taken beyond the legislator's intention by accountants who adopt a legalistic viewpoint which ignores the spirit of the law.

Professions are generally self regulated, where that framework of rules is intended to protect the community against excesses of member behaviour. The accounting profession has been active in this regard under a co-regulatory approach which requires its members to abide by the provisions of APES 110. Regulatory intervention (including codes of conduct) may however diminish ethical behaviour given that an authority has taken it upon itself to tell practitioners what is right and wrong. For example, APES 110 gives instruction on ethical behaviour to thereby alleviate the burden of individual decision making. As a consequence, members of the accounting profession are made less responsible for their actions if they adhere to the Code. They can argue that legislative authorities and the professional bodies have made the rules of conduct, so that their compliance with them is the only matter for individual concern.

A further shift in decision making responsibility is found where consumers of professional advice avert criticism, blame and penalty for their actions. Here, accounting services users seek to insulate their responsibility and take cover under the cloak of the professions. In these

circumstances, consumers may claim that they had relied on professional advice if their transgression is discovered. Responsibility is thereby deflected by alleging that the law was inadequate or the profession is responsible for the advice it gave. The profession in these situations is claimed to have approved and facilitated an ill-regarded course of action.

An accounting client may at times seek advice on options or treatments that achieve an outcome beyond the law's policy intent. For example, a tax advisory client may wish to plan for the tax consequences of disposing of an asset or the exit of a business arrangement, and so may seek out a scheme that avoids taxation. The taxation advisor in this situation may be asked to provide a broader view of taxation outcomes which lie outside the accepted view of the Australian Taxation Office. If actioned, this advice may risk the application of the general avoidance provisions of Part IVA of the *Income Tax Assessment Act (1997)*.[361] The advisor in this situation must decide whether to provide advice that facilitates non-compliant behaviour, or dissuade the client from a reckless course of action. Some consumers of accounting services will however pursue a course of action irrespective of the harm it might cause, and so engage an accountant who is prepared to assist them with their arrangement. The temptation to acquiesce with a client and operate outside professional standards of behaviour is more likely to arise in a conflict of interest situation. Chapter 7 of this thesis considers the application of APES 110 to auditor independence situations. It finds APES 110 to be a useful reference point, and that its guidance has been largely internalised by members of the accounting profession. Although the Code seeks to ensure that certain types of actions will not be performed by members of the profession, the chapter concludes that it has not been completely effective in that regard.

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[361] Part IVA of the *Income Tax Assessment Act (1997)* (s 177A to 177F) ('Pt IVA') applies to schemes entered into with the sole or dominant purpose of obtaining a tax benefit.

The language used in the provisions is extremely wide, and practical application of Pt IVA depends on the Commissioner making a determination in accordance with the powers conferred under s 177F. The Australian Taxation Office will only exercise these powers where it considers that a scheme is blatant, artificial or contrived, although it is somewhat uncertain which schemes would be treated as falling within that description.

5.3.2 Accounting as a Profession - the Social Contract

Member compliance with APES 110 helps to reduce the incidence of disciplinary action against accountants. It also ensures that the practice of accounting has proper regard to community wellbeing. The accounting profession occupies a privileged position in Australia. The business community relies on accounting products to support business operations. Complex business structures and dealings call for strategic advice and technical skills to match, but this complexity also brings opportunities for unethical behaviour and conflicts of interest with it. Members of the accounting profession are expected to go beyond merely providing technical advice to embrace their responsibility as a financial market gatekeeper. As such, accountants must direct their clients toward those courses of action that meet community expectations, rather than succumb to self-interest and the desire to maintain a business relationship. Accountants could otherwise be thought of merely in terms of the services they supply, where the proper means by which an outcome is achieved is set aside in favour of getting the desired result. This more limited functional view of the accounting profession tends to emphasise outcomes rather than the ethical nature of the approach to be followed. [362] Chapter 4 considered the rise of the accounting profession in detail. Some general discussion on the role of professions in society is now covered for background, before examining the ethical rules contained in APES 110.

Professions do not have a right to exist. It is important to note that the existence of a professional association is a contingency and not a necessity. A profession is not the product of a law of nature but rather a social artefact. Although many people are engaged in occupations that require them to have an excellent knowledge and understanding of the discipline that employs them, these occupations are not necessarily professions. These individuals may be able to attract clients who recognise their capability and are willing to pay for their learning and skill, but nonetheless this commercial activity does not amount to a

[362] Longstaff, Simon, *An Ethical Dilemma for Accountants* (March 1997) St James Ethics Centre <http://www.ethics.org.au/ethics-articles/ethical-dilemma-accountants>.

profession. [363]

To achieve occupational profession status, people must voluntarily come together to form an association which society allows to survive. The longevity of a professional association then needs several conditions to be present. These conditions are not mutually exclusive, and a professional association may develop over several phases where its professional status may change over time. At any moment, a sufficiently powerful force can obliterate a profession or a profession can destroy itself when its internal supports have decayed. Internal conditions that support professional status include:[364]

- a continued reason for the association;
- the membership of the association remains committed to its preservation;
- a decision-making process able to resolve and manage internal disagreements and chart new directions.

In addition, external conditions require that an association:

- is relatively insignificant and therefore escapes attention;
- is conceived by society as an expression of itself;
- is perceived to offer no threat to society;
- is believed to offer positive benefits to society;
- falls under the protection of a sufficiently power force to shield it from attack;
- is sufficiently powerful to ward off any attempt to curb its status.

These external conditions emphasise that an profession's existence relies heavily upon the goodwill or indifference of the host society. The place of professions within Australian

[363] Simon Longstaff, *What Can Accounting Offer for Improved Ethics?* (February 1995) St James Ethics Centre <http://www.ethics.org.au/ethics-articles/what-can-accounting-offer-improved-ethics>.
[364] Ibid.

modern democracy thereby gives sovereignty to the people, as the community has the power to dissolve an association and take away its professional status. [365]

Australian society is founded on the idea of equality of all rather than positive discrimination in favour of one group over another.[366] Given that communal goal of equality, society's decision to tolerate an association is difficult to understand. A profession is an occupation group whose members are permitted to enjoy privileges not available to others. These groups are however accepted by the community, as they are established to redress some acknowledged wrong or promote the interests of the community. Privileges are given to the professions in return for social goods that would not otherwise be available. The idea of a social contract between society and an occupational group or associations is an important element of the relationship between the professions and society.

As already noted, some occupational groups use internal standards to regulate member conduct and their dealings with society.[367] These groups are not necessarily considered to be professions. The distinction between professional groups and these other occupational bodies is founded on the idea that professionals develop a particular appreciation and understanding of some defining end. Professionals must give their service in the disinterested pursuit of these ends. In this regard, the distinctive end of the accounting profession is the pursuit of truth. More particularly, auditors must conduct an examination to attest whether financial accounts present a true and fair view.

Membership of a profession brings a range of commitments with it, so that the privileges associated with professional membership may on occasion not outweigh the associated obligations. In addition, the benefits that flow from society to a profession are not always equally divided amongst its members. In many cases the proper fulfilment of obligations as a member of the accounting profession will require sacrifices to be made. Accountants must suppress their normal desire to place self-interest before the interests others when

[365] Ibid.
[366] Ibid.
[367] See section 3.6.

discharging their professional obligations. Honouring that societal responsibility may prove difficult where accounting products are supplied in a competitive market place, and where the pursuit of self-interest represents the ideal economic model. [368]

Society is qualitatively improved when its members act in the spirit of public service and are held accountable to their peers for not doing so. This aspect is particularly relevant to the accounting profession's response to cases of audit failure and corporate collapse. With respect to these cases, one view is that the pursuit of self-interest has caused accountants to take on conflicted positions. The Enron Corporation ('Enron') and HIH Insurance Ltd ('HIH') corporate collapses discussed in Chapter 2 clearly demonstrate this. Creative accounting practices were used in both these cases to disguise the true state of financial affairs. Here, unethical and self-interested behaviour cascaded down several layers of trusted advisors who were engaged to protect stakeholder interests. During the demise of these corporations, the individuals involved did not respond to the wreckage they saw unfolding before them, nor did they hold their peers to account for their actions.

Unethical accountant behaviour reduces community trust in the accounting profession. The community can no longer rely upon informal canons to control behaviour, and so must resort to more formal mechanisms of regulatory intervention and surveillance. Somewhat ironically, that intervention tends to weaken the community's ethical bonds with the profession. Reliance on regulation leads to an abrogation of responsibility. [369] A regulatory response is also generally accompanied by increased compliance costs. [370] These costs include increased agency charges and taxes, and the social cost of more regulatory surveillance. One example of this is the Financial Reporting Council's[371] new role in

[368] Longstaff, *What Can Accounting Offer for Improved Ethics?*, above n 363.
[369] Ibid.
[370] 'Compliance costs' are defined as 'the direct costs to businesses of performing the various tasks associated with complying with government regulation' (see Commonwealth of Australia, *Best Practice Regulation Handbook* (2007) 26). Compliance costs include planning and administration, in addition to the direct time and costs incurred completing documents and forms, and lodging them with government agencies.
[371] The Financial Reporting Council is the peak body responsible for overseeing the effectiveness of the financial reporting framework in Australia. Its key functions include the oversight of the

monitoring registered company auditor compliance with ethical regulation. [372] New regulation of this type causes a shift in ethical responsibility. Regulatory intervention frees professional practitioners from the burden of deciding an ethical position. An authority has now taken responsibility to instruct practitioners as to what is right and wrong, and to then monitor their compliance with these rules. Members of the accounting profession become less personally responsible where they follow an authority or professional code of ethics without question, to shift responsibility for any ethical failing back to the rule maker.[373]

5.3.3 Capital Markets and the Accounting Product

Capital markets require that the financial position of investments be truthfully told and attested to. Information users need independent verification of the data they use for decision making purposes to ensure it is reliable, and that their decisions are made on a properly informed basis. Accountants have accepted that assurance role to report on whether financial information is true and fair. Accountants must maintain a particular orientation to the truth when performing this role. From a practical aspect, accountants must channel the tide of reliable information to users and allow it to reach its full flow.

The primary objective of accounting standard setting in Australia is to provide direction to accountants for them to produce financial reports that accurately reflect business performance. That information can also lead to reduced costs of capital from an international perspective. Reduced funding costs for Australian companies helps them compete on a more equal footing with their international competitors. Australian company participation in emerging global markets and cross-border financing requires that Australian regulation

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accounting and auditing standards setting processes for the public and private sectors, monitoring the effectiveness of the auditor independence regime, and advising the Minister on these matters. It is a statutory body under Part 12 of the *Australian Securities and Investments Commission Act 2001*.

[372] As a further example, increased professional services compliance costs have been brought about by amendments to *Corporations Act* s 300 (11B) commencing 1 July 2004. More detail must now be captured and reported. A company's annual directors' reports must now disclose the details of auditor provided non-audit services, to bring about additional record keeping and compliance costs more broadly.

[373] Longstaff, *What Can Accounting Offer for Improved Ethics?*, above n 363.

(including accounting standards) be in step with the regulation of its trading partners. [374] In addition, to achieve confidence in Australia's capital markets, investors must perceive financial reporting and the accounting standards that underpin them to be soundly based and aligned with overseas capital markets.

Accounting standards can guide the preparation of accurate financial information to allow financial performance comparisons across several entities. These standards promote investor confidence and market integrity, to thereby reduce the costs of capital.[375] While the owners of an enterprise bear the direct costs of compliance, they are also the ultimate beneficiaries of a well informed market through reduced funding costs.[376]

Chapter 2 highlighted the variation and discretion allowed in financial reporting under the Australian accounting standards. This fact seems to be largely ignored by capital markets. The accounting approaches used are generally accepted by the market place. Public company accounts are in the main perceived to be prepared on a consistent basis and accounting rules are generally understood to be complied with by most accountants. In reality, this is there is no alternative but accept the year-end reports as published even though underlying inconsistency may exist.

5.4 Ethics and Auditing

This chapter has largely focussed on the importance of ethics for the accountancy profession. Attention is now directed at ethical considerations of those accountants who act as registered company auditors in Australia, and how they are governed.[377]

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[374] Commonwealth of Australia, *Accounting Standards Building International Opportunities for Australian Business, Corporate Law Economic Reform Program Proposals for Reform: Paper No. 1* (1997) 13.
[375] Ibid.
[376] Ibid 16.
[377] To register as an individual registered company auditor, a person must meet the requirements in s 1280 of the *Corporations Act*, to register a company as an authorised audit company, a company must satisfy the registration requirements of s 1299B of the *Corporations Act*.

At a simplistic level, ethics in auditing can be achieved where moral and capable people become members of the accounting profession and are suitably trained to manage the temptations they face. Beyond that base level, a code of ethics lays down the minimum standards of professional conduct including a complaints and disciplinary process to deal with errant behaviour. Provided that an auditor has the necessary expertise to perform an engagement, it is then assumed that ordinary moral sensibility and the good example set by senior colleagues will ensure their ethical behaviour. That understanding of ethics requires professional firms to manage the risk of the occasional illegal activity and the improbable likelihood of liability or reputational damage that may result from it. This limited view of auditor ethics is centred on compliance with generally accepted principles of professional conduct. It falls short of community expectations that ask for more from a professional person then mere rule following .[378]

Chapter 2 discussed the demise of Enron in the United States and HIH in Australia. The chapter emphasised that the ethical conduct of an auditor cannot be taken for granted. In these cases, accounting and assurance practices were shown to be deficient, impaired and in some cases unlawful. A crisis of public confidence in the accounting profession followed these events to lessen the value of the audit product. The combination of corporate insolvency and audit irregularity causes business community mistrust in accounting and audit assurance services. On one view, audit failure is explained as atypical lapses caused by a few immoral individuals. That view assumes ethical problems arise from a practitioner who on occasion fails to abide with agreed professional standards of conduct. To focus on auditor ethics by reference to audit failure is too narrow, and becomes distracted by calls for regulatory intervention. Looking beyond this type of reaction, there is general agreement that moral values and virtues, truthfulness, honesty and the requirement to be law abiding are essential to ethical behaviour. A determination on auditor ethics cannot simply be based upon an auditor's capacity to follow standards, detect fraud, corruption and other criminal conduct.

[378] Campbell, above n 312, xxi.

5.4.1 Ethical Decision Making in Audit Practice

Ethical issues are faced at the individual level (as an auditor in practice); by accounting firm management when dealing with practice matters and cultural issues, and when regulators set auditing standards and laws relevant to audit. The requirements of virtue, integrity, objectivity, independence, confidentiality, upholding technical and professional standards, competence and due care found in APES 110. They are relevant to all audit activity and situations that auditors will find themselves in.

At the individual level, ethical decision making can appear straightforward. An auditor must act with care to diligently and punctually act in accordance with audit standards and professional body procedure. Deciding upon a course of action may then involve a calculation of the costs and benefits attached to each alternative. When carrying out that assessment, an auditor may discover conflicts of interest, particular obligations to audit team members and employers, and duties to clients and others who rely on the audit. Taking a moral position requires that an auditor considers other people, rather than just his or her individual gain and loss. Yet there is a powerful moral tradition that endorses a duty to oneself which must be balanced against duties to others. Every system of morality has a place for legitimate self-interest.[379]

The application of APES 110 principles at the audit firm level is however less simple. Morality may be tested if an engagement goes beyond the time allowed, or the complexity of procedures to be performed exceed the audit team's capability thereby rendering the audit task impossible. That incapacity may be disguised in order to avoid displeasing the client or the audit firm's management. A decision to conceal audit incapacity may be made to retain a client and not risk the loss of future income, or damage career progression prospects. The audit team may also choose to carry on assuming that their superiors would rather not be informed of procedural weaknesses. The ethical choices taken by an auditor in these circumstances are driven out of self-interest. The course navigated by him or her is a

[379] Ibid xxiii.

strategic exercise given that their decisions impact upon career advancement and material gain.

Auditors commonly face pressure to ignore irregularities or the problems they discover during the course of audit activity. That pressure is often exacerbated by conflicted situations, where a real or perceived threat to the auditor's commercial relationship with a client exists. A conflict of interest situation may develop where an auditor is financially dependent upon an auditee, where that compromised position sits at the core of an unbalanced relationship. An auditor's commitment to financial statement users and his or her social contract obligations more broadly are challenged where conflicted pressures are present. Notwithstanding those obligations, the legitimate need for an auditor to carry on a viable business introduces reasons to compromise on such matters.[380] Auditor conflicts of interest are examined in greater detail in Chapter 7, with particular focus on auditor independence in the case of auditor supplied non-audit services.

5.4.2 Ethical Theory in Audit Practice

As addressed in Chapter 3, the deontological approach to ethical decision making offers a robust platform to choose a course of action. A deontologist holds the view that morality is about duty, and duty requires not doing wrong to other people. Ethics according to the deontologist view is a matter of understanding and following certain general imperatives or rules, for example the Ten Commandments. Binding moral rules are independent of the consequences that come from putting actions into practice. It is not for a deontologist to calculate the consequences of truthfulness, but rather adhere to rule based ethics that bind individual duty under that view of ethics.[381]

The deontology approach is in direct conflict with consequentialism. Consequentialist actions are either right or wrong depending on the consequences that flow to those affected

[380] Ibid.
[381] Bruce Waller, *Consider Ethics: Theory, Readings, and Contemporary Issues* (Pearson Longman, 2005) 23.

by an action.[382] Utilitarianism is the most well known branch of consequentialism. Under utilitarianism, the consequences that morally matter are pleasures and pains. The morally right act is that action which maximises the balance of pleasure over pain, with each person's hedonic experiences given equal weight in that calculation. This view is summed up by Jeremy Bentham as 'the greatest happiness of the greatest number'.[383] Others have extended the consequentialist approach to include other types of consequences which are also relevant to moral calculations. Most typically, these consequences include wellbeing and wealth in an economics sense, either in monetary terms or with respect to consumer goods. All moral choices create tension between doing what is right according to established rules and deciding what is right according to the consequences of an action. Neither approach is more moral than the other. [384]

In addition, a combined moral approach has been put forward that includes a measure of both consequentialism and utilitarianism. Rule consequentialism attempts to strike a compromise between deontology and consequentialism, to avoid the problems of partiality and insensitivity. According to the rule consequentialism approach, an individual must follow pre-established moral rules when making a decision, but the rules themselves must be determined by consequentialist moral reasoning.[385] Under the rule consequentialist approach, departure from a rule is permitted if bad consequences are expected from the rule's application. Here, the balance between rules and their consequences is critical. Too much focus on consequences will undermine compliance with rules. Conversely, an absolute commitment to rules will drive away proper sensitivity to the consequences of an action. In addition, allowing an agent to choose between the rules and consequences opens the way for self-serving choices to be made. Many rules can be justified by the good consequences that flow from their application. However some rules have a non-consequentialist basis. In matters of private morality, each individual must decide when to ignore a rule or bend its

[382] John Stuart Mill, 'On Liberty' (1861) in A. D. Lindsay (ed.), *Utilitarianism, Liberty, Representative Government* (Dent 1910) 65, 170.
[383] See Jeremy Bentham, *Introduction to the Principles of Morals and Legislation* (Basil Blackwell (1823) 1948).
[384] Campbell, above n 312, xxv.
[385] Ibid.

application to suit their circumstances, although they must also accept the consequences when doing so.

Moral and practical constraints must also be balanced when making rules in an organisational setting. Organisations will generally issue internal rules of conduct or values, so that the individuals bound by them have less opportunity to take a personal moral stance.[386] Beyond the organisation level, further hierarchies of standard-setters including professional bodies and regulators have authority to set controls. These authorities ultimately culminate in the state which has the political right to establish legal rights and duties for all individuals and groups that fall under state authority.

Both deontological and consequentialism approaches can be found within the regulation of auditor conduct. In the case of the audit profession, an auditor will generally take a deontological or rule morality approach to the moral choices that he or she faces. In contrast, the Australian government and accounting bodies adopt a more consequentialist approach when setting rules. As the ladder of authority ascends from the individual auditor to authorities that set the rules, moral choices necessarily become more consequentialist given that the rule making process must be more transparent and takes on issues of greater complexity.[387]

5.4.3 Ethical Rule Making for Audit Practice

The rule making hierarchy for Australian registered auditors, and regulation of their moral reasoning is similar to most institutional settings. The ethics of organisational life requires that members of a profession have a moral obligation to conform to organisational rules which they had no part in creating. Moral choices are determined by those at higher levels of authority, where more complex decisions are made for those at lower levels in the organisational structure. Membership of a professional accounting body is similar to societal citizenship more broadly, and carries a commitment to abide by the rules of the professional

[386] Ibid.
[387] Ibid xxvi.

body. [388]

The western tradition of morality however places emphasis on individual autonomy.[389] An individual must ultimately decide what is morally right and wrong, and whether he or she will conform to socially and institutionally authoritative moral norms. Notwithstanding there are moral reasons to abide by the rules of a group, at times there may be an overriding individual moral responsibility to accept or reject those reasons. In these situations, an individual may on balance judge the rules as immoral or perceive the consequences that flow from them to be morally unacceptable. Every moral agent has a duty to form their own view as to how they ought to act.[390] A defining feature of ethical behaviour is that no individual can entirely excuse themselves from that responsibility by claiming they followed professional rules, obeyed a higher authority, or merely followed the examples of others.

In keeping with this line of thinking, ethics in the case of a professional practitioner is about individual responsibility. Members of the accounting profession must publicly commit to values that transcend self-interest. This entails a collective obligation to uphold professional values and follow the rules of the profession in a manner that serves the values of the profession. This commitment carries a duty to resist and if necessary disobey those rules believed to be morally wrong. [391] It follows that all accountants and auditors no matter their level of experience or seniority have moral reasons to conform to the norms of conduct accepted by their profession. They have a further obligation to question those professional rules of practice when applying them. Members of the accounting profession must thereby apply an ethical attitude towards the rules of public practice even where they appear relatively straightforward.

Rule compliance might appear uncomplicated if rules are conscientiously and meticulously followed without need for practitioners to hold an opinion on their application. If this

[388] Ibid.
[389] Immanuel Kant, 'The Moral Law' in H. J. Paton (trans.), *Groundwork of the Metaphysic of Morals* (Routledge, 2012) 24.
[390] Campbell, above n 312, xxvi.
[391] Ibid.

approach is accepted, practitioner views on what the rules should be, and any departure from them by reason of individual moral interpretation, is unnecessary. This thinking supports strict and unquestioning obedience to rule authority rather than awareness of the rationales for the rules. [392] The rule rationales can be explained through education about their role in supporting professional service delivery. Rule awareness in this limited way promotes rule-following so that rules are understood, interpreted and implemented in particular circumstances in particular ways.

Some accounting procedures are purely computational and can be understood and applied without appreciation of their larger purpose. Other more high level procedures may involve more analytic processes, and require judgment rather than just the performance of a mechanical procedure. These more creative and flexible accounting practices can be misused. Those applying them may go beyond their intended purpose to intentionally misstate financial accounts. For example, accountants may adopt a creative approach when distinguishing between income and capital expenditure, or may construct an arrangement to treat an entity as a subsidiary[393] and consolidate that entity within the group accounts. Assets may as a result be overstated, liabilities understated, or a more favourable profit situation reported on.

The asset and liability categorisations reported in financial accounts must be booked on a consistent basis and in accordance with accounting standards and accepted principles. These accounting processes must be repeatable and allow for meaningful historical and cross-organisational comparisons to be made.[394] Consistent application of accounting rules is just as important as the rule content itself, and sends a message of rule compliance and accounting practice validity. Information users place value in financial information produced by accountants where standards have been applied on a consistent basis. Ethical rule interpretation and rule following can thereby impute value into accounting process and audit systems. For example, an audit procedure may require that an auditor test an audit body's

[392] Ibid xxvii.
[393] McBarnet, above n 158, 25.
[394] Campbell, above n 312, xxviii.

internal control systems. Greater assurance can be placed in the output of that system once tested and found to be compliant.

Compliance with accounting rules and the consistent application of accounting procedure allows for more meaningful and reliable comparisons between companies. The degree of accounting rule compliance thereby determines the reliability of the accounting product. Non compliance not only constitutes a technical accounting failure, but also represents a moral failure given that departure undermines the purpose of external accounting.[395]

Departure from professional standards can be caused by a variety of factors. These include incompetence, a lack of awareness, or an intentional deviation to misstate financial accounts. A common ethical problem faced by external accountants and auditors arises when the auditee's management seeks to misrepresent a financial position. Management may be driven to misstate the true financial position in order maintain or attract investment capital to a company or falsely signal increased profitability to capital markets. An auditor conflict of interest in these circumstances can help facilitate false reporting, given that the viability of an auditor's business may hinge on an ongoing relationship with the client.

The APES 110 rules against conflicted accountant behaviour are not primarily focussed on financial account presentation or inspection. They are instead formulated to counter the forces that cause auditors to depart from accounting and auditing standards, that may cause them to falsely assure data for personal financial interest. Australian auditing standards and company laws encourage both real and perceived auditor independence. These rules seek to position an auditor so that he or she will make objective assessments and express audit opinions on financial accounts which are free of conflicts. These rules restrict an auditor from taking a financial interest in an audited body, and regulate the circumstances in which he or she can supply non-audit services to an audit client. They further seek to ensure that the accounting and assurance processes are trustworthy and not contaminated by factors that

[395] Jack Maurice, *Accounting Ethics* (Pitman Publishing 1996) 18.

compromise auditor independence. [396]

Audit firms are subject to the same ethical duties as an individual auditor and so must also comply with accounting rules and standards. In addition, firms have a collective responsibility to provide and guide individual auditors during the course of their audit activity. That responsibility requires that adequate resources and training be supplied by the practice within a culture that supports integrity rather than profit maximisation. Audit firms must thereby implement quality control systems to ensure procedural and rule compliance, including compliance with auditing standards at both the individual and practice levels.

Until recently, Australian accounting and audit standards, and the rules for auditor independence were issued by a self regulated accounting profession. Under self regulation, audit firms and individual auditors were subject to the profession's governance. The large accounting practices that dominated the profession also controlled the regulatory process at that time to blur the practical distinction between accounting firms and accounting bodies. In these circumstances, self regulation itself can be perceived as a conflicted situation. To address the problems of self regulation, the Auditing and Assurance Standards Board ('AUASB') was established as an independent Australian Government statutory board under section 227A of the *Australian Securities and Investments Commission Act 2001*. The AUASB's functions include:

(a) making auditing standards under section 336 of the *Corporations Act 2001*;
(b) formulating auditing and assurance standards for other purposes; and
(c) formulating guidance on auditing and assurance matters.

Although the board is held out to be an independent body, its membership is still heavily laden with representation [397] from the accounting profession, and currently includes members from the large four accounting firms. These individuals are positioned to influence

[396] The rules for registered company auditor independence in Australia are discussed in Chapter 7.
[397] As at 1 January 2012, the Board's membership included Mr. Victor Clarke (Partner PricewaterhouseCoopers), Ms. Anna Crawford (Partner Deloitte Touche Tohmatsu), Mr. John O'Grady (Partner Ernst & Young), and Ms. Kris Peach (Partner KPMG).

the direction of audit standard setting in the accounting profession's favour. As such, the direction offered by these members continues to be perceived as biased in favour of accounting profession objectives. This moral hazard is now less problematic than under the previous self regulated approach. Government involvement in the standard setting process has however added a further layer of moral complexity. The political views held on ethical conduct by some board members will not be shared with the accounting profession. It is expected that some moral disagreement will continue under co-regulation given that registered company auditors are instructed to comply with legal requirements which may not always be aligned to their duties to their profession. [398]

5.4.4 The Importance of a Code of Ethics

The professions tend to set their own standards of competence, education and entry requirements, and rules to discipline members according to a written code of conduct or ethics.[399] These codes are binding organisational moral law used to:

- motivate through peer pressure, by setting out a generally recognised set of behavioural expectations that must be adhered to when making a decision;
- act as a permanent guide to what is right or wrong;
- provide guidance in ambiguous situations;
- not only guide the behaviour of employees, but also control the autocratic power of employers that direct their work effort;
- specify the social responsibilities of the professional business itself;
- police the ethics of a business.[400]

A code sets out standards that a profession expects its members to observe, and the kinds of issues that present ethical threats to a professional person in practice. It cannot replace a

[398] Campbell, above n 312, xxx.
[399] The Institute of Chartered Accountants in Australia, *CA Program Unit 1 Ethics and Business Application*, above n 25, 18.
[400] Duska, Duska and Ragatz, above n 60, 77.

conscience, make an ethically blind person see, or cause an ethically insensitive person to care about an issue. The principles contained in a code of ethics can be broad or specific.[401] It is not however practical for a code of ethics to give complete instruction on the entire range of ethical matters a professional person may face.

In addition to this, codes of ethics must be enforceable so that the statements of values they make are more than just motherhood statements. Codes must have content that can be breached, and the organisation that administers the code must have a mechanism to evaluate suspected breaches and impose sanctions where they are found. Codes of ethics help make ethical issues visible given that they set out the profession's standards for all to see.[402] Those outside the profession can judge it and its practitioners by the standards it publishes. In this regard, APES 110 is an instrument for accountability and responsibility. It affirms the identity of the accounting profession and declares that certain principles will be observed by the accounting institutions that have adopted the Code.

Chapter 3 of this thesis introduced the concepts of descriptive ethics and ethical standards as acceptable moral standards. Ethics in this sense applies to members of a group simply because they hold membership of an association. This chapter now considers APES 110 in detail. That discussion is then expanded in Chapter 7, where the Code's application to the problem of breached auditor conflicts of interest and auditor independence is considered in depth.

5.5 APES 110: Code of Ethics for Professional Accountants in Australia

Accounting standards represent the customary practice of the professional accounting community. They contain standards of conduct for members of the profession to follow when deciding a course of action. In Australia, the Accounting Professional and Ethical Standards Board ('APESB') has issued APES 110 for professional accountants. Prior to the board's establishment in February 2006, the Australian accounting profession was

[401] The Institute of Chartered Accountants in Australia, *CA Program Unit 1 Ethics and Business Application*, above n 25, 18.
[402] Ibid.

responsible for issuing the code of conduct and professional standards. The accounting profession transferred responsibility for the miscellaneous professional statements ('APS') to the APESB, which has since continuously reviewed and relaunched the Accounting Professional and Ethical Standards ('APES').

Auditing Standards and the Force of Law

The auditing standards issued by the AUASB are legislative instruments under the *Legislative Instruments Act 2003*, and as such have the force of law with respect to audits conducted under the *Corporations Act 2001 (Cth)* ('*Corporations Act'*).[403] The Australian auditing standards make reference to compliance with 'relevant ethical requirements' relating to audit engagements. The Accounting Professional Ethical Standards Board's APES 110 is generally understood to be a 'relevant ethical requirement' for these purposes. APES 110 applies to 'members', and defines a member to mean a member of a professional body that has adopted the Code as applicable to their membership. Members of the Institute of Chartered Accountants in Australia ('ICAA') and CPA Australia must comply with APES 110 issued by the APESB on this basis.

The Institute of Chartered Accountants in Australia and CPA Australia led the development of APES 110. In July 2005, the International Federation of Accountants ('IFAC') released its *Code of Ethics for Professional Accountants*. Under the terms of IFAC's membership, the ICAA and CPA Australia were required to use their best endeavours to implement the IFAC code locally. The task was commenced by a joint taskforce set up in September 2005 which was later transferred to the newly established APESB. The Code issued by the APESB is thereby based on the IFAC code of the same name. The APESB adapted the IFAC code to suit Australian circumstances by changing the IFAC wording where appropriate and inserting Australian content.[404] In addition, the APESB sought to ensure that the obligations

[403] Audits conducted under the *Corporations Act* comprise audits of companies, registered schemes and disclosing entities in accordance with Chapter 2M, or financial services licensees in accordance with Chapter 8 of the *Corporations Act*.
[404] Denoted by the letters AUST before each paragraph number.

of members under APES 110 were consistent with their obligations under the former joint *Code of Professional Conduct.*[405]

5.5.1 The Structure of APES 110

APES 110 is not a comprehensive or exhaustive list of what is or is not permissible. It leaves scope for member judgement, although that flexibility does not permit any type of behaviour. APES 110 is structured into three parts:

- Part A: General Application of the Code (ss. 100–150);
- Part B: Members in Public Practice (ss. 200–290);
- Part C: Members in Business (ss. 300–350).

Parts A and B are applicable to public company auditors in public practice and are most relevant to this thesis, although the Part C requirements for members in business is also discussed here for completeness.

5.5.2 Part A: General Application of the Code

The conceptual framework approach

Under the Code, the accounting profession is required to distinguish itself by its willingness to act in the public interest. That public interest responsibility is described in APES 110 as serving the collective community and institutional wellbeing. APES 110 further states that the accountancy profession's areas of public interest comprise clients, credit providers, governments, employers, employees, investors, the business and financial community, and others who rely on the objectivity and integrity of members to assist in maintaining the orderly function of commerce. [406]

[405] Commonly referred to as the F1 Statement.
[406] *APES 110, Code of Ethics for Professional Accountants,* para 100.1.

A conceptual framework is included in APES 110 which requires that members identify threats against the five fundamental principles of integrity, objectivity, professional competence and due care, confidentiality, and professional behaviour. The guidance offered by APES 110 is then structured around these principles which underpin the professional conduct of members and their employers, to guide their performance and service delivery.[407] These principles are now discussed.

Integrity

Section 110 imposes an obligation on members to be straightforward, honest and sincere in both their professional and business relationships. It requires that members not be associated with reports, returns, communications or other information that contains false or misleading statements, or statements of information furnished recklessly, or where information has been omitted or obscured.

Objectivity

Compliance with the principle of objectivity requires that members not compromise their professional or business judgement because of bias, conflicts of interest or the undue influence of others. Relationships that cause bias or unduly influence a member's professional judgement are to be avoided. [408]

Professional competence and due care

Professional competence is a core ethical requirement for all professionals. Competence and due care are internal norms of professionalism, and central to professional practice and client trust. [409] A knowingly incompetent accountant is by that very fact alone unprofessional given

[407] Ibid para 100.4.
[408] Ibid s 120.
[409] Ibid s 130.

that he or she may expose a client's interests to harm. That practitioner may engage in deception that risks bringing the profession into disrepute and destroy public trust. Alternatively where a member is unknowingly incompetent, responsibility rests with the standards and administration of the profession to control their work activity.

Confidentiality [410]

Many professions regard confidentiality of information as a highly important ethical requirement in the conduct of professional practice. Client information is likely to be produced and compiled during the course of professional practice. This information could be incorrectly or prejudicially construed by others external to the practice if it were divulged to them.

Accountants have a duty of care to protect their clients' records and keep that information confidential. This duty is conceptually different from their client's rights to privacy.[411] Client privacy is often regarded as an absolute principle, similar to giving a promise, which is binding no matter the consequences.

Where information is acquired as a result of professional or business relationships, s 140 of APES 110 requires that members do not disclose that information outside the firm or business. Confidential information may only be shared with colleagues for the benefit of the client, but not with others unless:

- that distribution is required by law; or
- written consent is obtained from the client; or
- exceptional circumstances justify the disclosure (e.g. public safety or welfare reasons require disclosure).

[410] Ibid s 140.
[411] The Institute of Chartered Accountants in Australia, *CA Program Unit 1 Ethics and Business Application*, above n 25, 21.

More broadly, maintaining confidentiality over client information secures client trust, and ensures that client records are kept properly and securely.

Professional behaviour

Members must comply with laws and regulations relevant to their practice, and avoid any action or omission that may bring discredit to the profession. In addition, members must not bring the profession into disrepute when marketing and promoting themselves. Members are expected to be honest and truthful, and should not make exaggerated claims about the services they offer, the qualifications they possess or experience they have gained. [412]

Members must also not make derogatory comments to their clients or others about the competence of other accountants, or disparage former employers or employees. If the accountant is aware of unprofessional conduct of a colleague, that behaviour should be brought to the attention of the relevant professional body, employer or other relevant authority.

Threats to compliance with the five fundamental principles

APES 110.10 sets out some circumstances that potentially threaten a member's compliance with the five fundamental principles. These threats are the:

(a) Self-interest threat: the threat that a financial or other interest will inappropriately influence a member's judgment or behaviour:

(b) Self-review threat: the threat that a member will not properly evaluate the results of a judgment made or service performed by them (or by another individual within the member's firm or employing organisation) on which the member will rely when forming a judgment;

[412] *APES 110, Code of Ethics for Professional Accountants,* s 150.

(c) Advocacy threat: the threat that a member will promote a client's or employer's position to the point that the member's objectivity is compromised;

(d) Familiarity threat: a long or close relationship with a client or employer may create a threat that the member will be too sympathetic to the client or employer's interests, or too accepting of their work; and

(e) Intimidation threat: the threat that a member will be deterred from acting objectively because of actual or perceived pressures, including attempts by others to exercise undue influence over the member.

The conceptual framework approach taken by APES 110 recognises that it is not possible to define every situation that will threaten a member's compliance with the fundamental principles. Accordingly, APES 110 offers a framework to assist members identify, evaluate and respond to threats to their compliance.

When a threat is identified which is clearly not insignificant, a member must apply appropriate safeguards to eliminate that threat or reduce it to an acceptable level such that compliance with the five fundamental principles is not compromised.[413] The safeguards used to eliminate or reduce threats to an acceptable level fall into the two broad categories of; safeguards created by the profession (legislation and regulation), and safeguards in the work environment.[414]

Safeguards created by the profession (legislation or regulation) include but are not restricted to:

- educational, training and experience requirements for entry into the profession;
- continuing professional development requirements;
- corporate governance regulations;

[413] Ibid paras 100.5-100.9.
[414] Ibid para 100.11.

- professional standards;
- professional or regulatory monitoring and disciplinary procedures;
- external review by legally empowered third parties with respect to the reports, returns, communications or information produced by a member. [415]

Work environment safeguards vary depending on whether the accountant works in public practice or works in a commercial environment. In either case, where the service to be provided will cause a threat, it must be declined or discontinued if safeguards cannot be implemented to address it.

As already mentioned, APES 110 adopts a principles based approach rather than a rules based approach. It does not attempt to define a set of exhaustive rules to follow. It instead alerts members as to how the threats of self-interest, intimidation and familiarity create conditions in which people might be tempted to act against the fundamental principles. It then provides direction on how safeguards can be used to overcome them.

5.5.2 Part B: Members in Public Practice

In addition to Part A, members in public practice must comply with Part B of APES 110. The areas covered in that part are:

Professional Appointments

A member in public practice must comply with s 210 of the Code when accepting a new client, new engagement or when there are changes to a professional appointment. In particular, a member must determine if the acceptance of a new client or engagement would create a threat to the member's ability to comply with the fundamental principles.

Where threats are found, consideration must be given as to whether safeguards can be

[415] Ibid para 110.12.

implemented to satisfactorily address them. A member is obliged to decline an engagement if safeguards against a threat are not available. In addition, a member must determine if they have the appropriate level of expertise and competency to perform the engagement. Section 210 also sets out the procedures to be followed for changes to professional appointments and the communication required to be had with an outgoing accountant.

Conflicts of Interest

Client independence is a significant and ongoing issue for the accounting profession. Many businesses and professions firms use internal controls and quality control systems to identify and deal with conflicts of interest. Although these systems are generally effective, they cannot stop all conflicted behaviour, so that both scope and opportunity for conflict of interest situations remain. These conflicted circumstances most frequently come about at the individual practitioner level, and are caused by a simple misunderstanding with respect to the existence of a conflict of interest situation and the problems that it may cause. [416]

Paragraph 220.1 of APES 110 requires that a member in public practice take reasonable steps to identify circumstances that pose a conflict of interest situation. Where circumstances threaten compliance with the Code's fundamental principles, a member must evaluate the significance of the threat and implement safeguards where possible.[417] Chapter 7 of this thesis considers these issues in more detail, and makes particular reference to ethical problems arising from auditor supplied non-audit services.

Second Opinions

A member in public practice may be asked to provide a second opinion for an entity which is not an existing client. These matters may include advice on a proposed accounting presentation or the interpretation of accounting standards, the application of auditing standards, or the application of other standards or principles to specific circumstances or

[416] Ibid s 220.
[417] Ibid para 220.2.

transactions. [418]

Giving a second opinion may threaten a member's compliance with the fundamental principles. [419] In these circumstances, a member in public practice must evaluate the significance of a threat. If it is not clearly insignificant, safeguards must be considered and applied to eliminate the threat or reduce it to an acceptable level.[420]

Fees and Other Types of Remuneration

Given that a member can determine the level [421]of fees rendered for a particular engagement, he or she may be tempted to quote loss leading fees or fees that are not economically sustainable. This approach to billing will create a self-interest threat to his or her compliance with the fundamental principles of professional competence and due care. Again, the member must adopt appropriate safeguards where such a threat is found. [422]

Contingent fees, referral fees and commissions are categories of remuneration used in accounting engagements. These fee arrangements may also cause a self-interest threat against the fundamental principle of objectivity. In these circumstances, members must again evaluate the significance of each threat and implement appropriate safeguards.[423]

Marketing Professional Services

Section 250 requires that members be honest when marketing professional services and not make exaggerated claims, disparaging references to the work of another member, or make false advertising claims that have potential to mislead clients.

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[418] Ibid s 230.
[419] Ibid para 230.1.
[420] Ibid para 230.2.
[421] Ibid s 240.
[422] Ibid para 240.1.
[423] Ibid paras 240.4-240.7.

Gifts and Hospitality

Members must only accept gifts which are clearly insignificant and do not create threats to their compliance with the fundamental principles. Section 260 recognises that a self-interest threat to the fundamental principle of objectivity may occur when a gift is accepted. Where threats of this type exist, a member must apply appropriate safeguards to eliminate or reduce them to an acceptable level. If it is not possible to reduce or eliminate the threats to an acceptable level, the member must decline the offer of a gift.

Custody of Client Assets

The holding of client assets may also create a threat to compliance with the fundamental principles. More particularly, holding assets may cause a self-interest threat to professional behaviour or self-interest threat to objectivity. [424] Paragraph 2701.1 requires that a member in public practice should not assume custody of client monies or other assets unless permitted to do so by law. If so, they must also comply with all additional legal duties imposed on members in public practice who hold such assets.

To safeguard against threats to the fundamental principles in these circumstances, a member in public practice who is entrusted with money (or other assets) belonging to others should:

(a) keep such assets separate from personal or firm assets;
(b) use such assets only for the purpose for which they are intended;
(c) at all times, be ready to account for those assets, and any income, dividends or gains generated, to any persons entitled to such accounting; and
(d) comply with all laws and regulations relevant to the holding of, and accounting for such assets [425]

Objectivity

[424] Ibid s 270.
[425] Ibid para 270.2.

Section 280 requires that members maintain their objectivity across all services that they supply. In particular, a member must remain objective with respect to his or her interests in, or relationships with a client's directors, officers or employees. Paragraph 280.4 offers the following safeguards where threats to objectivity are apparent:

- withdrawing from the engagement team;
- use of supervisory procedures;
- terminating the financial or business relationship giving rise to the threat;
- discuss the issue with the highest level of management within the firm;
- discuss the issue with those charged with governance of the client.

Independence – Assurance Engagements

Section 290 imposes a specific obligation on members who perform assurance engagements. When carrying out assurance engagements, a member must be independent of the assurance client in order to comply with the fundamental principles of integrity and objectivity. To be independent, a member must have:

> *Independence of Mind;* is that state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, and allows an individual to act with integrity and exercise objectivity and professional scepticism, and;
>
> *Independence in Appearance;* is the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information including safeguards applied, would reasonably conclude a firm's (or a member of the assurance team) integrity, objectivity or professional scepticism had been compromised. [426]

[426] Ibid para 290.8.

When performing an assurance engagement, a member must ensure the assurance team, audit firm and, where applicable, network firm are independent of the client.

Conflicts of interest and breached auditor independence are a significant and contemporary issue for auditors to manage. Chapter 7 of this thesis addresses this issue in detail.

5.5.3 Part C: Members in Business

In addition to Part A, members in business must also comply with Part C of APES 110. Although not directly applicable to auditors in public practice, these rules impact on members who produce information for auditor examination. The part addresses:

Potential Conflicts

Members in business have a professional obligation to comply with the fundamental principles of APES 110. In certain instances, a member's responsibility to their employing organisation and their professional obligations as a member of a professional body may be in conflict. For example, the member may be placed under pressure to act contrary to the law or a technical or professional standard, or to facilitate unethical or illegal management strategies. In these circumstances the member in business must consider if appropriate safeguards are available, such as obtaining advice either from within the employing organisation or externally. The member may also consider obtaining legal advice to help him or her determine a course of action. [427]

Preparation and Reporting of Information

Section 320 requires that members in business must prepare and present information fairly, honestly and in accordance with relevant professional standards. A member in business may

[427] Ibid s 310.

be pressured to associate him or herself with misleading information. Safeguards must be considered and applied to eliminate or reduce these threats to an acceptable level. Where it is not possible to reduce the threat to an acceptable level, the member should not be associated with information they consider is, or may be, misleading. Where this occurs the member may also seek legal advice or resign from the organisation in the worst-case scenario.

Acting With Sufficient Expertise

Members in business should only undertake tasks for which they have, or can obtain sufficient specific training or experience. Members should not intentionally mislead an employer as to the level of their expertise or experience, or fail to seek appropriate expert advice and assistance when required. [428]

Financial Interests

Section 340 recognises that members in business may have financial interests (or a family member may have financial interests) that could in certain circumstances give rise to threats to compliance with the fundamental principles. In these circumstances, members must examine the nature of the financial interest and evaluate the significance of their interest. Safeguards should be considered and applied to eliminate or reduce them to an acceptable level. The safeguards are described in paragraph 340.3. They include disclosure of all relevant interests and consultation where appropriate with superiors of the employing organisation.

Inducements

Section 350 considers circumstances when a member in business (or a family member) may be offered a monetary or other incentive which creates a threat to compliance with the fundamental principles. When a member or a family member is offered such an incentive or

[428] Ibid s 330.

inducement, the situation should be carefully considered before accepting it.

Self-interest threats to objectivity or confidentiality are created where an incentive is offered in an attempt to unduly influence a member's actions or decisions, encourage illegal or dishonest behaviour, or obtain confidential information. The significance of such threats will depend on the nature and value of the inducement, and intent behind the offer. If threats exist that are not clearly insignificant, safeguards should be considered and applied to eliminate the threats or reduce them to an acceptable level.

Ethical competence must be exercised by accountants when applying the provisions of the Code in order for them to recognise ethical questions and then make ethical decisions in response to them. Developing that ethical competence requires an individual to have adequate levels of sensitivity, awareness, knowledge and a conceptual understanding about ethics. APES 110 provides an important reference point that guides members of the accounting profession towards sound ethical decisions. Notwithstanding the Code provides a sound platform, accounting practice is built on unstable and conflicted business relationships which can undermine the Code's application.

5.6 Conclusion

Although most people are inherently ethical, many individuals find it difficult to recognise an ethical dilemma. Many people are not conscious of the fact that nearly all their actions have an ethical dimension, and even simple forms of behaviour are loaded with ethical significance. The appropriate response when faced with an ethical dilemma is to answer a fundamental question, namely, what ought one to do? Ethical theory underlies ethical decision-making to assist the resolution of ethical issues.

The Australian community has given elevated status and privilege to the accounting profession. In doing so, it expects that an accountant will not exploit others, but rather develop virtues of integrity and honesty, to practice a life with desirable quality. The

accounting profession has demonstrated a genuine commitment to ethics by adopting APES110. This Code has given the profession a sound platform of ethical rules as an essential reference point for the conduct of members.

Registered company auditors in Australia encounter ethical dilemmas on a daily basis. At the most basic level, individual auditors might just be expected to work hard according to their contractual obligations and report on the problems they discover. Although complex moral questions must be answered in the course of that activity, these questions should not distract an auditor from his or her work. Formal and informal sanctions offer some protection from unethical conduct and acceptable behaviour. Under this restricted view, an auditor's duties are clearly stated, so that he or she should just do their best to fulfil them. The community's expectation is quiet different to this simple and inadequate approach to managing ethics. The audit role extends beyond this limited expectation. Auditors act as one of society's most trusted gatekeepers. Auditors are expected to protect and enhance the quality of life enjoyed by society as a whole. This responsibility amounts to more than a requirement to do no harm, it requires the auditor to do good and set an example for other members of the community.

It may be argued that ethical principles are largely theoretical and cannot be applied in practice. The five fundamental principles of integrity, objectivity, professional competence and due care, confidentiality, and professional behaviour inscribed in the Code are however important to modern audit practice. The fundament principles espoused by APES 110 are not an old fashion requirement, nor do they hark back to useful ideas of a bygone era. The accounting profession in Australia has useful guidance in APES 110 which helps it comply with its social contact and meet its societal expectations. But if professional status is to continue for accountants at its current level, the profession must be considered more than an enterprise association from which society merely consumes the audit product. Members of the profession must demonstrate a practical commitment to being ethical, and doing that which is right and good to help build and maintain an ethical society. This requires that members of the accounting profession must apply an ethical attitude towards the rules of public practice even where they appear straightforward.

Chapter 6: Auditing Governance and Accountability

6.1 Auditor Governance and Accountability

A key role of the auditor in society is to remove doubts about the quality of financial statements caused by agency problems. The audit function is an important mechanism used to improve the reliability of financial reports. Media reports on audit failures however detract from the credibility of this function. The examples of corporate failure cited in Chapter 2 have shaken the foundations of investor confidence in the transparency, integrity and accountability of corporations and capital markets more generally. There has also been public disquiet about the role that auditors have played in these corporate collapses. The immediate reaction of regulators worldwide has been to attribute blame to the auditors of these failed corporations. While society's expectations of auditors are high, the legal position is that auditors have a very specific and, to some extent, limited role. [429] Auditors are not the gatekeepers of corporate crime, nor are they responsible for the success or failure of a company's business operations and management.

A gap has existed for many years with respect to the level of assurance that auditors provide on management compiled financial information. The expectations of many investors and other financial statement users exceed an auditor's actual responsibilities. Many members of the public expect that an auditor should accept prime responsibility for the financial statements that they report upon. They further believe an unqualified opinion guarantees the accuracy of financial statements, and that an auditor will detect fraud, review all transactions, and give an early warning about possible business failure. Such expectations go beyond the actual standard of performance required of an auditor which has been developed at common law, and which is expressed in regulation and guidance found in the

[429] *In re Kingston Cotton Mill Co (No 2)* (1896) 2 Ch 279.

Corporations Act 2001 (Cth) (‘*Corporations Act’*) and professional standards. This difference in understandings has led to the term audit expectation gap.

The auditing profession contends that company management as the preparers of the financial statements are chiefly responsible for their content. Auditors provide an opinion on the fairness of presentation of financial reports for the purpose of adding credibility to them, but do not guarantee the solvency or financial performance of an audit client. Auditors plan and conduct an audit engagement with an attitude of professional scepticism; however the carrying out of an audit does not promise that fraud will be detected. Given these differing opinions, the profession has needed to devote substantial resources to increase the public’s understanding of the nature and inherent limitations of an audit. Recent efforts to close the expectation gap have focused on influencing public opinion and changing professional standards. These measures have been taken to ensure that audits are designed to provide reasonable assurance that material error, irregularities and misstatements within financial statements will be detected, and the public is made aware of this.

This chapter examines auditing from a legal perspective. It discusses the role of auditing in Australia, examines the audit expectation gap in light of recent corporate collapses, and proposes new measures to bridge the gap. Reform of the auditing profession alone is unlikely to solve the problem of corporate misconduct or prevent corporate collapse. It is clear that under the present environment of failed corporate governance, a gap has arisen because of failed communications and misaligned views on the roles and responsibilities of auditors. Any solution short of improving the audit product is likely to be unsuccessful. With this in mind, this chapter considers broadening of the scope of audit services, with a particular focus on expanding the role of an auditor to detect fraud. The later chapters of this thesis then consider stepping outside the traditional audit model. Financial statement insurance (‘FSI’) is offered as a solution to restructure stakeholder relationships and provide report users with additional information about the public companies in which they invest.

6.1.1 The Nature of Audit

The term auditor literally means one who hears. This designation has its roots in history at a time when public accounts were examined and read on an oral basis. The origin of auditing is connected with notions of corporate governance and accountability, and is a by-product of measuring the performance of an economic enterprise. [430]

Throughout most of its history and up until today, the objective of auditing practice has been to protect the owner of economic resources from fraud and error associated with the stewardship of those resources. The notion of stewardship requires that those responsible for the administration and handling of assets and managing the businesses must account to the owners of those assets and businesses. Thus in medieval times, the steward accounted to the owner and often employed a person to listen to the account and assess the reasonableness of that account. That person became known as an auditor. The primary purpose of the audit function at that time was directed at detecting the fraud or error of a steward acting as an agent for his or her principal, that is the property owner. It also served the complementary task of preventing the occurrence of fraudulent behaviour and misstated financial accounts. In these times, the distinction between the owner and entity was more obscure, and has only became more sharply defined when new forms of enterprise, other than sole ownership, were developed. [431]

Since these times, there has been considerable argument and disagreement about whether an audit is expected to detect fraud and error. A significant change in this regard came from a shift from the legislative requirement that accounts reflect a "true and correct" position.[432]

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[430] Arun Kumar and Rachana Sharma, *Auditing Theory And Practice* (Atlantic Publishers & Dist, 2001) 1.

[431] Derek Matthews, *A History of Auditing: The Changing Audit Process in Britain Since 1800* (Routledge, 2006) 142.

[432] The requirement for the balance sheet of companies adopting Table B of the 1856 UK *Joint Stock Companies Act* to show "a true and correct view" was continued until 1947, when the Cohen Committee's recommendation of "a true and fair view" was adopted. The *Victorian Companies Act* of 1955 was the first Australian Act to follow the 1947 UK amendment, which was generally adopted through incorporation in the 1961 *Uniform Companies Acts*.

The current legislative requirement is that the financial statements show a "true and fair view". [433] This requirement caused auditing to shift from being primarily directed at detecting fraud and error, to a position where the auditor must discharge the attest function. The attest function gives assurance that the financial statements are prepared in accordance with accounting principles, practices and regulatory obligations. [434]

The value of financial statement audit is supported by economic analysis and cost effectiveness. Basic economic theory is predicated on the idea that each economic unit (in this case investors and public company business operations) has perfect knowledge of the market they engage in. The most efficient economic decisions are made where an investor has full and accurate knowledge of the financial position of a potential investment. In a practical sense, prohibitive costs would ensue if investors and shareholders were to independently confirm the validity of financial statements. Audited financial statements are thereby a cost efficient means of addressing the information gap between the theoretical ideal of perfect knowledge and the practical reality that financial statements may not be a true and fair. Audited financial statements reduce the information cost of investors and shareholders in this way.[435]

The information dichotomy grows wider as ownership separates from management. This is particularly apparent in the case of publicly listed companies. In this situation, shareholders must place reliance on a company's board of directors as managers of the enterprise. The financial statements of those entities are more likely to be used by third party investors for decision making purposes. The wider effect of this agency arrangement is that properly audited financial statements will strengthen trust in, and the integrity of the free-market system. With such an onerous obligation placed on company auditors, it is inevitable that

[433] *Corporations Act* s 297.
[434] LexisNexis Butterworths, *Australian Corporation Law Principles & Practice,* (at service 182 - October 2012) [3.7.0185].
[435] Andrew Chan, 'The Modern Role of the Auditor in Corporate Governance Auditor Independence and the Proposals for Reform' *ALSA Academic Journal* (Australian Law Students' Association Inc, University of Sydney 2003) 21, 24.

intense scrutiny is directed toward auditor independence and ethical standards. [436]

6.1.2 The Audit Requirement

The audit requirement has been imposed since the earliest Australian company law statutes. The first Australian companies legislation included mandatory financial reporting requirements. The *Companies Act 1896 (Vic)*, was enacted in the wake of large-scale company losses, land fraud, and bank and building society failures. Section 28(1) of that Act stated that:

> No balance-sheet of any company shall deemed to be filed … unless the same shall have subscribed thereto or indorsed thereon a certificate signed by the duly appointed auditors that such auditors have audited the same and have certified to the correctness or otherwise of the said balance-sheet.

Section 301 of the *Corporations Act* provides the current statutory requirement that a company must have its financial report audited and must obtain an auditor's report on the findings of the audit. That section states that:

> (1) A company, registered scheme or disclosing entity must have the financial report for a financial year audited in accordance with Division 3 and obtain an auditor's report.
>
> (2) A small proprietary company's financial report for a financial year does not have to be audited
> if:
>
> (a) the report is prepared in response to a direction under section 293; and
> (b) the direction did not ask for the financial report to be audited.

An auditor must also comply with the objectives set out in individual auditing

[436] Ibid 25.

standards that are relevant to planning and performing an audit. Auditing Standard ASA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards* ('ASA 200') describes the objective of an audit is to obtain reasonable assurance that the financial report is prepared in all material respects in accordance with the applicable financial reporting framework, and to report on the financial report and communicate findings in accordance with Australian Auditing Standards.[437] The equivalent phrases used to express the auditor's opinion are to 'give a true and fair view' or 'present fairly in all material respects'.

Although the auditor's opinion can enhance the credibility of a financial report, ASA 200 states that users cannot assume that the audit opinion gives assurance as to the future viability of the entity nor the efficiency or effectiveness with which management has conducted an entity's affairs.[438] The audit objective as stated by ASA 200 is exclusively related to an attest function. The standard does require that the auditor obtain reasonable assurance as to whether the financial report when taken as a whole is free from material misstatement whether due to fraud or error, [439] although there is no mention of protection from fraud or error. Likewise, the objective of an audit is not directed towards the future, so that no predictions can be drawn from the auditor's report that future success will follow. Furthermore, although the purpose of an audit is targeted at the accountability of directors, the auditing profession restricts its review of that accountability to an examination of mainly historical matters.

For audit to be of value to financial information markets, the attestation of public company accounts must be competently undertaken and executed by those with relevant audit expertise. An auditor must have expertise in both audit planning and execution, and in some cases may require the services of a specialist with knowledge of the auditee company's industry. To be competently completed, the audit must include relevant and sufficient audit processes, methodologies, and technologies. Also, for an audit to be of value, it must be

[437] *ASA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards* [11].
[438] Ibid [A1].
[439] Ibid [11].

undertaken with judgments that are independent of the management and the auditee company's board of directors. The auditor's judgments must test the assertions and representations made by the auditee's management without conflicts of interest influencing that process.

6.1.3 The Role and Rationale of Auditing

Auditing has been defined as:

> A systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users. [440]

The AUASB Glossary defines a reasonable assurance engagement (audit) as:

> …an assurance engagement where the assurance practitioner's objective is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the assurance engagement as the basis for a positive form of expression of the assurance practitioner's conclusion. A reasonable assurance engagement is commonly referred to as an audit. [441]

An audit has an attest function. When providing audit services, the auditor's objective is to provide a high level of assurance through the issue of a positive expression of an opinion that enhances the credibility of a written assertion(s) about an accountability matter. Auditing is necessary to gain an unbiased view of the financial condition of an entity and its achievements (or otherwise) during an accounting period. The product emanates from the need for independent assessment that is free from conflicts of interest. Audits are necessary given the volume and complexity of accounting information generated by modern business.

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[440] Definition of auditing used by the American Accounting Association in the Committee on Basic Auditing Concepts publication, *A Statement of Basic Auditing Concepts* (American Accounting Association 1973) .

[441] Auditing and Assurance Standards Board, *AUASB Glossary* (October 2009). The Auditing and Assurance Standards Board (AUASB) formulates the *AUASB Glossary* pursuant to section 227B of the *Australian Securities and Investments Commission Act 2001*.

The financial report reader would not otherwise be able to determine whether the reported events correspond with economic reality. More specifically, the role of an auditor includes:

Stakeholder Protection

A chief rationale for an audit is to ensure that financial statements accord with economic reality. A mandatory audit is a critical requirement for the disclosure of public company financial affairs. Mandatory public financial reporting was introduced in the United Kingdom by the *Joint Stock Companies Act in 1844* and has since been an important feature of modern corporate legislation and regulation. At the time of its introduction, the audit requirement was prompted by concerns over the high incidence of corporate fraud. The rationale was summed up by Justice Brandeis that:

> ..sunlight is the best disinfectant, electric light the best policeman. [442]

This concern about protecting investors from financial fraud has continued as a rationale for mandatory financial audits of public companies to this day. The need for investor protection is premised on an assumption of investor susceptibility and lack of expertise. This rationale assumes that potential victims of corporate misconduct will take note of publicly available and professionally verified information. That they will also take appropriate steps to protect themselves when problems are reported.

Informed Decision Making

A further justification for the audit function is that audits promote confidence and empower investors to make rational and informed financial decisions. This requirement was described by Street CJ in *re Castlereagh Securities Ltd* [1973] in the following way:

> A sound share market and the ability of shareholders to reach reliable conclusions are dependent upon shareholders, brokers and financial experts having access to full and reliable

[442] Bottomley, above n 48.

> information concerning the affairs of companies. The courts do not, and directors should not, yield to the laconism that the only financial information most shareholders want is the figure on their dividend cheques. It is the clearly discernible intention of the companies legislation that companies should make adequate disclosures to enable shareholders individually, and the market collectively, to reach informed judgments. Over value and under value are both obnoxious. Where authentic details are not forthcoming, inference and even speculation inevitably take over. Decisions based on gossip or on inside information are concomitants of an unhealthy market. [443]

Economic theory further supports this argument. For example, audits are said to improve the reliability of financial statements, to make them more credible and increase shareholders confidence in them. In this way, audits are said to add value to the financial statements and to the capital markets in general.[444] The statutory audit requirement provides credibility and adds value given that an independent third party has verified the financial information produced by a company's management. This process will then in theory reduce the costs that users of that information would otherwise incur if they had to verify the information for themselves. Auditors thereby serve as reputational intermediaries, assisting the efficient operation of the financial markets by enhancing corporate information. [445] The demand for audit services is largely driven by the self-interest of shareholders, although benefits will also flow to the audited entity. The managers and directors of an audited company receive independent verification of the quality of their stewardship. Management is thereby more likely to continue their stewardship role in the event that an unqualified audit report is issued.

Concession Theory of Incorporation

A corporation comes into existence with the permission of the state, and is only allowed to continue if it operates in the interest of society as a whole. A further justification for the mandatory imposition of the audit requirement is found in the concession theory of incorporation. According to this theory, the grant of independent legal status to a company

[443] *re Castlereagh Securities Ltd* [1973] 1 NSWLR 624, 638.
[444] Ramsay, above n 47.
[445] Bottomley, above n 48.

by the state creates a private actor with special powers and capacities. A company's status as a separate legal entity must thereby carry commensurate obligations. Concessional theorists propagate the idea that a corporation is given its legal origin by a concession of the state which can be revoked by the state at any time. The incorporation of a company as a creature of the state is thereby subject to regulation by it. There would otherwise be potential for a company to exploit its separate legal entity status and serve individual interests if left unchecked. In this regard, Bottomley commented that:

> On this view, the requirement that a company should publicly disclose its financial affairs on a regular basis and be subject to an audit is the quid pro quo for the grant of incorporation by the State. On this view, when an auditor is engaged to meet the company's statutory audit requirement, they can thus be said to be performing a dual function. The first function may be described as 'private'. It arises from the contractual relationship between the auditor and the company….. Breach of these duties may result in an action for damages brought by the company against the auditor. Secondly, there is a more public function. The companies legislation not only requires that an auditor should report to the company about its financial statements, but also that this report should become part of the public record about the company. [446]

There clear tension between these private and public roles. That strain becomes most evident when considering the question of auditor's liability to persons outside the contractual relationship for audit services. This aspect is covered later in this chapter.

The Information Value of Audits

Public company audits are generally highly valued by users of financial information. The fact a company is audited conveys a message of lower information risk to the market place. To achieve this, the audit attestation process must be competent and independent of an entity's management. A market perception is then created that the audited financial statements are both valid and reliable. Financial information perceived as valid and reliable

[446] Ibid 4.

carries less risk then otherwise. This lower risk converts into added value to a company through higher share prices and a lower costs of debt.

Different levels of public company audit quality also convert into differences in prices for shares traded on the Australian Stock Exchange. A public company that engages an auditor with a strong reputation for audit quality will translate into greater demand for that company's shares.[447] Similarly, traders of company debt attach different risk premiums to audited companies compared to those that are not. Even less risk is attributed to companies that employ the services of a high quality auditor as compared to those not subject to that level of inspection.

Unlike most commodities, an audit is not a good that can be observed *ex ante*. An audit is referred to as an 'experience good', that is a good whose qualities cannot be observed prior to its purchase. The qualities of an 'experience good' are not usually observable until the good is actually experienced. This makes choosing an auditor more difficult than choosing many other types of goods and services. Further to this, even after the audit is purchased and experienced, it is not always possible to observe the qualities of that audit. [448]

Those closest to the audit process (for example the audit committee) are more likely to have an opportunity to observe auditor competence. Even in these circumstances, there is only limited opportunity to view an auditor's competence and independence. There are only rare instances where auditor independence threats can be fully observed, including how the auditor deals with them once they arise. Auditor independence is difficult to monitor even in the most intimate of circumstances unless the auditor initiates a means by which his or her audit approaches are made transparent.[449] A shift to greater transparency has recently been achieved by the requirement for auditors to publish transparency reports.[450]

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[447] Keith A Houghton and Christine A Jubb, 'Auditor Independence: Regulation, Oversight and Inspection' in Tom Campbell and Keith Houghton (eds), *Ethics and Auditing* (Australian National University, 2005) 224.
[448] Ibid 221.
[449] Ibid.
[450] Part 2 of Schedule 1 of the *Corporations Legislation Amendment (Audit Enhancement) Bill 2011*

Auditors act as agents for a company's shareholders when performing an audit. This relationship relies on trust and confidence, similar to the relationship between a director and shareholders. Given the significance of trust in that auditor/shareholder relationship, the question is inevitably asked, who is auditing the auditor? Differing motivations and information asymmetries may cause concern about information reliability. This in turn impacts on the level of trust that principals have in their agents. To some extent, reporting requirements that promote transparency can compensate for the weak rights of principals and regulators. They also help to maintain confidence and trust in capital markets. Reporting mechanisms can be used in this way to align the interests of agents with principals and allow principals to measure and control the behaviour of their agents. This added visibility then reinforces trust in agents.[451]

6.1.4 Legal Framework and the Legal Obligations of Auditors in Australia

6.1.4.1 Statutory Functions of the Auditor

Auditors face legal liability under the *Corporations Act*, their contract of engagement with an audit client, the law of professional negligence, professional auditing and assurance standards, the *Competition and Consumer Act 2010* (Cth) and the state fair trading acts.[452] The scope of an auditor's duties and responsibilities under those authorities is particularly relevant to community perceptions about the auditor's role in the context of the audit expectation gap. The requirements of these authorities are now outlined before discussing the expectation gap.

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inserted Part 2M.4A into the *Corporations Act* which requires the publication of a transparency report by firms conducting audits of ten or more Australian entities of the following categories: listed companies, listed registered schemes, authorised deposit-taking institutions (ADIs) and insurance companies.

[451] The Institute of Chartered Accountants in England & Wales, *Agency Theory and the Role of Audit* (ICAEW 2005) 4.

[452] Melissa Fogarty & Alison Lansley, 'Sleepers Awake! Future Directions for Auditing in Australia' (2002) 25 (2) *University of New South Wales Law Journal* 408, 412.

The Corporations Act 2001

The auditor's position under the *Corporation Act* is a logical oddity. An auditor's duty is owed to the shareholders of a company, however an auditor's remuneration and the extent of non-audit services provided is determined by company management. This arrangement represents a fundamental conflict of interest situation that has persisted for decades under the Australian corporate governance framework.[453]

The Division 3 provisions of the *Corporations Act* apply to the issuing of an audit report. The key provisions of that division are s 301(1), which requires that the annual report of particular types of companies be audited, while s 307 then imposes a duty on an auditor to form an opinion with respect to those companies. Section 301 has been outlined above, and the requirements of s 307 are now discussed.

Duty to Form an Opinion: section 307

Section 307 of the *Corporations Act* requires that the auditor report to the members of the company on whether the company's financial reports are presented in accordance with the *Corporations Act* to give a true and fair view and comply with accounting standards. More specifically, an auditor is under a statutory duty to form an opinion on a financial report or half-year financial report of a company, registered scheme or disclosing entity as to whether:

> (a) the financial report or half-year financial report has been prepared in accordance with the accounting standards and regulation, and presents a true and fair view of the financial position and performance of the entity:
>
> (aa) if the notes to the financial report or half-year financial report contain additional information, whether the inclusion of that additional information was necessary in order to give a true and fair view;

[453] Chan, above n 435, 34.

(b) the auditor has obtained all necessary information, explanations and assistance to conduct the audit;

(c) the entity has kept financial records sufficient to enable a financial report or half-year financial report to be prepared and audited; and

(d) the entity has kept all other records and registers required by the Act.

The procedures and techniques adopted by an auditor when conducting an audit must be planned and implemented so as to provide the required level of assurance to form an opinion. An auditor must thereby form an opinion in accordance with his or her statutory duty under s 307.[454]

The term "true and fair" used in the audit report does not mean correct or accurate. The expression instead requires that the financial statements are interpreted subjectively given that the accounting standards themselves are not precise guidelines. Whether or not "true and fair" should be interpreted as a technical term[455] from an accounting viewpoint or as a legal term has not yet been fully considered by the judiciary, and remains a matter of some contention.[456]

After completing his or her examination, an auditor may decide that a financial report has not been prepared in accordance with applicable accounting standards. In addition, the auditor may find the report does not present a true and fair view of the financial position and performance of the entity. The reasons for forming that opinion must be stated in the audit report together with a description of any defects or irregularities found. In particular, if the auditor is of the view that the financial report does not comply with the accounting standards, the auditor's report must, where practicable, quantify the effect of the noncompliance with

[454] CCH Australia, *Australian Audit Manual*, above n 75.
[455] Chan, above n 435, 31.
[456] See generally Roman Tomasic, Jim Jackson and Robyn Woellner, *Corporations Law: Principles, Policies and Process* (Butterworths, 4th ed 2002) [9.37] - [9.43].

the standards.[457]

6.1.4.2 Duties of the Auditor at Common Law

In addition to these statutory requirements, auditors must also comply with their duties at common law as relevant to the conduct of the audit. These duties are based in the tort of professional negligence arising from the relationship between the auditor and those whom the auditor owes a duty of care. Furthermore, the auditor has duties in contract law stemming from the auditor's agreement with the auditee. [458]

Common Law Duties of Skill and Care

The general law has played a leading role in determining the liability of an auditor to fill in regulatory gaps. The auditing and assurance standards have their limitations, while the scantness of the *Corporations Act* provisions has handed the courts a significant role in deciding the scope of the auditor's statutory function. The main body of precedent on auditor liability concerns the auditor's common law duty to exercise reasonable skill and care. [459]

In that regard, it was held in re *City Equitable Fire Insurance Company Limited* [460]that:

> It [the Companies Act] says nothing as to what [the auditors] are to do in order to form that opinion, or to ascertain the truth of the facts to which they are to certify. That is left to be determined by the general rules which, in point of law, are held to govern the duties of the auditors, whether those rules are to be derived from the ordinary law, or from the terms under which the auditors are to be employed.

An auditor who enters into a contract to perform certain tasks promises to perform those tasks using that degree of skill and care as is reasonable in the circumstances. The classic

[457] CCH, *Australian Company Law Commentary* (at 13 September 2007) ¶104-020.
[458] Bottomley, above n 48, 9.
[459] CCH, *Australian Company Law Commentary*, above n 457, ¶104-050.
[460] *Re City Equitable Fire Insurance Company Limited* [1925] Ch 407.

statement of the level of this skill and care expected was given by Lopes LJ in *re Kingston Cotton Mill Co (No 2)* (‘*Kingston Cotton Mill* ’):[461]

> An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful.

The watchdog (and not a bloodhound) analogy has been subject to much repetition throughout case law. In essence the statement reflects a concern that the auditor should not be required to ferret out any fraud or other conduct which might be regarded as deceptive or misleading. The watchdog role has however been the subject of critical comment although it has never been denied complete authenticity by the cases that followed *Kingston Cotton Mill*.[462] An alternative view on auditor responsibility is found in the remarks of Rogers CJ in *AWA Ltd* v *Daniels t/a Deloitte Haskins & Sells & Ors (No 2)* [463] who warned that:

> [w]hether auditors are watchdogs, or bloodhounds, or any other form of canine, they cannot allow themselves to be utterly toothless.

Donovan J in *International Laboratories Ltd* v *Dewar and Ors* also noted: [464]

> [the auditor] will not have performed the functions of his office if after one howl he retreats `under the bar’ or if he confines his protest to a fellow watchdog.

Similarly, Holmes LJ in *Irish Woollen Company v Tyson*, commented as follows:

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[461] (1896) 2 Ch 279.
[462] CCH, *Australian Company Law Commentary*, above n 457, ¶104-050.
[463] (1992) 10 ACLC 1,643.
[464] (1933) 1 DLR 34.

> Now, time after time, this passage about the 'watch-dog and the bloodhound' has been made use of, and I would wish to say a word regarding it, too. His Lordship then read from Lord Justice Lindley's judgment the passages dealing with the duties of auditors, in one of which it was laid down that 'an auditor was a watch-dog, but not a bloodhound'. This, Lord Justice Fitzgibbon remarked, was very unfair to the bloodhound, who was just as little likely to have his sense of suspicion aroused as the watchdog. Applying this instance of the dogs to the present case, was not the watchdog bound to bark? and if, when sniffing round, you hit upon a trail of something wrong, surely you must follow it up, and there is just as much obligation on the auditor, who is bound to keep his eyes open, and his nose, too. As in the case of the hound, the auditor will follow up this trail to the end, and the first things he will 'root up' are those statements of account, and then the fraud is discovered.[465]

When addressing the liability of the auditors in the *Pacific Acceptance Corporation Ltd* v *Forsyth & Ors* ('*Pacific Acceptance*') case,[466] Rogers J emphasised the point that an auditor's duty must be decided in the light of the standards of today.[467] Case law finds the auditor to in fact shoulder a significant burden in carrying out his or her duties. The level of skill expected is not that of a reasonable person but that of an expert. It was held in *Pacific Acceptance* that:[468]

> In principle an auditor is really in no different position from any skilled inquirer. To the inquirer in any field to know by direct examination is surer proof than to believe on the hearsay of others or by inference. The latter and second-best alternatives may well be acceptable if a direct examination is not possible or the delay, expense or effort that will be occasioned by such examination is out of proportion to the importance of the matter to be proved. These approaches are but the dictates of reason and experience.

On this basis, the watchdog-bloodhound analogy made in the *Kingston Cotton Mill* case may

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[465] Reproduced in Lawrence R. Dicksee, *Auditing: a Practical Manual for Auditors* (Gee, 18th ed, 1969) 809.
[466] (1970) 92 WN (NSW) 65-69.
[467] see also *AWA Ltd* v *Daniels t/a Deloitte Haskins & Sells & Ors (No 2) (1992) 10 ACLC 990*.
[468] (1970) 92 WN (NSW) 67-68.

however no longer represent the modern standard of care and skill expected of an auditor, particularly in the case of an auditor's duty to enquire and detect fraud or error. This aspect is discussed later in this chapter.[469]

Duties to persons outside the company

The private and public aspects of a statutory audit raises questions about whether an auditor owes a duty of care to individuals outside the company. Given that the audit report becomes a matter of public record, those with access to the audited accounts may contend that auditors play a role in investor protection for which a wider liability is justified.[470]The duty owed by auditors to third parties was determined by the High Court's decision in *Esanda Finance Corporation Limited* v *Peat Marwick Hungerfords*[471] ('*Esanda*'). That case resolved uncertainty in this area of the law at the time.[472] The High Court in *Esanda* found that a statutory duty of care arose because the auditors foresaw or ought reasonably have foreseen that the creditors and financiers of the company might reasonably and relevantly rely on the audited financial statements of the company.

The High Court's decision comprised five separate judgments which were unanimous in the outcome. The main principle of the case is that an auditor does not owe a duty of care to a third party such as a shareholder, lender or investor, unless particular circumstances give rise to a relationship between the auditor and that third party, and there is an intention on the part of the auditor that the third party should rely on the audit, or the auditor assumes a responsibility to the third party.

Under the *Esanda* decision, for a third party to establish that an auditor owed it a duty of care, it is not enough that the auditor foresaw or ought reasonably have foreseen that a class of members might rely on the audited financial reports when entering into a financial transaction. Something further is required which the judges variously described as

[469] CCH, *Australian Company Law Commentary*, above n 457, ¶104-050 .
[470] Bottomley, above n 48, 12.
[471] (1997) 15 ACLC 483.
[472] CCH, *Australian Company Law Commentary*, above n 457, ¶104-050.

reasonable reliance on the auditor's statement. That is, a special relationship of proximity marked by reliance or the assumption of responsibility by the auditor, or a response by the auditor to a particular request by the third party.[473]

Those who provide financial accommodation to a company or the shareholders of a company would not ordinarily be in a special relationship of proximity with the auditor in relation to the audited financial reports. This is the case even though the audited financial report is intended to meet the needs of investors and lenders, either as a general purpose financial report, or a special purpose financial report within the meaning of the accounting standards. [474]

There is no authoritative decision as to whether auditors owe a duty of care to shareholders in Australia. In the United Kingdom decision of *Caparo Industries plc v Dickman & Others* [1990], it was held that the auditor owed a duty to the company's shareholders as a whole but not to individual shareholders. The Australian case of *Esanda* does not inevitably lead to that same conclusion. [475]

A claimant's successes is likely to be greater where the auditor prepares a report on something other than the financial statements required by the *Corporations Act*. In *Morgan Crucible Co plc* v *Hill Samuel & Co Ltd & Ors* (1991), the English Court of Appeal held it was arguable that when performing such a function for the directors of a company subject to a takeover bid, an auditor owed a duty of care to the takeover bidder. Based on this decision, the Court in *Columbia Coffee & Tea Pty Ltd & Anor* v *Churchill & Ors* [476]held that auditors who know the purpose of an interim audit is for potential shareholders to decide on whether to purchase shares do owe a duty of care to those persons. [477] Chapter 8 of this thesis puts forward a new types of remedy where shareholder loss is incurred as the result of auditor

[473] Ibid.
[474] Ibid.
[475] Ibid.
[476] (1992) 10 ACLC 1,659.
[477] CCH, *Australian Company Law Commentary*, above n 457, ¶104-050.

assured misstated financial statements. It proposes an insurance solution to enable shareholder recovery in these circumstances.

The Audit Expectation Gap

The former Australian Treasurer, Peter Costello referred to the audit expectation gap when he stated that:

> ..most of the public believes auditors are sort of there to stop fraud … I am not sure that that is what the actual legal position [is], as understood by auditors, ..[478]

The preceding analysis of case law on auditor liability reveals limitations in the audit assurance function. Auditors do not guarantee the accuracy of financial information. They are only required to exercise a reasonable degree of skill and care in forming an opinion about whether a company's financial reports comply with accounting standards and whether they present a true and fair view of the company's financial position and performance. Furthermore, auditors are not the guardians of good corporate conduct. An auditor's liability for failing to detect the fraud or misconduct of company employees and report it to shareholders, investors and the audited company is also limited. The courts have made it clear that the auditee company and its board of directors are primarily responsible for good corporate management. They are not entitled to abdicate this responsibility to the auditors.[479]

A recent public focus on auditor performance and audit failure has been triggered by instances of corporate collapses. Some of the views broadcast by the Australian media highlight misconceptions surrounding an auditor's responsibilities. In particular, the extent of the auditor's responsibility to protect stakeholders against corporate failure is not well understood. A common catchcry following a corporate failure is *where were the auditors*? An audit expectation gap exists between society's expectations of auditor responsibility and

[478] Karen Murphy and Tony Walker, 'Costello: Audit Crisis of Confidence', *Australian Financial Review* (Sydney) 8 February 2002, 1.
[479] Fogarty and Lansley, above n 452, 418.

the reality of their obligations as decided by the legislature, the courts, and the accounting profession. This is not a new phenomenon. In the aftermath of the 1987 stock market crash there was a widespread feeling that somebody should be made accountable for financial disasters and the financial loss that resulted. Simply stated, it was broadly perceived that any person who has any pecuniary interest in the affairs of a company should be able to rely on its audited accounts as a form of guarantee of company solvency, propriety and its future viability. [480]

Since the 1970s, the quantum of civil claims against auditors has continued to stimulate debate about the extent to which auditors should be liable for the economic loss incurred when a company fails. The auditing profession has expressed its concern about the expectation gap between the auditors' legally defined role and what the investing public expects of it:

> The general public believes that the auditor has a responsibility for detecting all fraud, while the auditing profession believes its responsibilities are limited to planning the audit so that there is a reasonable expectation of detecting material fraud. [481]

Whether the expectation gap is best treated (and narrowed) by court judgements on concepts such as foreseeability, proximity and reliance, or whether statutory intervention is the better course remains unresolved. On one view, legislative reforms are unnecessary given the limits imposed on auditor liability to third parties as decided in the *Esanda* case[482] and the use of contributory negligence principles according to the *Daniels v Anderson* decision.[483] The alternative view is that legislative intervention is the more effective approach. In Australia, the CLERP 9 reforms have taken this latter approach of statutory intervention. But while ever the expectation gap persists, attention is diverted from other causes of corporate

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[480] David Godsell, *Auditors' Legal Duties and Liabilities in Australia* (Longman Professional, 1993) 2.
[481] Grant Gay and Gregory Pound, 'The Role of the Auditor in Fraud Detection and Reporting' (1989) 7 *Company and Securities Law Journal* 116, 118.
[482] *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* (1997) 142 ALR 750.
[483] *Daniels v Anderson* (1995) 16 ACSR 607.

misconduct and failure. Blame is pinned disproportionately on auditors, and in response, audit reform becomes the focus of corporate law reform. The audit expectation gap is now explored in the context of corporate failure in Australia.

6.1.5 Corporate Collapse and the Role of Auditors – HIH Insurance Ltd

Corporate failures continue to occur even in circumstances where an audit has been properly performed and where regulation governing the audit has been complied with. This is seen as a signal by some that the audit process is not capable of delivering a product of value to the market for financial information. An excessive and unreasonable level of audit effectiveness is expected by some market participants and information users which will never be achieved. Notwithstanding that view, it is generally acknowledged that the reason for corporate collapse lies in a lack of effective corporate governance. The incidence of conflicted behaviour by some traditional gatekeepers (including auditors) then compounds that failed governance. This has lead some commentators to claim that auditors have betrayed public trust and suffered a credibility crisis that will take many years to resolve.

The HIH Insurance Ltd ('HIH') corporate failure demonstrates how accountants and auditors can act in concert with other professionals to fail in their gatekeeper role. This type of contrivance is particularly damaging to the audit profession's credibility. This section now provides an analysis of the HIH failure. It shows how individual auditors and the accounting profession by association are perceived to have abandoned the gatekeeper role. That view, if commonly shared and accepted, widens the audit expectation gap and further isolates Australian auditors from the reality of their role.

HIH was known as price-cutter and a more willing underwriter than its competitors in the insurance industry. That excessive discounting was a factor that contributed to the company's failure. However, it was arguable that the hostile takeover of FAI Insurance Ltd without a proper due diligence investigation being first undertaken marked the beginning of the company's demise. HIH also incurred major losses from its United States and the United

Kingdom operations which ensured its eventual downfall. HIH was placed in provisional liquidation in March 2001 with reported losses of $800 million, although later estimates put the deficiency at between $2.7 and $4 billion.

A Royal Commission ('the Commission') into the affairs of HIH by Justice Owen was announced in June 2001. The terms of reference were sufficiently wide-ranging to enable the Commission to fully investigate the circumstances surrounding HIH's failure. The adequacy of Commonwealth and state regulatory body oversight was to be examined together with whether changes should be made to the current legal framework. A report on the failure of HIH was issued by Justice Owen in April 2003. In that report, Justice Owen found the accounting systems and procedures adopted by HIH were unsatisfactory, and in one observation noted that:

> … users of HIH accounts may not have understood it at the time, but in 1999 and 2000 – the years to which primary attention was given in the inquiry – the financial statements were distorted by questionable entries, heavy reliance on one-off end-of-year transactions, and aggressive accounting practices … including, despite significant losses, continuing to record as an asset in its financial statements the full value of the future income tax benefits.. [484]

The mismanagement of HIH's affairs was epitomised by a lack of attention to detail and deficient accountability for performance. A lack of integrity in the company's internal processes and systems and poor decision-making was apparent. HIH was found to have a corporate culture that relied on leadership both ill-equipped and unable to recognise risks and take those actions needed to allow the organisation to prosper.[485] In relation to the efficacy of the audits, Justice Owen commented that:

> … in my view, Andersen's approach in the audit of 1999 and 2000 was insufficiently rigorous to engender in users confidence as to the reliability of HIH's financial statements. This

[484] Commonwealth of Australia, HIH Royal Commission, *The Failure of HIH Insurance Vol. 1 A Corporate Collapse and its Lessons* (2003) xlvi.
[485] Ibid xvii.

> detracted from the users' ability to appreciate fully HIH's true financial position.[486]

The Commission also found the level of audit committee independence was deficient. The chairman was a former partner of Arthur Andersen ('Anderson') which acted as HIH auditor. The finance director was a former Andersen partner, and two other members of the audit committee had business relationships with the company.

The Auditor's Role

The Commission considered the role of the HIH external advisors. This included the task and responsibilities of the company's auditors, accountants, lawyers, investment bankers and other financial consultants. Justice Owen found that those to whom HIH owed obligations (including shareholders, policyholders, creditors and regulators) were entitled to expect the company's external advisers would be independent of management and would exercise their professional skill for the company's benefit. Justice Owen found instances where external adviser conduct fell short of what was required. [487] The community was entitled to be disappointed given those advisers failed to exercise their professional skills as expected of them.

Justice Owen further commented that auditors play a vital role in the financial reporting process. This was particularly so in the HIH case because the company's true financial position and performance was a matter of national economic significance. A properly conducted audit allows users of a financial report to rely on them with a degree of confidence. The audit process must be designed to provide a company and the users of its accounts with early notice of potential risks affecting the company's short and long term viability to achieve this. [488]The auditor did not deliver on this purpose.

The work carried out by Andersen was analysed by the Commission together with the

[486] Ibid lvii.
[487] Ibid lv.
[488] Ibid lv.

circumstances that may have affected the proper performance of its audits. Those circumstances included the fact that the auditors were misled on some occasions in relation to material matters. A selection of specific accounting matters and issues dealt with by Andersen during the 1999 and 2000 audits were examined in detail. It was concluded that Andersen did not obtain sufficient audit evidence to support its conclusions in respect of several of these matters, and that adjustments ought to have been made to the accounts in many instances. The Commission considered two questions in its investigation about why these accounting defects occurred. They were; was Andersen's independence compromised, and was Andersen's methodology fundamentally flawed? [489]

Andersen's Independence

To be effective, an auditor must be independent both in fact and in appearance. Three former Andersen partners were members of the HIH board of directors. Of these, one was the chairman and also recipient of continuing benefits from Andersen including fees from a consultancy arrangement. In addition, the pressure placed on Andersen partners to maximise their fees from non-audit work also represented a potential conflict with their audit obligations, and was a cause for concern for the Commission. The combined effect of these relationships between Andersen and HIH gave rise to the perception that Andersen was not independent of HIH. Nevertheless, Justice Owen's analysis of Andersen's conduct during the 1999 and 2000 audits revealed no reason to conclude that Andersen's independence was in fact compromised. [490]

The courts have regularly remarked on the importance of an auditor's independence, and the difficulties that he or she may experience in maintaining it. In *Pacific Acceptance,* Moffitt J commented that while the shareholders appoint the auditor, most often than not it is the directors or senior managers who determine the terms of this engagement. Therefore the auditor may be subject to pressure to produce a report which pleases those managers who appoint him or her, such that the auditor:

[489] Ibid lvi.
[490] Ibid lvi.

> ...is put in a position where there must often be a real and practical conflict ... between his duty to the shareholders and his interest not to take action which may prejudice his reappointment or his relations with those with whom he works. [491]

The requirement for auditor independence has long been an issue of concern for Australian regulators. Scrutiny of the Australian corporate collapses of 2001 and those following has found a lack of auditor independence contributed to these failures.[492] In response, new provisions and statutory revision were introduced into the *Corporations Act* and to professional codes in an effort to correct deficient aspects of auditor independence.[493] This aspect of failed auditor ethics is considered in closer detail in Chapter 7 of this thesis, with particular focus on the provision of auditor provided non-audit services and the ethical problems that those services cause.

The Audit Methodology

Andersen used formal systems of quality control and audit procedures to govern and direct its audit work. The audit firm's internal processes required conformity with standards and policies that were consistent with auditing and assurance standards at that time. On the whole, its general approach to the HIH audit was found by the Commission to have complied with those requirements although some aspects of Andersen's methodology caused concern. [494]

These concerns included the significant reliance placed by Andersen in the valuations made by HIH's consulting actuary, David Slee, during the course of its audit. The largest item on the balance sheet of a general insurer is usually the provision for payment of future claims based on actuarial valuations. Andersen did not have the required level of actuarial expertise

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[491] *Pacific Acceptance Corporation Ltd* v *Forsyth & Ors* (1970) 92 WN (NSW) 131.
[492] Bottomley, above n 48, 17.
[493] Ramsay, above n 47, [4.14] - [4.18].
[494] Commonwealth of Australia, HIH Royal Commission, *The Failure of HIH Insurance Vol. 1 A Corporate Collapse and its Lessons* (2003) lvi.

nor did it retain such expertise to assist it with the HIH audit. It instead relied heavily on Slee's work to confirm the credibility of the outstanding claims provision.

Andersen's responsibility as auditor required it to be satisfied as to Slee's competence, integrity and objectivity in these circumstances. The auditor also needed to gain an understanding of the assumptions and methods Slee adopted. It then was required to consider whether they were reasonable based on their knowledge of the business and the results of their other testing procedures. Andersen was found by the Commission to not have adequately considered Slee's work in order for it to rely so heavily upon his reports. [495]

The Audit Expectation Gap

Justice Owen commented that there has been much debate about the nature and scope of audit services and the so-called audit expectation gap in recent years. He explained the gap was the difference between what auditors actually do when they conduct an audit and what shareholders and others think auditors do or should do when conducting the audit. In addition, Justice Owen found that audit reports in general are uninformative as to the nature and scope of the audit services performed. He based this finding on his past experience and the evidence placed before the Commission. The terms of a standard audit report were thought by Justice Owen to be quite formulaic and do not assist a reader to understand the nature or extent of the audit activities carried out.

The Commission's report included a recommendation that the annual report of a company contain a summary of the nature and scope of the audit services provided as a way to narrow and possibly close the audit expectation gap.[496] HIH Commission policy recommendation 14 states that:

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[495] Ibid lvii.

[496] See HIH Royal Commission, *The Failure of HIH Insurance Vol.1 A Corporate Collapse and its Lessons* (2003) paragraph 7.2.7 which specifically addresses the scope of the audit in the context of the audit expectation gap. The paragraph is targeted at bringing both the actions and interactions of auditors in line with shareholders and their expectations.

> I recommend that the *Corporations Act 2001* be amended to require public listed companies to include a brief, plain English summary of the nature and scope of the audit services provided by their auditor each year.

This summary could be included in the body of the audit opinion itself or within another section of the annual report that provides notes on the audit. This summary would enable readers of listed public company annual reports to compare the nature and scope of the audit services provided across several other companies, and would promote efficiency and competition in the market for audit services.

Many of the Commission's recommendations recognised issues that are relevant to the regulation of modern corporate groups, and the need to disclose information about these groups to capital markets. The recommendations aimed at financial reporting and the audit function continued the trend at that time for increased disclosure of matters affecting auditor independence, and the enhanced disclosure of financial information more broadly.

The Federal Government responded to the recommendations of the Commission by stating that significant change had already been made to corporate governance disclosure and practice requirements by amendments made to the ASX Listing Rules and the release of the ASX *Corporate Governance Council's Best Practice Recommendations*. [497] The recommendation that the *Corporations Act* be revised to require listed companies to include a brief summary of the nature and scope of the audit services provided by their auditor each year was decided to be unnecessary. This requirement was thought to be better suited for inclusion in the auditing standards rather than being prescribed by legislation. [498] The profession in Australia has since taken steps to reduce the expectation gap by adopting an expanded audit report under auditing standards ASA 700, *Forming an Opinion and Reporting on a Financial Report*, ASA 705, *Modifications to the Opinion in the Independent*

[497] ASX Corporate Governance Council, *Principles of Good Corporate Governance and Best Practice Recommendations* (ASX, 1st ed, March 2003).
[498] Peter Costello, 'Government's Response to The Recommendations Of The HIH Royal Commission', (Media Release No 082, 2003).

Auditor's Report and ASA 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*.[499]

The audit expectation gap as described in the HIH Commission report has seen auditors unjustly bear the role of convenient scapegoats in some cases. Given the requirement to hold professional indemnity insurance, an auditor is most often the only party to emerge financially intact in the event of a corporate collapse. The audit expectation gap is now further examined together with proposals to bridge the gap.

6.2 The Audit Expectation Gap

Many members of the public expect that auditors should accept prime responsibility for the financial statements that they report on, and that an unqualified audit opinion guarantees the accuracy of financial statements. Some others think that that auditors perform a one hundred percent check during testing, that auditors will give early an warning on the possibility of business failure, and that audits are intended to detect fraud. Such expectations of auditors go beyond the actual standard of performance required of auditors and have contributed to the existence of the audit expectation gap.

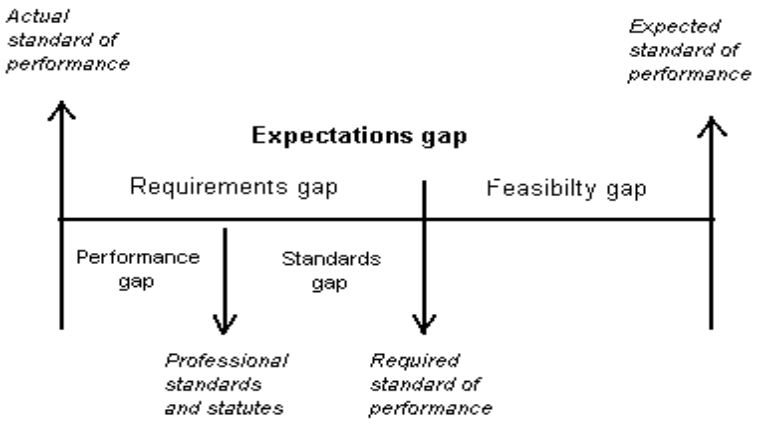
The reality according to the accounting profession is that management, as the preparers of the financial statements, is primarily responsible for their content. Auditors further contend that they only provide an opinion on the fairness of presentation of the financial statements for the purpose of adding credibility to them. An audit provides no guarantee of solvency or financial performance, and an auditor is only required to test selected transactions. It does not make economic sense for an auditor to check all transactions, and it is not economically viable for that matter. In particular, an audit does not guarantee that fraud will be detected, although auditors are required to plan and conduct an audit engagement with an attitude of

[499] ASA 700 deals with the auditor's responsibility to form an opinion on a financial report. It also addresses the form and content of the auditor's report. ASA 705 and ASA 706 deals with how the form and content of the auditor's report are affected when the auditor expresses a modified opinion, or includes an *Emphasis of Matter* paragraph, or an *Other Matter* paragraph in the auditor's report.

professional scepticism, recognising that circumstances such as fraud may be present.

The audit expectation gap has been attributed to a number of different causes including the ignorance, naivety, misunderstanding and unreasonable expectations of non auditors about the audit function. In the case of audit failure, the evaluation of audit performance may be based upon information or data which was not available to the auditor at the time the audit was carried out. This new intelligence tends only to encourage the flow of unjust criticism and goes to expand the expectation gap. The gap has also been broadened in recent years by the evolutionary development of auditor responsibilities. Any time lag in the accounting profession's response to these changing community expectations tends to widen the gap. Auditors have simply not kept up with new expectations and accountability requirements which have been triggered by instances of corporate failure.

The audit expectation gap was originally defined as the difference between the different levels of expected performance as understood by auditors and the users of financial reports. A more comprehensive analysis separates the gap into several elements. The expectation gap can be depicted as comprising the following components:



Under this analysis, the audit expectation gap is firstly split into two components, the requirements gap and the feasibility gap. These elements are now discussed.

The Requirements Gap

The requirements gap represents the difference between an auditor's actual standard of performance and the performance required of them by the current standards of society. The requirements gap may be further divided into the performance gap and the standards gap.

The performance gap is caused by the failure of an auditor to conform to statutory requirements and professional standards. This gap can be narrowed by more closely monitoring auditor performance, and by increasing and improving professional education undertaken by practitioners. Performance monitoring includes peer review which entails the review of work policies, procedures and work performed by an audit firm by a member of another accounting practice. Performance reviews can also involve quality reviews or the systematic evaluation of practices and procedures performed within an audit firm by a committee or task force established by the firm for that purpose. Making improvements to disciplinary procedures and extending the range of corrective actions available to oversight bodies can also influence compliance with statutory and professional requirements, to in turn narrow the performance gap.

The standards gap is the gap between the standard of performance as determined by reference to professional standards and statute on the one hand, and the standard of performance required by society on the other. The community expects that auditor performance will satisfy general law standards as handed down in courts of law decisions. The standards gap exists largely because statutes and professional standards fail to fully reflect the standard of performance decided as appropriate by the courts. This gap can only be narrowed by developing professional standards and legislation that predicts community expectations. As this shift would require a voluntary extension of auditor's duties and an extraordinary degree of foresight, this gap is unlikely to ever be completely closed.

Feasibility Gap

The feasibility gap is the gap between an auditor's required standard of performance and various levels of public expectation. Examples of these public expectations include the belief that auditors are responsible for the preparation and certification of financial statements. The failure of the public to recognise the limitations of an audit creates a feasibility gap.

The feasibility gap is caused by society's increasing and often unrealistic demands for auditor accountability. One way in which this gap may be narrowed is by improving public education. This may involve a public campaign informing that existing professional standards and legislative requirements properly and adequately reflect the auditor's responsibility. Alternatively, auditors can either accede to society's more reasonable demands or improve the manner by which they communicate their findings to financial statement users. This latter approach can be achieved by issuing yet more professional standards and/or expanding the standard audit report to better explain the objectives and limitations of the audit product.

While a general consensus as to the causes of the audit expectation gap has not yet been arrived at, the gap's persistence has been acknowledged. This bears testimony to the profession's inability to remove it despite numerous attempts to do so by educating the public and codifying existing practices.

6.2.1 Judicial and Practitioner Views

While the earliest recorded articulation of the notion of an audit expectation gap appeared relatively recently in the literature, the recognition of a longstanding divergence between auditor perceptions of their duties and those held by non-auditors does not appear to be in dispute. The existence and relevance of the expectation gap was established by British jurisprudence. One early decision on the standard of skill and care expected of professional persons who execute specialised work was delivered in *Lanphier v Phipos.*[500] In that case,

[500] (1838) 8 C & P 475.

Chief Justice Tindall gave direction to the jury that everyone performing such tasks undertakes to bring a *reasonable* degree of care. Not the highest degree of skill, but he or she undertakes to bring fair, reasonable and competent skill. This notion of reasonableness underpins negligence cases to this day. This is particularly so where there is an apparent or alleged failure to meet the minimum level of conduct required by common law, and where no specific standards exist either through private agreement or legislation.

A line of cases followed. Two landmark United Kingdom decisions concerning audit profession responsibility were delivered against a background of unreconciled judicial and auditing profession views. The UK Court of Appeal delivered these two significant judgments within a short space of time on the issue; *London and General Bank (No 2)* [501] and *Kingston Cotton Mill.* These authorities represented a watershed on auditor responsibilities and both provoked much comment at the time. These cases have since been frequently relied upon as precedent across several jurisdictions. More than any other decisions, they have served to put the nature of auditor responsibilities into perspective and settle the law in this area. The auditor was not expected to discover every fraud under these decisions, but was required to use reasonable care and skill in his perusal of the relevant books and records. There was implied recognition that a company auditor be reasonably qualified to carry out his or her examination in a professionally expert manner in these cases.[502]

These two cases were also of significant importance given their recognition of auditing as a profession. Under these decisions, the auditor does not guarantee that the financial report is fairly presented any more than the solicitor guarantees to win a case or the doctor to effect a cure. An auditor does not warrant that he or she will bring to bear the highest degree of skill in the performance of their duties since there may well be more skilful auditors within the profession. Neither is the auditor necessarily answerable for an error of judgment provided they exercise the skill and care of a reasonably competent and well informed member of the

[501] (1895) 2 Ch 673.

[502] Philip Cobbin, Eu-Jin Teo, Geoff. H. Burrows (July 2003) 'A Revisitation of the Audit Expectations Gap: Judicial and Practitioner Views On the Role of the Auditor In Late-Victorian Britain' (Paper presented at The Third Accounting History International Conference, Siena Italy, 18 September 2003).

profession.[503]

The Duty to Enquire, and the Detection of Fraud or Error

As discussed,[504] the classic formulation of the scope of the auditor's duty was stated in the *Kingston Cotton Mill* case. The extent to which that formulation stands for the proposition that the auditor has a relatively passive role in relation to the discovery of fraud or error, and that the auditor is justified in relying on management representations in the absence of suspicion may however no longer represent the duties expected of the modern auditor. [505] This classic formulation appears out of step with modern community and investor expectations, although the difference in views is partially attributable to the audit expectation gap. Nonetheless, the auditors' duty is higher than merely being reasonably cautious and careful. The court in *Pacific Acceptance* was careful to limit the scope of the *Kingston Cotton Mill* principle, stating that:

> If, during an audit, there are a substantial number of irregular or unusual matters encountered by audit clerks and some, singly or in combination, indicate the real possibility that something is wrong, then to separate each off into watertight compartments and pose the question whether it individually raises a suspicion of fraud and, on receiving a negative reply, asserting that it follows that the clerk does his duty if he does nothing further, is a misuse of the dictum of Lopes LJ [in Kingston Cotton Mills] and denies both the true tests of legal duty of care and of common sense. What then is the true ambit of relevant circumstances? They are such circumstances as the auditor ought reasonably to have considered in relation to the matter discovered. [506]

To some extent, the views expressed in the *Kingston Cotton Mill* formulation are aligned with the Australian auditing standards. The auditing standards reinforce the notion that an

[503] Ibid.
[504] See 6.1.4.2 Duties of the Auditor at Common Law.
[505] CCH, *Australian Company Law Commentary*, above n 457, ¶104-050.
[506] *Pacific Acceptance Corporation Ltd v Forsyth & Ors* (1970) 92 WN (NSW) 62.

auditor must approach an audit with a sense of professional scepticism.[507] Auditing Standard ASA 240, *The Auditor's Responsibility to Consider Fraud and Error in an Audit of a Financial Report* provides that the primary responsibility for the prevention and detection of fraud and error rests with those charged with the governance of the entity and the entity's management. The audit is designed to provide a reasonable assurance that the financial report taken as a whole is free from material misstatement, whether or not caused by fraud or error. The auditor is not and cannot be held responsible for the prevention of fraud and error.[508]

When planning and performing audit procedures and evaluating and reporting on the results, an auditor should consider the risk of material misstatements in the financial report resulting from fraud or error. This means that the auditor's duty in part includes a requirement to pay due regard to the possibility of fraud or error. The process of verification cannot properly be carried out unless the audit procedures take account of the possibility that the affairs examined may not be true due to errors innocent or fraudulent.[509] Moffitt J in *Pacific Acceptance*[510] provided the "business judgment rule" qualification in this regard:

> An auditor pays due regard to the possibility of fraud or error by framing and carrying out his procedures, having in mind the general and particular possibilities that exist, to the extent that if a substantial or material error or fraud has crept into the affairs of the company he has a reasonable expectation that it will be revealed. The problem is an intensely practical one. On the other hand, it may be unjust to criticise a procedure, particularly with hindsight, merely because it was not apt to reveal some fraud devised with particular ingenuity or some isolated

[507] *ASA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards* [15].
[508] ASA 240.4 *Responsibility for the Prevention and Detection of Fraud* provides that:

> The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment.

[509] Auditing and Assurance Standards Board, ASA 240, *The Auditor's Responsibility to Consider Fraud in Audit of a Financial Report* (June 2011) [5].
[510] (1970) 92 WN (NSW) 29.

> or minor fraud or error.[511]

6.2.2 Bridging the Expectation Gap

The need to address the audit expectation gap and find clarity around an auditor's duties was recognised by David Knott [512]who stated that:

> ..community expectations of audit need to be examined from a broad perspective, not by assuming that independence is the only, or necessarily the most important, issue at stake. It is logical to assume that lack of independence may lead to a bad audit. But it is a non sequitur to deduce that an independent audit will be a good audit. We need to question just how rigorous and investigative we want our audits to be; what we are prepared to pay for them; and how strictly we will hold the accounting profession to account for failing to detect and report when financial statements do not reflect and true and fair view of the enterprise. [513]

The remainder of this chapter offers suggestions on how to bridge the expectation gap. Emphasis is placed on expanding the scope of audit to encompass the detection of fraud. The challenge set for the audit profession is to determine what measures can realistically be adopted to close the gap. Auditors cannot reasonably be required to provide certainty for the quality of financial reports prepared by management or certainty about management's ability to run the business of the audited entity for that matter.

The gap may be reduced by increasing the public's understanding about the nature of audit, its governance, and its inherent limitations. In addition, in order to bridge the expectation gap in the long term, the audit profession may look to expand its services and undergo a fundamental change in attitude from self-defence and self-preservation to meet society's expectations. Such a reorientation and expansion of services may be required to include more work aimed at detecting fraud, increased audit of internal controls, and greater

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[511] *Pacific Acceptance Corporation Ltd v Forsyth & Ors* (1970) 92 WN (NSW) 65.
[512] David Knott was the ASIC chairman at that time of making the statement.
[513] Knott, 'Corporate Governance - Principles, Promotion and Practice', above n 171.

disclosure of audit outcomes. This increase in services would present further opportunities to increase the quality, diversity and scope of audit services, and generate greater audit firm revenues.

To close the gap even more completely, the audit profession and financial community must re-examine the fundamental role of audit in society. New ideas and approaches may then be offered to help ensure that financial statement preparers and users share the same understanding of audit that auditors hold. The expectation gap will remain, and auditors will continue to be faced with legal action for as long as users and auditors hold conflicting understandings of what 'presents fairly' means according to generally accepted accounting principles. [514]

6.2.3 Out of Court Settlements

At the time of a corporate failure, focus is almost always directed at auditor responsibility. Doubts are cast on whether the auditing profession has learnt the lessons from the past. It is interesting to note that of the 14 legal suits against auditors in the late 1980's, 12 were settled out of court. The settlement amounts in these cases represented a small fraction of the claims brought against the auditors involved in these actions.

Out of court settlements are inevitable given the complex nature of the issues involved in cases against auditors and the significant legal cost of taking court action. Those settlements however cause information that may have been published as legal judgments to escape public examination. That lack of transparency hinders the audit profession's response to audit failure. The public's confidence in the profession is not helped by out of court settlements. Areas that require new standards or audit techniques are not brought to light, and problems needing regulatory intervention do not become evident. Settlements thereby contribute to misleading perceptions and in fact broaden the audit expectation gap. Case law concerning auditor failure is a valuable source of information as it highlights problems

[514] Hian Chye Koh and E-Sah Woo 'The Expectation Gap in Auditing' (1998) 13(3) *Managerial Auditing Journal* 147, 152.

confronting auditors, such as an auditor's role in fraud detection.

An auditor's responsibility to detect fraud will arise where the possibility of a fraud comes to his or her attention. Auditors must include steps to detect fraud in their audit programs and support these approaches using professional standards, training, and their past experience in such matters.[515] As mentioned above, this process is further assisted by making information on the facts and outcomes of court cases involving fraud and audit failure available. Instruction and guidance on fraud detection can be more easily formulated where the narratives on its perpetration are made public. The audit profession then has the opportunity to deliver improved testing methods to discover fraud and ultimately reduce the audit expectation gap.

A company's going concern status may be difficult to determine with any precision. This difficulty combined with unrealistic public expectation of the auditor's responsibility to assess financial viability perpetuates the expectation gap. The existence of fraud is likely to impact upon a company's going concern status and hinder an auditor from accurately deciding upon its future viability. This is especially the case where fraud is carried out by a related party of the audited entity. For example, a company's directors or management may cause liquidity problems by diverting a company's assets for their personal benefit and conceal their actions. Out of court settlements prevent details of these actions and the strategies used from becoming public knowledge. On the other hand, decided cases publicise important facts, issues and contentions which may not otherwise come to light.[516] Many entrepreneurs involved in the management of collapsed companies are persuasive individuals and are able to control information flows. Case law can provide important insights into an auditor's response to dishonest entrepreneurial behaviour, and is instructive for audit profession change into the future.

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[515] *Pacific Acceptance Corporation Ltd v Forsyth & Ors* (1970) 92 WN (NSW) 66.

[516] Rodney Johnson, 'The 1980's Corporate Collapses : Unresolved Auditor Business', in Garry Carnegie (ed), *The Second Accounting History International Conference* (Deakin University 2001) 1-31.

This thesis does not suggest that out of court settlements be prohibited given that the court process may involve costly and lengthy proceedings. Instead, the audit profession could be given the means to analyse instances of audit failure in settled cases in order to better understand why they occurred and to then develop corrective procedures.

One approach is to implement a mechanism to ensure that the details of settled disputes are published. This solution would require that copies of the plaintiff's statement of claim be submitted to the Australian Securities and Investment Commission ('ASIC'). A summary of issues involved is prepared by the parties, attached to the claim, and examined by ASIC for accuracy. Summary information for all out of court settlements could then be published by ASIC to ensure that details on these settled cases are available. This information could then help guide the debate on auditor responsibility and provide guidance for the profession and its standard setting. This public record would be available to those examining similar facts to enable them to make more appropriate and timely judgments concerning the nature of audit failure.

6.2.4 Expanding the Scope of Audit in Australia

The Institute of Chartered Accountants in Australia ('ICAA') identified a need for Australian businesses to work with the auditing profession to improve investor confidence by expanding the scope of audit. The proposals were released by the ICAA in its paper titled *Financial Report Audit: Meeting the Market Expectations*. [517]The ICAA recognised that the role of audits had come under the public spotlight. It proposed that the business community work with the profession to make changes to audit procedures to reinforce the value of the product and reassure and reengage sceptical stakeholders. Former chief executive of the ICAA Stephen Harrison acknowledged that the profession has failed to close the expectation gap to date, and stated that:

> The audit expectation gap has not significantly narrowed and the Institute's *Financial Report*

[517] See Ken Trotman, *Financial Report Audit*: *Meeting the Market Expectations* (ICAA, 2003).

> *Audit: Meeting the Market Expectations* is proposing a different approach - changing the scope of audit so it better lines up with community expectations. [518]

Even with increased public focus on the audit product caused by corporate collapse[519] and the publicity given to the Ramsay Report, the Charles Report and CLERP 9, the ICAA contended that little has been done to reduce the expectation gap. Given the seriousness of the attacks on the reputation of audited financial reports in recent years, the solution offered by the ICAA was to commit to a comprehensive program that encourages and promotes the evolution and expansion of audit services.

Many past attempts by the profession to reduce the expectation gap by moving community expectations into line with audit product deliverables have largely failed. This thesis finds the idea of expanding the scope of audit to meet market expectations as proposed by the ICAA to have some merit. Approaches used to expand the scope of the audit could involve both the expansion of core audit services, and an extension of audit services to more closely address internal control, fraud, and the evaluation of an auditeee's going concern status. These extended audit services may also cover business risk, management decision making and analysis, the quality of accounting policies, corporate governance, continuous disclosure, performance audits and continuous audits. This expansion is intended to improve the audit product, to reassure and engage sceptical stakeholders and close the expectation gap in a real sense. [520] Expanding the scope of the audit is also consistent with the recommendations of the Charles Report of 2002, which stated that:

> …rather than advocating prescriptive regulation and mandating arbitrary limits or benchmarks, the central element of our reform proposal is to provide a framework enabling a broadening of the scope of the audit function to include, for example, corporate governance risk, management, internal control issues or other performance type issues. [521]

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[518] B. Wood, *ICAA Sparks Debate on How to Improve Investor Confidence* (20 October 2005) The Institute of Chartered Accountants in Australia, <http://www.icaa.org.au/>.
[519] Examples provided included One.Tel Ltd, HIH and Ansett Ltd.
[520] Wood, above n 518.
[521] Ibid.

The Charles Report found that adopting a more comprehensive audit process could address the broader information needs of shareholders.

6.2.5 Auditor Communications

The standard audit report is the primary means by which auditors communicate their findings to users of financial statements regarding their audits. As such, securities regulators must carefully consider whether the standard audit report communicates useful information to investors and whether its form and content contribute to audit quality.[522] The current modified version of an audit report does provide some useful detail for financial statement users with respect to a reporting entity's accounts. The requirements and guidance when issuing a modified report are found in Auditing Standard ASA 705, *Modifications to the Opinion in the Independent Auditor's Report* ('ASA 705') where the terms used to describe modifications to the auditor's report are:

- a qualified opinion;
- a disclaimer of opinion; or
- an adverse opinion. [523]

That standard prescribes mandatory reporting requirements and provides guidance on the circumstances when the auditor's report is to be modified, and the form and content of modifications. The table below illustrates how an auditor judgement about the *nature of the matter giving rise to the modification*, and the *auditor's judgement about the pervasiveness of its effects or possible effects on the financial report* will affect the type of opinion to be expressed. [524]

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[522] International Organisation of Securities Commissions, *Auditor Communications, Consultation Paper* (September 2009), 1 <http://www.iosco.org>.
[523] Auditing and Assurance Standards Board, ASA 705, *Modifications to the Opinion in the Independent Auditor's Report* (June 2011) [2].
[524] Ibid [A1].

Nature of Matter Giving Rise to the Modification	*Auditor's Judgement about the Pervasiveness of the Effects or Possible Effects on the Financial Report*	
	Material but Not Pervasive	*Material and Pervasive*
Financial report is materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

Further advances in audit reporting have been made by the release of Auditing Standard ASA 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* ('ASA 706') which was issued in June 2011. That standard deals with the auditor's responsibility to provide additional communication in the auditor's report, when the auditor considers it necessary to:

> (a) Draw users' attention to a matter or matters presented or disclosed in the financial report that are of such importance that they are fundamental to users' understanding of the financial report; or
>
> (b) Draw users' attention to any matter or matters other than those presented or disclosed in the financial report that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report. [525]

Regardless of whether the profession extends the scope of the audit, there is an opportunity to reduce the expectation gap and go beyond the requirements of ASA 705 and ASA 706 by further redesigning and developing audit reports and reporting. A redesigned audit report may include changes to clarify exactly what the audit does and does not cover. This would be particularly relevant for issues such as the detection of fraud and the auditor's

[525] Auditing and Assurance Standards Board, ASA 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* (June 2011) [1].

responsibilities relating to an entity's going concern status. This change alone would have a substantial impact on reducing the expectation gap. The format of the audit report may for example include a listing all services provided by the auditor. Another option is to divide the audit report into sections that describe core audit and extended audit services. The report could also state the level of assurance attached to each service. An extended audit report may be of greater use to a broader range of readers including shareholders, company officers, the audit committee, ASIC and the Australian Stock Exchange.

Audit reports can be presented in plain English, legally-worded, adopt standard wording or an open ended format. Standard wording can assist user interpretation, given that any departure from a standard report signals that a problem may exist. Notwithstanding the benefits of standardisation, a more open-ended report provides scope for auditors to give greater detail. The International Organisation of Securities Commissions ('IOSCO') issued a consultative paper in September 2009, *Auditor Communication* ('the IOSCO paper') which drew a link between auditor communications, the expectations gap and the adequacy of the standard audit report.[526] After having considered the similarities and differences in the underlying objectives of audit reports throughout the world, the IOSCO paper concluded that the primary objective of audit reports across jurisdictions is relatively consistent. That is, to clearly express the auditor's opinion on the financial statements and to describe the basis for that opinion.[527]

The IOSCO paper found that the standard audit report has not kept pace with the growing complexity of business operations, financial reporting and auditing, and as a consequence, the usefulness of the standard audit report has been questioned. These criticisms of the standard audit report were classified under three categories, [528] that the audit report:

- expresses an opinion that is binary in nature, that is, a pass/fail model.

[526] Commonwealth of Australia, *Audit Quality in Australia A Strategic Review* (The Treasury March 2010) 50.
[527] Ibid.
[528] Ibid 51.

• contains 'boilerplate' and technical language; and

• does not reflect the level of effort and judgment inherent in an audit, to thereby exacerbate the expectation gap.[529]

Compounding this, larger audit firms issuing these reports are usually structured as partnerships. Minimal information about the ownership, governance, business structure and activities of these entities is made publicly available. The IOSCO report found that the inclusion of this type of information about the auditor might render changes to the standard audit report less necessary. For example, audit firm transparency reports may address concerns on about the firm and the team engaged to conduct the audit. A more complete picture of audit quality could then be formed.[530] The IOSCO paper also raised a concern that the nature of auditing is not widely understood by users of audit reports. Rather than informing users by further developing the standard audit report, the paper suggested that information about the nature of auditing could be provided through more general education and communication to investors.[531]

Against this backdrop of strategies and ideas aimed at improving auditor reporting, the knowledge disparity between retail users and more sophisticated investors continues to present a difficulty for regulators. The Australian Treasury has taken user comprehension, the different levels of user engagement, and the fact that audit reports are frequently not read by users into account when formulating its response. Notwithstanding those differences, the Treasury has stated a concern that more disclosures in the audit report might result in greater confusion and actually increase the existing gap between users and the suppliers of audit services.

The Treasury was instead was more attracted to strategies that involve the publishing of plain English educational material which explains the scope of the audit.[532] This approach

[529] International Organisation of Securities Commissions, above n 522, 8.
[530] Ibid 14.
[531] Ibid 14-15.
[532] Commonwealth of Australia, *Audit Quality in Australia A Strategic Review* , above n 526, 67.

would send the message that an audit involves sampling and is risk focused. That the purpose of audit is to provide reasonable assurance of financial statement integrity rather than give an iron clad guarantee. Audit firms, the professional accounting bodies and other industry bodies such as the Australian Institute of Company Directors and the Australian Shareholders Association should be involved in the preparation and dissemination of this material [533] according to Treasury.

The Treasury also suggested that audit firms and the professional accounting bodies could explore measures to encourage greater levels of confidence in the audit framework and professionalism of the audit function. These measures would include the issuing of transparency reports by audit firms in conjunction with publicity about the quality review programs undertaken by the professional accounting bodies. [534]

The *Corporations Legislation Amendment (Audit Enhancement) Bill 2011*[535] has progressed the Treasury's suggestion of greater auditor transparency. The Bill proposed legislation requiring that annual transparency reports be published by firms conducting ten or more audits of Australian entities of the following categories; listed companies, listed registered schemes, authorised deposit-taking institutions and insurance companies. The broad objective of this requirement is to improve audit quality by increasing transparency around audit firm operations. The requirement for audit firms to publish transparency reports is intended to make information about their significant audits available to existing and potential clients. The introduction of audit firm transparency reports brings Australia into line with developments in Europe and North America where the publication of transparency reports is already in place.

6.3 Meeting User Expectations – The Detection of Fraud

[533] Ibid.
[534] Ibid.
[535] The Bill was passed on 18 June 2012 to become law as the *Corporations Legislation Amendment (Audit Enhancement) Act 2011*. See Corporations Act s 332A, Transparency reporting auditors must publish annual transparency reports.

Justice Moffat's judgement in the *Pacific Acceptance* case[536] ruled that an auditor's duty includes reporting all suspected fraud to management, even if the financial effect of the fraud is not material to the financial statements. Not to do so would be negligent. There is a clear expectation gap in relation to the auditor's role in the detection of fraud. This issue was discussed extensively by the US Panel on Audit Effectiveness ('O'Malley Panel')[537] which devoted a chapter of its report on this issue.[538] The Panel was concerned that the audit profession has not kept pace with rapidly changing business environments, and stated that:

> …the profession needs to address vigorously the issue of fraudulent financial reporting, including fraud in the form of illegitimate earnings management.[539]

The O'Malley Report recommended that audit firms should aspire to a goal of zero defects. This however does not imply there would never be an undetected material financial report fraud, given the standard of responsibility for auditors is that of reasonable assurance, not absolute assurance. The remainder of this chapter focuses on the idea of expanding the auditor's role to detect fraud as one way to address the audit expectation gap with the view to narrow it.

Financial markets have increased their demands on preparers of financial statements. They require that reports are issued in shorter time frames, and that auditors carry out more comprehensive audits. Some users expect that auditors should detect and report on all instances of fraud despite what the professional standards and court decisions say about the role of financial statement auditing. [540] Any such expansion of the auditor's role to detect fraud and meet these expectations would encounter difficulties in its introduction. Auditors would need to adopt a fresh attitude to overcome past hurdles and resistance, and address

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[536] *Pacific Acceptance Corporation Ltd v Forsyth & Ors* (1970) 92 WN (NSW).
[537] Shaun O'Malley, The Panel on Audit Effectiveness submission to The Public Oversight Board, *The Report of the Panel on Audit Effectiveness* (31 August 2000) [2.87], [2.122].
[538] Ibid, see Chapter 4 of the report 'Earnings management and Fraud'.
[539] Ibid [3.27].
[540] Maria Kapardis and Andreas Kapardis, 'Co-Regulation of Fraud - Detection and Reporting by Auditors in Australia: Criminology's Lessons for Non-Compliance' (1995) 28 *The Australian and New Zealand Journal of Criminology* 193, 202.

reasons why they had not reported on fraud in the past.

Fraud is not just a criminal offence but also a major social problem. Although the role of professional advisers in the prevention and detection of white collar illegality has received little attention in the past, the high profile prosecutions by ASIC of several HIH directors has attracted some attention in this area. The question why auditors have not reported the fraud they find is of particular importance given that auditors are a target of blame for corporate collapse. To some degree, this blame is unfair as auditors, like lawyers, are captives to a model of professionalism which encourages a narrow and often legalistic approach to their function. In practice, the auditor's role has been to negotiate systemic uncertainties in the law for the benefit of their clients. [541]

One reason offered why auditors do not report suspected breaches of the corporations law to the ASIC is attributed to the large accounting firm environment. Auditors in this cultural setting are not generally encouraged to ask penetrating questions, or look across the broader context in which their firm operates. This is especially the case for large accounting firms that provide a broad range of services to these clients. Accounting firm independence may be impaired through the provision of these non-audit services to audit clients. This type of conflict is further explored in Chapter 7 of this thesis. The ambiguity inherent in an auditor's conflicted client relationship may often be incentive enough for an auditor not to report a corporate breach. Not surprisingly, when auditors qualify their reports they do so rather sparingly, and on rather minor issues.

The reasons why auditors who discover fraud do not qualify their audit report can be separated into three categories. Firstly, inter-organisational factors including competitive pressures impose time and resource constraints on the auditor, and invite or even make corner cutting inevitable.

Secondly, intra-organisational factors may influence the audit opinion. An individual auditor

[541] Ibid 203.

in a large accounting firm is less a moral agent, and more an employee who must contend with the various constraints and pressures of organisational life. These pressures tend not to encourage moral reflection. Fragmenting audit tasks across an audit team when combined with auditor remoteness from the consequence of his or her work tends to diffuse responsibility among an audit team. This makes it less likely that fraud will be reported.

Finally, auditors are like human beings in general. They are likely to selectively perceive and interpret information depending on their own motivations, conceptions and character. Personal motivation governs how an individual will resolve ambiguity or assesses risk, especially when deciding whether or not to avoid undesirable consequences for themselves, their firm, or their client. In confronting their failure to prevent or to detect client illegality, an auditor may acknowledge their moral agency or may seek to portray him or herself as a moral calculator when making that judgement. [542]

In denying responsibility for failure to detect fraud, some auditors may maintain that their audit was carried out in accordance with auditing standards, and that it is impossible for them to guarantee fraud will be detected. In this context, Grabosky stated that auditor failure to detect fraud:

> ... would appear to arise most commonly from commercial pressure, when accountants underprice their services and then tailor their work to fit the fee. When failure occurs, the professional denies responsibility for diagnosing and investigating fraud. [543]

Auditing Standard, ASA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report* sets out the responsibility for the prevention and detection of fraud. For those charged with oversight of an entity including those of the auditor, paragraph 5 provides that:

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[542] Ibid 204.

[543] Peter Grabosky, 'Professional Advisers and White Collar Illegality: Towards Explaining and Excusing Professional Failure' (1990) 13(1) *University of New South Wales Law Journal* 73, 96.

> An auditor conducting an audit in accordance with Australian Auditing Standards is responsible for obtaining reasonable assurance that the financial report taken as a whole is free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial report may not be detected, even though the audit is properly planned and performed in accordance with Australian Auditing Standards.[544]

The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error. This is because fraud may involve sophisticated and carefully organised schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations made to the auditor.[545]

A legislative offensive against fraud has been tried in Australia, with emphasis placed on managerial responsibility. Management have primary responsibility for the prevention and detection of fraud. Under section 295A of the *Corporations Act*, the chief executive officer or chief financial officer of a company must make a declaration that, in their opinion, the financial statements and notes to the accounts are in accordance with the Act (including the accounting standards) and that the financial statements and notes give a true and fair view of the company's financial position. [546]

A recent paper issued by the six largest global audit firms, *Global Capital Markets and the Global Economy: a Vision from the CEOs of the International Audit Networks* made some useful observations on the issue of fraud and the expectation gap, and stated:

> It is essential that all parties engaged in business reporting — employees, management, directors, auditors and policy makers — put in place appropriate procedures and policies to

[544] Also see *ASA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards* [A51].
[545] Auditing Standard, ASA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report* [6].
[546] Commonwealth of Australia, *Audit Quality in Australia A Strategic Review*, above n 526, [6.12].

> prevent and detect fraud. Nonetheless, there is a significant 'expectations gap' between what various stakeholders believe auditors do or should do in detecting fraud, and what audit networks are actually *capable* of doing, at the prices that companies or investors are willing to pay for audits. [547]

There are limits to what auditors can reasonably uncover, given the limits inherent in the conduct of the modern audit and the techniques used. More specifically, unless companies or investors are willing to pay the price for auditors to police all transactions, auditors are limited to using more indirect means to ascertain whether fraud has occurred. Meanwhile, the expectation gap will persist given that many investors, policy makers and the media believe that the auditor's main function is to detect fraud. An auditor is often presumed to be at fault if he or she fails to discover it. Given the limitations on any outside party being able to discover fraud, the generally accepted methodologies used by auditors in practice and the cost constraints of the audit itself, this presumption is not aligned with the current auditing standards. [548]

The increased complexity of global business operations require that more judgements and estimates be made about account balances, including fair value measurements. These judgements tend to cause greater variation in financial reporting. The problems caused by this disparity gives weight to calls for improved audit report content beyond the current pass/fail model, to include a more relevant narrative about the audit carried out on the financial statements. An improved auditor's report would give more relevant information to financial statement users, and clarify the role of an auditor in his or her financial statement audit ('FSA') role. [549] Accordingly, this type of auditor report would clearly articulate the auditor's role and limitations in detecting fraud. Communicating a clear message on the actual role of auditors in finding and reporting on fraud will help narrow the expectations

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[547] *Global Capital Markets and the Global Economy: A Vision From the CEOs of the International Audit Networks*, (November 2006) Global Public Policy Symposium
12 <http://www.cybsoc.org/CEO_Vision.pdf>.
[548] Ibid.
[549] Commonwealth of Australia, *Audit Quality in Australia A Strategic Review* , above n 526, [6.18].

gap.[550] Future constructive dialogue between the accounting profession and investors, other company stakeholders, and policy makers is needed. In particular, these conversations should address what can be done to prevent fraud to help close or at least narrow the expectations gap.[551]

To some extent, new standards on audit reporting have helped deliver clearer messages on role identification.[552] Auditing standard ASA 700, *Forming an Opinion and Reporting on a Financial Report* ('ASA 700') requires that the audit report must state the responsibilities of those charged with governance together with the auditor's responsibilities. These statements of responsibility include the extent that a company's management and its auditors have accountability for the detection of fraud. [553]

In particular, ASA 700 now requires that the audit report make a statement about those charged with governance of the financial report. This includes management responsibility for designing, implementing and maintaining internal controls relevant to the preparation and fair presentation of the financial report so that it is free from material misstatement whether due to fraud or error. Further to this, ASA 700 requires the report to set out the auditor's responsibilities and state that the procedures selected depend on the auditor's judgement. These auditor procedures include the assessment of the risks of material misstatement of the financial report whether due to fraud or error. [554]

6.4 Conclusion

The audit expectation gap is described as the gap between the public's perception of the auditor's role and the auditor's perception of that role. Since the 1970's, the accounting

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[550] Ibid.
[551] *Global Capital Markets and the Global Economy: A Vision From the CEOs of the International Audit Networks*, above n 547.
[552] ASA 700, *Forming an Opinion and Reporting on a Financial Report*, ASA 705, *Modifications to the Opinion in the Independent Auditor's Report* and ASA 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*.
[553] *ASA 700, Forming an Opinion and Reporting on a Financial Report'* [A 20].
[554] Ibid [31].

profession has attempted to address this gap. It however still persists, not only with respect to naive users but also for more sophisticated report users as well. Over the last two decades, Australia has experienced a spate of corporate and audit failures which have placed the audit expectation gap debate firmly on the agenda of accounting professionals, regulators and the public as an area requiring further attention.

Investors, creditors and analysts look to auditors not just to attest that the accounts comply with standards, but for the fundamental reassurance that the accounts depict a company's real financial position. To shift the role of auditors and nature of audit from where they have historically been and close the audit expectation gap in favour of financial statements users would require a radical rethinking of the framework that auditors operate within. It would mean shifting the scope of audits from an attestation function to provide greater comfort that the financial statements reflect the underlying reality of a company's position and performance. It would also involve moving from the current snapshot approach from where audits now attest that financial statements comply with accounting standards at year end, to a broader and more forward looking approach on what the financial accounts say about a company's condition into the future. Auditors would as a consequence need to apply greater resources to assess the financial viability of a client, detect fraud, and report the potential impact of any questionable or debatable findings.

Much of the fallout following corporate collapse in Australia has focused on the audit profession, and created a danger that regulation will become a punitive instrument of political expediency. In response, the audit profession must acknowledge and address financial user perceptions to restore trust in both the capital markets and the profession. Regulators must then too recognise that the audit function is a necessary part of the corporate governance framework and accept its limitations. Regulation alone will not regain public trust and close the expectation gap.

Confidence in the Australian capital markets relies on the belief that reporting processes and the regulatory framework will deliver accountability and transparency. This in turn relies on

the integrity and core ethical beliefs of corporate management and company auditors. This thesis concludes that the audit role must be redefined and stakeholder relationship restructured given the history of corporate failure on the profession's watch. To regain public trust and safeguard the profession's reputation, audit firms must embed ethics and compliance into their culture and core business processes so that they are seen by the public at large as having processes that work effectively.

Having now defined the roles and responsibilities of auditors in Australia, this thesis continues on in Chapter 7 to more closely examine the relationship between and the auditor and the auditee. More particularly, it goes on to examine the issues surrounding conflicts of interest and auditor independence. Australian registered auditors must carry out their role free of any client influence. This aspect is central to the concepts of governance and accountability covered in this chapter, and is the basis upon which auditor credibility is built.

Chapter 7: Auditor Independence

7.1 Introduction

An auditor's independence or lack thereof is determined by reference to conflict of interest situations. Much of the behaviour that falls within the realm of a conflict of interest begins as a minor questionable call, to on occasion escalate into a violation of ethical standards and the law. Conflicts of interest can result in inaccuracies of self-perception; they increase in line with financial incentives and clash with professional obligations. Compromised independence may cause a professional person to act against their obligations to society and their clients, and make them more likely to deviate from professionally defined standards of ethical behaviour.

Independence is an essential attribute of the external audit function. External audits are a potentially valuable and efficient form of monitoring a company's performance. Independent auditors add value to financial statements by reducing the likelihood of the deliberate misreporting of accounting information. Auditor provided non-audit services are a profitable and growing revenue stream for the audit profession, and have become important for the ongoing viability of the accounting profession more generally. The issue of auditor provided non-audit services is also significant to company's stakeholders given that the supply of these consulting services represents a potential threat to auditor independence.

There is growing concern among corporate stakeholders and regulators that the provision of non-audit services by auditors to their audit clients will impair or be perceived to impair audit independence. Those opposing auditor supplied consulting services claim that auditors who provide these services are less likely to issue a qualified audit opinion or constrain the aggressive accounting practices of their audit client. Auditor provided non-audit services are claimed to increase the economic bond between auditor and client. This bond then leads to

the perception of compromised auditor independence as an auditor may be unwilling to criticise the work of its consultancy division. Consultancy service fees are widely believed to contain a higher profit margin than audit fees. Auditors who provide non-audit services may thereby be reluctant to disagree with auditee management interpretation on accounting matters, as any such disagreement may result not only a loss of audit fees, but in all probability the loss of the consultancy fees as well.

The joint supply of audit and consulting services has been a robustly debated topic over many years, and is of considerable interest to corporate regulators. Regulatory authorities in several countries have banned or restricted the joint provision of audit and consultancy services.[555] The debate continues to be reported in the Australian financial media with reactionary calls for increased regulation of auditor independence. Recent corporate collapses both internationally and in Australia have triggered considerable public discussion about the role of auditors. Much of that focus has been placed on the issue of conflicted auditor independence. Demand for action and more stringent government legislation is generally the automatic response.

There have been several recent Australian regulatory and professional initiatives directed at controlling auditor independence and the supply of non-audit services to audit clients. The Australian Government commissioned Professor Ian Ramsay to conduct a review of the independence of Australian company auditors and provide proposals for the regulatory reform of auditor independence. The *Independence of Australian Company Auditors 2001* ('Ramsay Report') was presented to the Federal Government in October 2001. The Government has since adopted several key recommendations proposed by the Ramsay Report within the Corporate Law Economic Reform Program, CLERP 9 revisions to the *Corporations Act 2001 (Cth)* ('*Corporations Act'*) .

Most company auditors will claim that they are not influenced by fee dependence. They

[555] See, eg, *Sarbanes-Oxley Act* (2002) (United States).

contend that different accounting practice partners often perform the audit and consultancy work, and that the joint supply of these services actually enhances rather than detracts from each service. Australian regulators have however long held the view that the combined supply of audit and non-audit services to the same client is likely to impair an auditor's independence. That regulatory intervention is an effective means of addressing fee dependence and the damaging conflicts of interest that result from these situations. This chapter builds on auditor governance and accountability rules, and some present day challenges faced by auditors discussed in Chapter 6. It examines audit independence in the context of non-audit services, together with the restrictions placed on these services under Australia regulation and professional accounting statements. Chapter 8 of this thesis then offers financial statement insurance ('FSI') as a unique solution to realign financial reporting stakeholder relationships. Financial statement insurance will be shown to be a remedy which is capable of resolving conflicts of interest situations and reduce them to a level where even auditor provided non-audit services does not present a risk to auditor independence.

7.2 Conflicts of Interest

People rely extensively on the advice of experts as a reliable source of technique or skill, whose faculty for judging or deciding rightly, justly, or wisely is accorded authority and status by their peers or the public in a specific well-distinguished domain. Often these experts face conflicts of interest between their professional obligation to provide good advice and their own self-interest. For example, physicians are charged with caring for the best interest of their patients. This goal can be compromised if doctors refer patients to clinics or to pharmacies in which they have an ownership interest. In addition, pharmaceutical manufacturers induce physicians with free product samples and other benefits in an attempt to influence the choice of drugs they prescribe. Physicians are in the business of prescribing the services that they themselves will perform. Although these conflicts of interest may cause a medical practitioner's advice to be prejudiced, a physician typically believes their advice to be unbiased. Similarly, politicians are elected to represent the interests of their

constituents. Politicians can be accused of being influenced by private interests such as personal ties and donations to their political campaigns which can taint their decisions. For instance, special interest groups may fund 'independent' research used at political gatherings and public conferences, while lobbyists may seek favourable legislation and corporations make influential donations to electoral campaigns for commercial gain. [556]

One view of a conflict of interest has been expressed by Davis:[557]

> A conflict of interest is a situation in which some person *P* (whether an individual or corporate body) has a conflict of interest. *P* has a conflict of interest if and only if:
>
> (1) *P* is in a relationship with another requiring *P* to exercise judgement in the other's behalf
>
> and
>
> (2) *P* has a (special) interest tending to interfere with the proper exercise of judgement in that relationship.
>
> The crucial terms in this definition are 'relationship', 'judgement', 'interest' and 'proper exercise'.
>
> The 'relationship' required must be fiduciary; that is, it must involve one person trusting (or at least being entitled to trust) another to exercise judgment in his service. 'Judg(e)ment' is the ability to make certain kinds of decisions that require knowledge or skill correctly and reliably. 'Interest' is any influence, loyalty, concern, emotion or other feature of a situation tending to make P's judgment (in that situation) less reliable than it would normally be. 'Proper exercise' of judgment is normally a question of social fact and includes what people ordinarily expect, what P or the group P belongs to invite others to expect, and what various laws, professional

[556] Don A. Moore, Philip E. Tetlock, Lloyd Tanlu and Max H. Bazerman, 'Conflicts of Interest and the Case of Auditor Independence: Moral Seduction and Strategic Issue Cycling', (Working Paper # 03-115, Haas School of Business, 2002) 4.

[557] Michael Davis, 'Conflict of Interest' in R. Chadwick (ed.), *Encyclopedia of Applied Ethics* (*vol. 1, A-D),* (Academic Press1998) 590.

codes or other regulations require.[558]

A conflict of interest renders one's judgment less reliable than it normally would be, and can result in a failure or abuse of a fiduciary duty. According to the view expressed by Davis above, a conflict of interest can generally arise in one of two ways.

- Firstly, a self-interest conflicts occurs where a person has a self-regarding interest that is in conflict (or at least potentially so) with that person's fiduciary duty. This interest tends to interfere with the proper exercise of one's judgment with regard to that duty.

- Secondly, a role conflict arises where a person has two potentially competing fiduciary duties or roles that are in conflict with each other (or at least potentially so). They again have the tendency to interfere with the proper exercise of that person's judgment with regard to one or the other of the two competing duties or roles. A person in that situation is not able to properly exercise both.[559]

Self-interest conflicts of interest are reasonably obvious, however role conflicts may be less so. Role conflicts primarily involve a conflict between two roles, offices or institutions. Some professions, occupations and businesses restrict the opportunity for conflicted roles by imposing systems of control. The principle of division and separation of responsibilities underlies this institutional division of potentially conflicting roles. This disconnection facilitates the proper exercise of judgment and allows an individual to occupy two potentially conflicting roles or functions.[560]

7.2.1 Conflicts of Interest, Ethics and Morals

Conflicts of interest in the corporate, medical, and political realms can be argued for the most

[558] Ibid.
[559] Spence, above n 163, 113.
[560] Ibid.

part to be harmless or often work to the client or recipient's benefit. Those with a vested interest in a discipline are also those most likely to possess the most relevant expertise in a given field. For example, an audit firm is generally better equipped to handle a client's complex accounting tasks in circumstances where the auditor has previously consulted to that client. It is further contended that conflicts of interest are innocuous given that the professionals who face them maintain high ethical standards. Aside from the occasional unethical practitioner, the great majority of professionals, including auditors, can be expected to successfully navigate the conflicts of interest they face in an honest, unbiased, and non-corrupt way. However, the recent corporate scandals (as discussed in Chapter 2) and research undertaken on this issue provide ample reason to question this assumption. [561]

Conflicts of interest can be considered morally wrong for at least three reasons as can be seen in situations where:

- An individual is involved in a conflict of interest situation but does not respond to it.

  That behaviour is morally wrong if the individual fails to exercise his or her fiduciary duty of care for the benefit of those to whom a duty is owed, and the beneficiary is unaware that a conflict of interest exists. That person who fails to act may be found to be negligent;

- An individual is aware (or should be aware) that those owed a fiduciary duty are not aware that a conflict of interest exists, and does not reveal that conflict to them.

  That behaviour is morally wrong and amounts to a deceitful act for self-gain at the expense of others;

- A conflict of interest will remain notwithstanding its disclosure, if not as a moral problem then at least as a technical problem.

[561] Moore, Tetlock, Tanlu and Bazerman, above n 556, 5.

> Such conflicted behaviour continues to be ethically problematic and may also harm professional or institution reputation. [562]

The best remedy to resolve a conflict of interest is to avoid the situation altogether. In the case of an unavoidable or less severe conflict, it may be possible person to continue in the role. This will require the conflict to be disclosed and managed in an apparent and accountable way. 'Apparent' conflicts of interest may prove to be just as ethically problematic as actual conflicts given that they impact on the judgement of those owed a duty under a fiduciary relationship. Making full information available about an apparent conflict of interest can show the true extent of the conflict to those impacted. This approach is intended to preserve and maintain public confidence in the professions and public institutions by eliminating or at least reducing the appearance of conflicts of interest.[563]

7.2.2 Conflicts of Interest in the Accounting and Auditing Profession

The auditor is the guardian of financial integrity. An independent auditor owes his or her ultimate allegiance to his or her client's creditors, shareholders, and investing public. As discussed in Chapter 6, this role has been often been described as a public watchdog function that requires the auditor to be independent in fact and in appearance from the audited body at all times, and to demonstrate complete devotion to public trust.

Well informed and transparent financial markets require auditors to be independent given that auditor independence is the keystone of the Australian financial reporting system. At a high level, an absence of independence in fact or in appearance puts audit validity at risk, and questions about an audit body's financial soundness can be raised. The threats to independence of self-interest, self-review, advocacy, familiarity, and intimidation can compromise an auditor's ability to make unbiased decisions. Further factors endanger auditor independence at the accounting practice level, including situations where an auditor

[562] Spence, above n 163, 121.
[563] Ibid 125.

is related to, or maintains a financial interest in an audit subject. Financial dependency may also compromise audit independence if an audit firm's viability relies upon a small number of high paying clients.

As detailed in Chapter 2 of this thesis, the purpose of auditing is to provide independent public assurance by way of issuing an audit report on whether the financial statements of an entity present a true and fair view. That opinion is then relied on by the audit body's stakeholders with regard to financial statement accuracy and completeness. As such, the audit process provides both the means and end of an independent assurance process through certification of an entity's financial statements. By contrast, the primary function of accounting and consultancy services is to provide a product that allows for the application and implementation of financial accounting practices and policies. These services seek to maximise a corporation's profits and asset values, or minimise its losses and liability amounts. Financial consultancy is designed to enable a corporation to present its financial statements in the best possible light within the boundaries of the law, to enhance the entity's market profile and render it more attractive to prospective investors. As such, the strategies used by providers of consultancy services are external to audit services, where an auditor expresses an opinion whether financial statements are true and fair.[564]

The Enron Corporation ('Enron') case offers up many examples of conflicts of interest, including two categories of breached independence involving:

- a conflict between a person's self-interest and the requirements of the role he or she occupies,

- a conflict between two different roles a person occupies, or role confusion which serves to mask a conflict of interest.

The Enron case involved accountants using creative accounting devices to misstate financial

[564] Ibid 120.

accounts, even though these practices may have conformed to corporate law and reporting regulation in a strict sense. The resulting accounts did not reflect a true and fair view. Those responsible for their preparation and assurance were found to have acted outside the interests of the shareholders, prospective investors, and other financial statements information users.[565]

The role of an auditor may be in conflict with that of adviser, especially where one accountant performs both roles for the same client. A conflict of interest can arise when an accounting firm provides audit services for a company for which it also provides lucrative financial consultancy services. The consulting role may distort an auditor's assessment of independence and potentially interfere with the proper exercise of his or her duty to ensure the company's financial accounts present a true and fair view. Andersen's role in the Enron collapse clearly illustrates how conflicts of interest in auditing can assist corrupt activities. The Enron narrative tells that conflicts of interest in auditing must be avoided wherever possible, as their disclosure does not remove a conflict or eliminate the potential for it to cause corruption.

7.2.3 Agency Theory

Auditor independence sits at the core of efficient and effective capital market operations. According to agency theory, rational, self-serving but not risk averse principals and their agents have differing goals and objectives. This is because they have different time horizons, attitudes to risk and work ethics. Company owners can be considered principals while their appointed managers are regarded as their agents. The differing goals and objectives of both sides may cause some company managers to operate the company out of self-interest rather than in the interests of the owners. That self-interest of management may cause these agents to misreport the financial performance and financial position of the companies which they are entrusted to administer.[566]

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[565] Ibid 124.
[566] Ikin, 'Do Auditor Provided Non-audit Services (APNAS) Fees Impair Auditor Independence?', above n 50.

The independent audit of public company financial statements functions to serve capital market efficiency. An audit can add value to financial statements, and as a consequence add value to capital markets through financial statement credibility. The effectiveness of capital market resource allocation is thereby improved given that more informed decision making by financial statement users can result. In addition, audits are claimed to reduce information risk and lower the cost of capital of those companies that issue audited financial statement.[567]

Investors and owners are generally not positioned to fully monitor the behaviour of their managers in an economic manner, and hence owners will often estimate and deduct the cost of incongruent behaviour from a manager's remuneration. A rational manager therefore has an incentive to engage the services of an independent person to attest to fairness of the financial performance and financial position that they report on. An audit report which finds management representations to be true and fair will add credibility and reliability and positively confirm manager performance. This auditor oversight function helps to eliminate information asymmetry between a company and its investors, and helps maintains market place efficiency as a consequence. [568]

Agency theory applies to a debtor/borrower relationship in a similar way. A financier who provides funds to a company expects that the debt will be managed responsibly until the funds are repaid at a future date. Under this arrangement, financiers are considered principals, while company managers are their agents. Agents have differing goals and objectives to their principals. This may cause a fear that an agent may mismanage the borrowed funds, or transfer resources away from a debt provider. Management is thereby motivated to engage a trustworthy auditor to conduct a reliable audit of the company's

[567] Ramsay, above n 47.
[568] Ikin, 'Do Auditor Provided Non-audit Services (APNAS) Fees Impair Auditor Independence?', above n 50, 294. See Rick Antle and Barry Nalebuff, 'Conservatism and auditor-client negotiations' (1991) 29 *Journal of Accounting Research* (Studies on Accounting Institutions in Markets and Organizations) 34, who find that auditors attest to the financial reports and they can reduce the information asymmetry that exists between managers (not directors) and stakeholders in the firm.

financial statements to manage and minimise interest rate risk premiums. The audit report in these circumstances will add credibility to management's representations of good stewardship over the financier's funds.[569]

In these agency situations, the degree of credibility and reliability attached to an audit report will depend largely on the engaged auditor's competence and independence. The value of the audit product relies upon the belief that material misstatements will be discovered by a competent and independent auditor, and be unbiasedly brought to the attention of users of those financial statements. Having provided some general background to the problem of conflicts of interest, this chapter now discusses the requirements for auditor independence, the implications of auditor provided non-audit services, and the regulation of these services in Australia.

7.3 The Requirement for Auditor Independence

Australia has established comprehensive legislative and professional requirements for the conduct of an audit. Auditor independence rules are contained within that framework. The principal audit requirement is set out in the *Corporations Act* which requires that all disclosing entities, public companies (except some companies whose members' liability is limited by guarantee), large proprietary companies and registered schemes must prepare financial reports and have them audited. [570]These audits must be conducted by auditors or audit companies registered by the Australian Securities and Investments Commission ('ASIC') for that purpose.[571] To complement these requirements, institutional arrangements

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[569] Ibid.

[570] Australian Securities and Investments Commission *[CO 98/1417] Audit relief for proprietary companies* (Issued 13/8/1998) provides that:

> Subject to certain requirements, Class Order [CO 98/1417] gives relief to the following companies from the audit obligations in the *Corporations Act 2001*:
>
> (a) large proprietary companies; and
> (b) small proprietary companies which are controlled by foreign companies.

[571] Australian Government Financial Reporting Council *Annual Report 2009-10* (Commonwealth of

have been put in place to monitor auditor compliance and where necessary and take appropriate follow-up action in the event of a breach. The principal organisations that administer these institutional arrangements are ASIC, the Australian Securities Exchange ('ASX'), the professional accounting bodies (the ICAA, CPA Australia and the IPA), the Accounting Professional & Ethical Standards Board ('APESB'), and the Companies Auditors and Liquidators Disciplinary Board ('CALDB'). [572]

In addition, the *Australian Securities and Investments Commission Act* 2001 ('ASIC Act') empowers the Financial Reporting Council ('FRC') [573] to monitor the effectiveness of auditor independence and issue reports and advice about this matter to the Minister. The FRC is authorised to monitor and assess the nature and overall adequacy of systems and processes used by audit firms to ensure their compliance with auditor independence requirements. In 2009-2010 reporting year, the FRC performed this function by gathering information from ASIC under the terms of a memorandum of understanding. It reviewed reports published by the ICAA, and also examined other information held by the professional accounting bodies under the terms of its memorandum of understandings with those organisations. On the basis of that review, the 2009-2010 report expressed the view that the systems and processes used by audit firms to ensure compliance with auditor independence requirements were generally working effectively. Nevertheless, the FRC was disappointed that ASIC examinations continue to reveal that some firms inspected for the first time must improve their systems and processes. These firms needed to make system improvements to ensure that they are sufficiently robust and comply with legislative and professional requirements.[574] Although the FRC's findings appear positive on their face, auditor conflicts of interests continue to go undetected up until the time of a corporate failure, and when it is then too late to take corrective action.

Australia, 11 October 2010) [4.1].

[572] Ibid.

[573] See Functions and Powers of the Financial Reporting Council, *Australian Securities And Investments Commission Act 2001*(Cth) s 225.

[574] Australian Government Financial Reporting Council *Annual Report 2009-10*, above n 571, [4.2].

7.3.1General Requirements for Auditor Independence

Auditor independence has been a central theme in many decided cases, articles and reports written about the audit function. Auditors are appointed by company shareholders and generally are regarded to be the agent of members rather than agents of the company directors.[575] Auditors are required to report to shareholders directly and not to or through the company directors. [576] This requirement seeks to ensure that company shareholders receive independent and reliable information which reflects the true financial position of the company at the time the audit is concluded.

Whilst an auditor might rely on the work of others to form a view, the auditor cannot abandon his or her statutory and contractual obligations when reporting on an audited body's financial statements and records. The role of the auditor has been distinguished from that of an accountant in the past. For example, in *Re Transplanters (Holding Co) Ltd*, Wynn-Parry J stated that:

> Once a man takes upon himself a position of an auditor ... he must stand aloof and divorced from the aims, objects and activities of the company. [577]

The *Corporations Act* together with auditing standards, auditing practice notes and professional statements issued by the professional accounting bodies govern the regulation of auditor independence in Australia under a co-regulatory regime. Together these authorities comprise:

- Divisions 3 and 5 of Part 2M.4 of the *Corporations Act*, which sets out the independence requirements for the auditors of those entities which are subject to the audit requirements of the Act;

[575] *Spackman v Evans* (1868) LR 3 HL 171.
[576] *Re London and General Bank (No 2)* (1895) 2 Ch 673.
[577] *Re Transplanters (Holding Co) Ltd (1958)* 2 All ER 711.

- Auditing Standard ASA 220, *Quality Control for an Audit of a Financial Report and Other Historical Financial Information*, which was approved by the AUASB[578] in October 2009 and is operative for financial reporting periods commencing on or after 1 January 2010;

- Auditing Standard ASQC 1, *Quality control for firms that perform audits and reviews of financial reports and other financial information, and other assurance engagements*, which was approved by the AUASB in October 2009 and is operative from 1 January 2010;

- Section 290 of the *Code of Ethics for Professional Accountants* ('APES 110'), which was issued by the APESB in June 2006 and amended in December 2007 and February 2008;

- APES 320 *Quality control for firms*, which was originally issued by the APESB in May 2006 and reissued in May 2009. [579]

The Corporations Act 2001

Auditor independence is principally regulated under the *Corporations Act* under Part 2M.4 of Division 3.[580] Subdivision A of that Part imposes a general obligation on auditors (individuals, firms and authorised audit companies) to ensure that a "conflict of interest situation" does not exist in relation to an audited body. This subdivision provides the general test of independence under which a breach will constitute a fault based or strict liability offence. The main practical effect of this rule is to compel auditors to maintain quality control systems which are able to detect and deal with conflict of interest situations. Under the sections contained in Subdivision A, an auditor must be, and be seen to be independent of the audited body. An auditor that engages in audit activity in relation to an audited body will

[578] Auditing and Assurance Standards Board ('AUASB').
[579] Australian Government Financial Reporting Council *Annual Report 2009-10*, above n 571, [4.1].
[580] CCH, *Australian Company Law Commentary*, above n 457, ¶106-300.

contravene s 324CA(1) where that auditor is aware that a conflict of interest situation exists but fails to take reasonable steps to ensure the conflict of interest situation ceases. An auditor will also be found to have contravened the subsection if he or she fails to notify ASIC within the prescribed time of becoming aware of the conflict of interest situation.[581]

In addition, subdivision B imposes restrictions on specific employment and financial relationships between an auditor and the audited body. Restrictions are also imposed on retiring auditors who wish to join the board of an audited body. Subdivision B is regarded as the principal body of laws governing auditor independence, while Subdivision A sets out the general standard for auditor independence which acts as a catch-all provision. It regulates those circumstances which may fall within the spirit of the auditor independence rules, but technically fall outside specific Subdivision B prohibitions.

The "Conflict of Interest Situation": s 324CD of Subdivision A

Section 324CD is the primary reference point used to decide the general standard of auditor independence. It provides that independence (or more specifically, lack of independence) is determined by reference to a "conflict of interest situation", which is in turn defined by s 324CD (1) as:

> [A] conflict of interest situation exists in relation to an audited body at a particular time if, because of circumstances that exist at that time:
>
> (a) the auditor, or a professional member of the audit team, is not capable of exercising objective and impartial judgment in relation to the conduct of the audit of the audited body; or
>
> (b) a reasonable person, with full knowledge of all relevant facts and circumstances, would conclude that the auditor, or a professional member of the audit team, is not capable of exercising objective and impartial judgment in relation to the conduct of the audit of the audited body.

[581] Ibid.

The general test of independence under this section is based on the phrase "a reasonable person... would conclude" and is less stringent than tests used by other professional groups. For example, the test used to disqualify a judge from hearing a case is 'for reason of appearance of bias'. That judicial disqualification test inquires whether a fair-minded lay observer might reasonably apprehend that the judge might not bring an impartial and unprejudiced mind to the resolution of the question the judge is called upon to decide.[582]

In determining if a conflict of interest situation exists, s 324CD(2) requires that regard must be had to circumstances arising from "any relationship" that may exist, has existed, or is likely to exist, between the audit practice and the audit client.[583] These relationships may comprise financial, employment, business, professional or personal relationships. More specific restrictions on employment and financial relationships between auditors and their corporate clients are covered by subdivision B as has been noted above. The assessment of a conflict situation arising from these relationships is tantamount to identifying threats to independence.

Under *APES 110 Code of Ethics for Professional Accountants* ('APES 110', or 'the Code'), section 100.12 also gives practical guidance on threats and safeguards in the event of a conflict situation. The Code states that auditor independence is potentially affected by threats that include self-interest, self-review, advocacy, familiarity and intimidation. Of these, self-interest and self-review threats are most relevant to an auditor who provides non-audit services. A self-interest threat will occur when a financial interest or other interest can influence the auditor's judgment or behaviour. In contrast, a self-review threat is the threat that an auditor will not appropriately evaluate the results of a judgment made, or a service performed by him or her (or by another individual within the auditor's firm or employing organisation), on which the auditor will rely when forming a judgment as part of providing a current service.

7.4 Auditor Provided Non-audit Services and Auditor Conflicts of Interest

[582] Ibid.
[583] *Corporations Act* s 324CD(2).

Enhanced levels of financial statement credibility are achieved through the independent external audit of financial reports. The investing public's perception of that credibility will in turn drive capital market efficiency and pricing. In a sense, the accounting profession is trusted by the public to act as a gatekeeper, to protect investors and maintain market confidence by expressing a view on whether public company financial statements are true and fair. Conversely, public confidence is impaired where an auditor is found not to be independent of the audited body, or where circumstances exist that a reasonable person would believe are likely to influence an auditor's independence. Financial statements provide a basis for public company analysis for investment purposes. Investors rely heavily upon the integrity of financial statements, so that capital markets will be adversely impacted if investors lose their confidence in them, or if the integrity of financial reporting and assurance processes falls under suspicion.

The accounting profession and academics have long debated whether auditor supplied consulting services will compromise auditor independence in fact or in appearance. Non-audit services including financial advice, taxation accounting, and management consulting services do have the potential to cause conflicts and impair auditor independence. Financial statement users may perceive a conflict to exist given that these services may involve a mutual or conflicting client interest. For example, an auditor may be required to audit his or her own work, function in a client management role or employee role, or act as the client's advocate.[584]

The potential for a conflict caused by auditor provided non-audit services may lead some financial statement users to conclude that an auditor will be less forceful in his or her audit testing activities. On that basis, it is argued that auditors must not only avoid conflicts of interest, but also avoid the appearance of such conflicts altogether. Investors must have faith in auditor representations in order to make properly informed judgments. Any representations made by an auditor who has a conflict of interest, or the appearance of a conflicted interest, will not inspire such faith. A reasonable person taking a commonsense

[584] Ronald F. Duska and Brenda S Duska, *Foundations of Ethics, Accounting Ethics* (Blackwell Publishing, 2003) 132.

approach to human behaviour would believe that certain relationships affect an individual's behaviour, and that the appearance of conflict presents a temptation that while currently resisted, may sooner or later prevail. [585]

Company shareholders have the power to appoint, instruct, remunerate and remove an auditor. Australian public company boards of directors generally appoint an audit committee and oversee the company's arrangements with its auditor. The audit committee role add a further layer of complexity to the principal-agent structure, and generates more speculation as to whether the auditor is in effect an agent of the shareholders, the audit committee, or management. In reality, an auditor can never truly be independent of company management. This is because an auditor is subject to their own unconscious self-serving biases given they receive a fee for their services from the audited body. Auditor independence cannot be achieved in a pure sense given that an auditor works for the company shareholders, while at the same time being remunerated by company management. Although alternative structural arrangements have been suggested to help remedy conflicts of interests evident in financial statement audit ('FSA') relationships in the past, none of these have been considered seriously by the accounting profession to date. [586] In Chapter 8, this thesis will examine and champion FSI as such a solution to conflicts, to propose that it is now time for a new approach to restructure stakeholder relationships.

This chapter now examines the question of whether auditor independence is impaired from the supply of auditor consulting service fees. It concludes that while some research finds a perceived threat to auditor independence, there is no substantial evidence that supports the view that independence is breached by the provision of non-audit services. [587] This question of compromised independence however remains contemporary and significant, as regulatory agencies and professional bodies attempt to secure public confidence in the audit product in light of recent audit practice failures. This thesis contends that any reaction to these events to

[585] Ibid 135.
[586] Ikin, 'Do Auditor Provided Non-audit Services (APNAS) Fees Impair Auditor Independence?', above n 50, 296.
[587] Ibid 290.

further regulate auditor provided non-audit service must be balanced. Insights and evidence from academic auditing research must also be taken into account.

7.4.2 The Occurrence of Non-audit Services in Australia

Non-audit services include the preparation of accounting records and financial statements, valuation services, internal audit services, information technology systems services, temporary staff assignments, acting for or assisting an audit client in the resolution of a dispute or litigation, legal services, recruiting, acting in senior management roles for an audit client and facilitating corporate finance activities.[588] Over the past 50 years, public accounting firms have increased these types of consultancy revenues while at the same time the number of large audit firms has gradually fallen.[589] Consequently, questions about the extent of real competition in the market for audit services and the degree to which non-audit services fees now generated by auditors will compromise auditor independence are commonly asked. The greater amounts of auditor provided consulting services fees rendered in recent times, both in type and dollar amount have caused some investors to become sceptical of those auditors who promote their practices as providers of all professional services. Auditors who advance their practices as such are generally perceived to be less trustworthy and unable to remain truly objective when performing the audit function. This scepticism stems from concerns about auditor fee dependence, that auditors will be required to attest to their own recommendations, usurp managerial functions, or act as advocates for the company they audit.

This significant growth in non-audit services [590]by auditing practices in Australia and overseas was referred to in the Ramsay Report.[591] That report cited United States Securities and Exchange Commission audit client statistics, and in particular, the ratio of accounting

[588] CCH, *Australian Company Law Commentary*, above n 457, ¶106-340.
[589] The number of large audit firms has fallen from eight in 1960s, to five by 2000 and then to four by 2002.
[590] Examples cited included General Electric having paid KPMG $23.9 million for audit work and $79.7 million for consultancy work in 2000. Similarly, J. P. Morgan Chase paid PricewaterhouseCoopers $21.3 million in audit fees, but $84.2 million for other management services including consultancy.
[591] Ramsay, above n 47, [5.76].

and auditing revenues to consulting revenues which declined from 6:1 (1990) to 1.5:1 (1999). This same trend is evident in Australia and was observed in an ASIC survey on auditor independence which found the supply of non-audit services to be common.[592] The ASIC surveyed the auditor independence of 100 companies and found the widespread supply of consulting services (particularly taxation advice) to these companies by audit practices. The survey also found that Australian audit firms earn substantial fees for providing these services, and that they accounted for almost 50% of total practice fees on average. The ASIC chairman at that time, Mr David Knott, stated that the restricted size of the survey required that some caution be exercised when interpreting the responses. Notwithstanding that limitation, the information collected from the survey supports the propositions that:

- The provision of non-audit services by audit firms to their clients is widespread in Australia, at least in respect of major public companies. Almost all respondents to the survey confirmed having retained their audit firms to provide other services, particularly taxation advice.

- Audit firms earned substantial fees for non-audit services, and these non-audit fees accounted for nearly 50% of total fees paid to them on average.

- The processes put in place to deal with potential conflicts of interest are in need of review. Most companies were found to lack robust processes to ensure that audit independence was not prejudiced by the provision of non-audit services.

- The rotation of audit partners remains inconsistent. Less than half of the respondents required rotation, while rotation of the audit firms themselves was almost non-existent.

- Most companies do not monitor investment made in their securities by their auditor's superannuation funds.

[592]David Knott, 'ASIC Announces Findings of Auditor Independence Survey' (Media Release 02/13, Wednesday 16 January 2002).

- Only a small number companies employ former audit firm partners on their board, and only a small number have employed ex-audit staff as senior executives.

- The vast majority of respondents to the survey had an audit committee in place with appropriate operating guidelines to manage committee operations.

One of the most alarming aspects of the ASIC review was Mr Knott's statement that the survey supports the view, that the high levels of non-audit services fees earned by audit firms reinforces the potential for conflicts of interest to exist.[593] This finding is particularly relevant to the subject matter of this chapter.

7.5 Non-audit Services in the Australian Context

A company will generally purchase consulting services from its auditor if there is a business need, the incumbent auditor has the necessary industry specific expertise to undertake the consultancy, and there is willingness of management to appoint the auditor to provide the service. A company's propensity to consume business services more generally will depend on other factors. The audit body size and the complexity of its business operations are likely to influence its appetite for consultancy services. A company's demand for services is expected to increase as it expands its operations and takes on more diverse business activities that require the advice of external experts. The use of a complex group structures in combination with diversified market exposure is likely to trigger increased demand for expert tax advice, while management information system, treasury and organisational restructuring services are also likely to be demanded to support more sophisticated business structures.

Consultants may also be called upon to assist an audit body reorganise its business structure from the initial strategic planning stage and through to implementation. That consultant may

[593] Ibid.

then provide advice with respect to post-implementation monitoring and compliance audits. Further to supplying strategic planning advice and implementation coordination services, consultants may be required to prepare due-diligence reports and advise the company on the treasury aspects of its business, for example, whether to fund its operations by capital or debt. A company issuing shares or debt to the public is likely to require expert advice including prospectus services, underwriting and broking services, stock-registry and treasury services, as well as corporate law and regulatory advice.

The appointment of a new chief executive officer ('CEO') may also herald changes within an organisation. A new CEO may wish to make changes to corporate accounting practices soon after his or her appointment, and when the past management can be held accountable for reconstruction costs. A new CEO may wish to increase the company's profitability, corporate image and market share by reorganising and reshaping past management and business processes. Conversely, a retiring CEO may choose to postpone costs and reduce levels of consultancy expenditure. While some CEO's are appointed to implement a new strategic direction already formulated by the existing board of directors and management, others are employed in the hope that they will be the catalyst for a redirected corporate focus. In any case, a change of CEO is likely to be associated with significant changes within a company that in turn will generate opportunities for auditor provided consulting services.

Poor operating performance may also prompt a company to request consulting services from its auditor. That poor performance could be the result of ineffective or inefficient operations, inappropriate management strategies, a lack of market competitiveness or obsolete products or information systems technology. A company's shareholders may become intolerant to persistent poor performance and influence management to engage expert advisers to take corrective action. The supply of non-audit services from an existing auditor may be the most convenient solution for company management to help it achieve competitive and profitable operations, and appease its member's expectations. An incumbent auditor in these circumstances would be expected to provide more constructive consultancy services relative to its competitors given the auditor's intimate knowledge of the clients business. The

incumbent auditor's ability to service the client quickly and with low start up costs given the pre-existing client relationship would make this an attractive option for company management to choose.

7.5.1 Consequences of the Supply of Non-audit Services

Auditor provided non-audit services have been claimed to reduce the overall cost of consulting services, while bringing about increased auditor technical competence and promoting competition within the audit services market. The combined delivery of services produces cost savings from productive economies of scope, usually referred to as knowledge spillovers that originate from sharing and transferring information about a client. Auditor provided consulting services can also positively impact upon competition within the markets for both audit services and non-audit services given the greater number of services suppliers. The most significant consequence of auditor supplied non-audit services is not however a commercial outcome, but rather their impact upon auditor independence. The final part of this chapter will consider this issue in detail.

7.5.1.1 Economies of Scope

Auditors have provided non-audit services since the time external auditing commenced in the nineteenth century to the present day. Accountants and auditors have supplied services that complement their principal task and have received the benefit of considerable economies of scope from doing so. The joint delivery of services generates cost savings given that the same person (or same firm) provides both types of service. Productive economies of scope stem from the transfer of information and knowledge. The term is also referred to in accounting literature as a knowledge spillover. A knowledge spillover (or productive economies of scope) will occur when the total costs of one accounting firm jointly performing both non-audit services and auditing services is less than the sum of the costs when each service is performed by different providers.

Productive economies of scope come about because both types of services provided utilize the same set of information, resources and, or the same professional qualifications of those performing the services. For example, the information required to evaluate an internal control system is largely identical to that needed to improve these controls. Auditors are therefore placed in an optimal position to advise a client on how they might strengthen their internal control systems. Similarly, audit substantive testing will require that the adequacy of taxation provisions be evaluated. This in turn requires an auditor to be competent in the field of taxation in order to substantiate these amounts. The provision of accounting systems advice and taxation consultancy by an auditor to the client thereby allows him or her to make better founded judgements regarding the client when carrying out the audit.[594]

Economies of scope arising from joint service provision can also enhance an audit firm's technical competence more broadly, and help an auditor detect shortcomings in the financial accounts under examination. In particular, non-audit services are an important source of information at times when an auditor exercises his or her professional judgement. When consultancy services are provided to an audit client, the auditor is able to make an improved professional assessment since he or she will have a greater depth of knowledge about the audited body's business, industry reputation, strength of organisational structure, and management capability. These attributes would not be as evident on the face of the accounts alone. Knowledge spillovers are however less apparent in the case of large accounting firms where different teams, divisions or even companies are made responsible for providing each type of service.[595] This strict division of roles does nonetheless restrict the possibility of conflict situations from occurring to bolster auditor independence.

7.5.1.2 Effects on Competition in the Audit Services Market

Increased levels of auditor provided non-audit services are unlikely to harm competition in the market for audit services but could lead to introductory pricing and confused price

[594] Benito Arrunada, 'The Provision of Non-Audit Services by Auditors: Let the Market Evolve and Decide' (1999) 19(4) *International Review of Law and Economics* 513, 514.
[595] Ibid 515.

structures. This is because any cost savings gained from the joint provision of audit and non-audit services is notionally available for transfer to the client. This may take the form of service fee reductions at the time of the initial contract for services, or reduced service fees under a subsequent service agreement depending on the market conditions that prevail at that time. If the market for audit services is competitive, auditors will compete against each other to offer lower fees for their initial engagement knowing that they can recover that leading loss from the supply of future consulting fees.[596]A loss leading fee is more likely where the initial engagement is for audit work. This is particularly the case where potential economies of scope exist, and the auditor has the necessary resources to supply future consultancy services to its audit client.

Auditors who provide non-audit services in the main contend that introductory pricing practices and the use of auditing or non-audit services as a loss leader is a natural response to competition. That is, introductory pricing merely reduces the future profits that an audit practice derives from its ongoing commercial relationship with its client, and that this outcome is optimal from a public viewpoint. Some auditor's further argue that their continuity of engagement and expanded client relationship for broader services is advantageous to the client as well as the auditor.[597]

Less efficient providers of audit services may alternatively argue that price manipulation amounts to an abusive trade practice, and that regulatory intervention is needed to correct this type of behaviour. In can however be equally argued that regulation preventing introductory pricing could defeat the goals of auditor independence and increased competition, given that an aspiring auditor would not be able to discount his or her initial audit engagement fee and enter the market. In addition, preventative pricing rules could increase the profitability of already engaged auditors. This is because a prohibition against discounted initial audit fees would allow the already engaged auditor to render higher fees to distort the market for audit services. The cost of an initial audit engagement would rise as a consequence, while audit fees rendered in subsequent years may then be set at a level that

[596] Ibid 516 .
[597] Ibid.

prevents competitor entry. The productive economies of scope at that time would go to benefit the incumbent auditor's pricing structure.

7.5.1.3 Effects on Competition in the Market for Non-audit Services

It is unlikely that the use of predatory audit services pricing and cross service subsidies as described in the previous section is a sustainable pricing strategy. Predatory pricing is not a viable monopolising instrument in a competitive market place given that all service providers are able to develop introductory pricing strategies. The competitive nature and relatively low barriers of entry to the Australian business services also allows for strong competition in the markets for those services. Notwithstanding that view, some analysts believe that business services supplied by large audit firms are an exception this, given there is a lack of competition between these participants. Nevertheless, these alleged oligopolies would be expected to carefully consider the importance of maintaining their quality control compliance and professional status when costing their services and setting their pricing strategies. Large accounting firms are thereby unlikely to undertake predatory pricing which negatively impacts upon their elevated professional status and puts their branding at risk.[598]

In any case, more sophisticated accounting services consumers are expected to carefully assess the advantages of buying both audit services and consulting services from their auditor, including any benefits of efficiency and improved quality. These clients are also likely to appreciate the risks associated with joint service provision and judge the cost of conflicts for themselves. A well informed and sophisticated client will reject multiple services offered by its auditor if the quality of those services is called into question. On that basis, the claim that audit firm participation in non-audit services markets is harmful to competition appears unfounded. It is more likely that the entry of these additional suppliers will increase competition. These providers are able to supply value added products given their pre-existing client knowledge to more efficiently deliver consultancy services and audit at a lower cost.

[598] Ibid 517.

7.5.2 The Impact of Non-audit Services upon Auditor Independence

Auditor independence is achieved where both an auditor's real and perceived objectivity is sufficient to overcome conflicting self-interest incentives that might otherwise cause that auditor to ignore, conceal or misrepresent their findings. There is a view that audit firms that receive huge consultancy fees cannot be truly independent. This chapter now focuses on the impact of auditor provided non-audit services upon auditor independence. Research undertaken on the association between auditor independence and the provision of non-audit services is reviewed together with current debate on the matter. The chapter then considers the impact of auditor provided consulting services in the context of auditor independence and an auditor's willingness to qualify an audit report. It goes on to examine whether the character of the audit firm is relevant to auditor independence in these circumstances, and then reviews the current state of non-audit services regulation in Australia.

Research on Auditor Provided Non-audit Services

Research findings on the association between auditor independence and auditor provided non-audit services has not been conclusive and not provided any definitive resolution to the debate. That debate commenced as early as 1977, [599] and has continued up to recent times, particularly in the United States where regulators introduced stringent rules to govern (and restrict) the types of services offered by auditors under the *Sarbanes-Oxley Act*.[600] There have been calls for similar rules to apply in Australia, and the most recent of these followed in the wake of the HIH Insurance Ltd ('HIH') and One.Tel. Ltd ('One.Tel') collapses.

Research into auditor independence in cases where an auditor also supplies non-audit services to the same client has proven to be a difficult task. Non-audit services fees have been

[599] See, eg, discussion in the Subcommittee on Reports, Accounting and Management, Committee on Government Affairs, United States Senate, 95th Congress, 1st Session, *Improving the Accountability of Publicly Owned Corporations and Their Auditors* (Committee Print 1977, Senate Report).
[600] *Sarbanes-Oxley Act* (2002) s 201.

difficult to observe, given that detailed information on the nature and amounts paid has not always been publicly available. Adding to this, non-audit services may comprise recurrent or non-recurrent auditor services, and early research on the topic unrealistically assumed the propensity to consume consulting services was constant across companies and the services they consumed.[601] As a result, research into the effect of non-audit services on auditor independence has produced conflicting results and conclusions, with several researchers reporting that an association exists, whilst others identified no connection. These studies can generally be broken into three categories:

- the economic implications of the joint supply of non-audit services and audit services;
- third party perceptions of the effect of non-audit services on auditor independence; and
- direct tests of the association between non-audit services and; an auditor's internal control evaluations and reporting of audit decisions. [602]

These categorisations are now discussed in turn.

The Economic Implications of the Joint Supply

Early economic researchers used explanatory models to study the effect of non-audit services on auditor independence. More specifically, the studies used analytical models to examine the effect that joint service provision has on an auditor's financial returns. These models assessed the potential for increased efficiency and lower client fees from productive economies of scope. They hypothesised that the provision of consulting services from an

[601] Christopher Ikin, *Political Cost Influences On The Determinants Of Non-Audit Services*, (April 2003), The Australian National University < http://cbe.anu.edu.au/people/info/ikinchris/PolcostsNAS.pdf>.
[602] Alan T Craswell, 'Does the Provision of Non-audit Services Impair Auditor Independence?' (1999) 3(1) *International Journal of Auditing* 29, 30.

incumbent auditor would reduce a client's fees given the opportunity for the accountant to transfer knowledge between services to enjoy the resulting cost savings. [603]

It was generally thought that economies of scope would serve to reduce audit fees where non-audit services fees were also provided. However, overseas and Australian studies have instead discovered evidence of a positive relationship between audit fees and auditor provided consulting fees. The fees from both of these services were found to increase. One explanation for this finding is that clients may decide to increase their demand for audit services if the marginal cost for all services they receive is reduced because of knowledge spillovers. It is however equally likely that an auditor financially benefits from economies of scope efficiencies by not passing the benefit of lower costs on to the client. While efficiencies from joint service delivery may exist, any cost saving generated by the supply of these services is likely be appropriated as rents by the auditor in some part.[604]

One further conclusion taken from these economic based studies, was that an auditor's costs and pricing structure for audit and consultancy services are interdependent. That explanation of the relationship between costs and pricing is inconsistent with the economies of scope theory. The theory would instead expect a client to benefit from knowledge spillovers. Therefore, a company wishing to rely on auditor provided consultancy services to maximise its profits will not necessarily benefit from lower service costs gained from economies of scope.[605] The existence of economic rents and the extent to which efficiencies are not passed on to the audit client is instead evidence of bonding between auditor and client. That attachment brings about yet further incentive for an auditor to compromise his or her independence.

Third Party Perceptions

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[603] Ikin, 'Do Auditor Provided Non-audit Services (APNAS) Fees Impair Auditor Independence?', above n 50, 296.
[604] Dan A. Simunic, 'Auditing, Consulting and Auditor Independence' (1984) 22(2) *Journal of Accounting Research* 679, 681.
[605] Ikin, 'Do Auditor Provided Non-audit Services (APNAS) Fees Impair Auditor Independence?', above n 50 296.

Other early literature adopted a behavioural approach to its research. It principally surveyed auditor and third party perceptions of the effects of auditor supplied non-audit services on auditor independence. This literature found dissimilar perceptions of that relationship, with auditors generally perceiving there to be little or no apparent conflict, while third parties recognising that non-audit services do pose a threat to an auditor's independence.

The results offered by this literature are not however compelling. The potential for bias from survey participants causes the conclusions drawn from questionnaire responses to be less reliable then alternative research techniques. By their nature, these studies suffer internal and external validity problems, and the evidence produced by them must be used with caution. It can however be argued, that these studies of third party perceptions do nonetheless provide evidence that auditor independence is thought to be compromised in circumstances where auditor consulting services are also supplied. There is general agreement from this body of work that auditors who supply both consulting and audit services cause an independence perception problem, although the evidence on which this argument is based is both indirect and inconclusive. [606]

Direct Tests of Auditor Independence

The impact of auditor supplied consulting services on auditor independence has also been researched. The approach taken in these studies was to analyse auditor decision making in the presence of non-audit services. That research tested how changes in levels of consulting services supplied to a client would influence an auditor's opinion.

Watts and Zimmerman carried out this types of direct testing by defining auditor independence in terms of the probability of an auditor reporting errors conditional upon an error being discovered. During the course of an audit testing, an auditor is required to design and execute audit programs with the intention of detecting errors, and then disclose the

[606] Craswell, above n 602, 31.

nature of any errors discovered in their reports. Watts and Zimmerman[607]contended that the discovery of errors relies upon an auditor's technical capability and competence, and that the reporting of these errors is connected to auditor independence. Notwithstanding that the ability to detect errors within financial records may depend upon the auditor's competence, an auditor can avoid facing claims that his or her independence is compromised if no errors are detected. Therefore, auditor independence tested under the Watts and Zimmerman model relied not only upon an auditor's incentives to report errors, but also their incentive to find them in the first place.

Irrespective of an auditor's incentive to discover errors, an auditor can only report an error once it is discovered. A more useful comparison would be, once an auditor discovered an error, did or did not disclose the error in a qualified report. While the circumstances in which auditors qualify their opinions are observable, it is impossible to observe those circumstances where a qualification should have been reported but was not. The decision taken by an auditor to not truthfully report his or her findings will generally only come to light in the case of audit failure.[608] This chapter will later further explore the influence of non-audit services on audit opinions, together with other factors that may influence the type of opinion issued where auditor consulting services are supplied.

Australian Evidence

The threat posed by auditor provided non-audit services to an auditor's independence has been researched in Australia. Two of the leading studies in this area were undertaken by Barkess and Simnett, [609] and Wines.[610] Wines used data from Australian listed companies, and found an association between non-audit services and qualified audit opinions to exist. He concluded that there is potential for an independence perception problem if an auditor

[607] Watts and Zimmerman, above n 86, 314.
[608] Craswell, above n 602, 32.
[609] Lyn Barkess and Roger Simnett 'The Pricing of Other Services by Auditors: Independence and Pricing Issues'(1994) 24(Spring) *Accounting and Business Research* 91-108.
[610] Graeme Wines, 'Auditor Independence, Audit Qualifications and the Provision of Non-audit Services: A Note'(1994) 34(1) *Accounting and Finance* 75-86.

supplies non-audit services. Wines found that auditors were not perfectly independent when they received both audit and consulting fees from the one client. In contrast, Barkess and Simnett concluded that auditors do not compromise their independence in these circumstances. Barkess and Simnett also used data from Australian listed companies, but found no association between qualified auditor opinions and the supply of auditor provided non-audit services.

While the data used in both of these studies bears some similarity, there are some important differences. In particular, the models adopted by Barkess and Simnett, and Wines differed in the following respects:

- Wines tested the relationship between non-audit services and auditor independence using a narrow model that involved qualified opinions. Testing was then controlled for company auditor classification ("Big six" or otherwise), auditee company size and industry type.

  This limited approach to testing left out a wider range of explanatory variables which were also likely to also impact on an auditor's decision to qualify a report. Regard to these factors may have changed the outcome of the Wines study had they been considered.

- The Barkess and Simnett [611] model attempted to capture factors that affect demand for non-audit services, including the type of audit opinion issued. The sample used by Barkess and Simnett was drawn from the top 500 publicly listed companies in Australia and was biased toward larger companies which were expected to maintain superior internal control systems and were less likely to be issued with qualified opinions.

[611] Barkess and Simnett, above n 609, 99.

> Barkess and Simnett investigated the link between auditor supplied non-audit service fees and auditor switches, and found no support for the contention that auditors are less likely to issue qualified audit reports when they sell higher levels of consulting services to their clients.[612]

The differences between the model used by Barkess and Simnett, and that used by Wines means that the two sets of results are not strictly comparable. It can be concluded that there has been little consensus reached so far in the research on the impact of non-audit services on auditor independence in Australia. This chapter now discusses the current debate on auditor provided consulting services in the context of auditor independence in Australia.

7.5.3 The Current Debate in Australia

As explained earlier in this chapter, audited financial statements are an important source of information for capital market consumption and investor decision making. They also play an important role in effective corporate governance. Auditor independence is fundamental to the credibility and reliability of audit reports. As seen in earlier chapters, there has been recent widespread concern about the value of the audit function given the incidence of corporate collapse in which conflicted auditor behaviour was implicated. The facts behind an incidence of corporate failure may show a company's actual financial position to be poor although the financial statements and audit report did not reflect their true condition. The ability of shareholders and financial market participants more broadly to adequately assess the financial health of a company was distorted in many of these cases.[613]

The sound operation of Australia's financial markets depends upon auditors issuing reports and performing services that are free from bias, undue influence and conflicts of interest. The level of auditor independence needed to achieve this requires auditors to have capacity to

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[612] Ikin, 'Do Auditor Provided Non-audit Services (APNAS) Fees Impair Auditor Independence?', above n 50, 307.

[613] Explanatory Memorandum**,** Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth) 4.9, 4.12.

exercise objective and impartial judgment when conducting an audit.[614] The accounting profession has undergone a substantial transformation in recent times which is contradictory with this objective. There has been a continuing trend for Australia audit firms to merge and increase in size. Accounting firms have established international networks and common name affiliations. There has also been a significant increase in consultancy services provided by audit firms to their clients both in terms of the range of services offered and as a proportion of total firm revenue they represent. Many accounting firms have developed into multi-disciplinary service entities and have entered into new forms of business relationships with their clients which compromise their independence.[615]

Compromised auditor independence can have a negative impact upon the level of investment in Australia. Disruption to capital market operations will result if shareholders and investors cannot make their investment decisions with confidence. Given that any such loss of confidence in these markets can severely influence the operation of the economy, the Australian Federal Government found it necessary to introduce new measures to the *Corporations Act* in 2003.[616] These rules were intended to promote greater auditor independence and reduce instances of auditor conflicts of interest.[617]

As seen in the previous section, the extent to which auditor provided consulting services does in fact compromise auditor independence has yet to be determined with any degree of certainty despite the research and analysis published on this issue.[618] The problem of auditor supplied non-audit services however remains an important issue for corporate stakeholders and regulators. Although an auditor may be management's preferred choice as service provider, the company's shareholders may see this engagement as a real or perceived threat to auditor independence. Sharing this viewpoint, corporate regulators have tended to understand the supply of auditor provided non-audit services as a threat to independence, and

[614] Ibid 4.9.
[615] Ibid 4.10.
[616] This statutory revision is discussed further at section 7.6.
[617] Explanatory Memorandum, Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth) 4.11.
[618] Ramsay, above n 47, [8.38].

as activities likely to cause fee dependence and unavoidable conflicts. Following this line of thinking, history has shown regulatory intervention is the preferred response to the problem of conflicted auditor interests.

7.5.4 Arguments Supporting the Provision of Non-audit Services

Advocates of auditor provided non-audit services argue that the supply of these services is in the public interest. Audit effectiveness is improved, where for example, a client engages its auditor to correct internal control weaknesses which were identified during the audit process. The provision of consulting services in this case would enhance audit effectiveness as the incumbent auditor has a better understanding of the client's internal control systems then other service providers. It has been further contended that those companies with the greatest need to improve internal controls may find the costs of appointing another accountant to perform this role prohibitive. In addition, many audit practices require specialist consultants to provide critical technical support or give expert advice on an issue during the course of an audit. The ability to attract and retain these specialists to sustain the audit function may be impeded if the supply of non-audit services was prohibited. The consequence of restricting consulting services in these circumstances may lead to reduced audit effectiveness, with flow on effects to capital market efficiency.

The provision of consulting services is a significant, profitable and growing revenue stream that has become important to the ongoing viability of the audit profession and accounting firms more broadly. Audit firms claim that they are not influenced by fee dependence as audit services and non-audit services are often performed by different practice partners and staff. They argue that the joint supply of services actually enhances their product rather than detract from the delivery of each separate service. It has been stated that:

> Instead of worrying that consulting services might compromise the objectivity of their financial sleuths, the major accounting firms argue that non-audit services actually make them

> better auditors.[619]

These supporters of auditor provided consulting services further contend that the performance of audit services and non-audit services for the same client delivers audit efficiency by leveraging on existing understandings of the client without losing auditor independence as explained in section 7.5.1.1 Economies of Scope. Public accounting firms point to favourable research on the issue, which has generally found there to be little evidence that performing non-audit services in conjunction with audit services harms independence. This view was expressed by Robert Garland, a former national managing partner of Deloitte & Touche who stated that:

> ...there is no evidence that [a] broad scope of services has had an adverse effect on audit quality. My own personal experience has caused me to conclude just the opposite. [620]

However, the issue of auditor independence continues to generate concern and debate in Australia. While advocates for auditor provided consulting services argue the benefits of joint service supply outweigh the disadvantages, some opponents have called for a complete ban on non-audit services. They argue that acting in the dual capacity of auditor and consultant compromises auditor independence and that this practice must be stopped.

7.5.5 Arguments Opposing the Provision of Non-audit Services

Those opposing the provision of consulting services by auditors argue that auditors who provide these services might be auditing their own work. In addition, these non-audit services cause an auditor to develop a mutual interest with a client's management, making the auditor subject to fiduciary conflicts of interests between the 'audit client' and their 'non-audit services client'. The supply of non-audit services will inevitably create

[619] Jennifer R. Joe and Scott D. Vandervelde, *Does Auditor Provided Non-audit Service Improve Audit Effectiveness or Impair Independence?* (Midyear presentation paper, Georgia State University, 2004) 1.
[620] Ibid.

circumstances that lead to conflicts of interest, given that the audit practice serves two different groups of clients. The accounting practice supplies consulting services to company management, while at the same time providing audit services to the audit committee, shareholders and others who rely upon the audited financial reports for their decision making. A prohibition on auditor provided non-audit services if legislated would not prevent an audit practice from providing consulting services, but rather exclude these services from being supplied to its audit clients.

It is further argued that the compensation and reward systems used by audit practices can influence the integrity of an audit. This may occur if an audit partner's success in marketing the firm's consultancy services is a determinant in the compensation, promotion and reward model of the practice. Those skills required for cross-selling non-audit services are however not aligned with the requirement for an auditor to exercise professional scepticism. These types of issues were found to exist in the relationship between HIH and Arthur Andersen ('Andersen') as its auditor. According to the *HIH Royal Commission Report* of 2003:

> The potential for a compromise of independence was exacerbated by the fact that the 'cornerstones by which performance was evaluated at Andersen did not include any express requirement of independence. Andersen witnesses gave evidence that such a requirement was implied ...' [621]

In that case, Andersen's audit partner Pye, denied that he at any time believed he was faced with a conflict between exercising independence and professional scepticism, while at the same time promoting the provision of Andersen's non-audit services. Notwithstanding that view, Pye gave evidence that his ability to promote the supply of Andersen's consulting services to HIH may have relied on his close relationship with the HIH management. The client satisfaction rating of Pye's performance evaluation was also a factor used to calculate his remuneration and ultimately his progression through the Andersen partnership. He agreed that the audit body's management may have been less happy had he shown greater

[621] Commonwealth of Australia, HIH Royal Commission, *The Failure of HIH Insurance* (2003) *Vol. III Reasons, Circumstances and Responsibilities* (2003) [21.5].

levels of auditor independence and professional scepticism. Pye stated that his ability to sell or promote the supply of non-audit services to HIH may have been impacted if he were called upon to exercise more independence and scepticism, and resist HIH management's proposals on the company's audit outcomes. [622]

The HIH Commission found that Andersen's performance evaluation model could give rise to the perception that its audit partners would prefer to develop Andersen's business relationship with HIH rather than comply with their professional obligations. Andersen submitted that there was no evidence to suggest that the generation of non-audit services by audit firms was uncommon at the time and indeed that there was considerable evidence to the contrary. The Commission accepted that such arrangements may have been common, but that fact did not determine their appropriateness.[623]

The HIH Commission's comments about the relationship between HIH and Anderson make it clear that the joint provision of non-audit services and audit services may cause an auditor to be less likely to disagree with management given that opposition may result in dismissal. A qualified audit report is often an indication of unresolved differences of opinion between management and the auditor. An auditor is expected to withstand management pressures to maintain his or her independence to truthfully report his or her findings. Where the auditor also provides non-audit services, the economic loss associated with the audit firm's dismissal is potentially greater than if consulting services were not supplied. Therefore, a potential threat to independence exists if an auditee's management can influence an auditor to issue an unqualified audit report because the auditor also provides consulting services.[624]

As the levels of consulting services purchased from an incumbent auditor increases, there is a corresponding increase in the economic bond between auditor and client such that the auditor is more likely to compromise his or her independence to ensure continued audit tenure. The

[622] Ibid [21.4.5].
[623] Ibid [21.4.5].
[624] Pelham Gore, Peter Pope and Ashni Singh, 'Non-Audit Services, Auditor Independence and Earnings Management' (Working Paper 2001/014, Lancaster University Management School, January 2001) 2.

incentive for an auditor to report truthfully is reduced when dismissal will also result in the loss of consulting services revenue. This is especially the case where the cost of relocating specialised resources used in those consulting activities is considerable. The contention that auditors who provide higher levels of non-audit services are less likely to issue qualified audit reports is now examined.

7.5.6 The Impact of Non-audit Services upon Audit Opinions

An auditor can be assumed to be a rational economic being who must balance his or her professional ethics with the economic practicalities of operating a viable business. An auditor may be less inclined to disagree with an audit body's management in conflicted situations, as disagreement may result in auditor switching and the loss of future revenue. As such, an auditor may perceive the economic consequences of dismissal to be greater than the need to maintain his or her independence.

Insolvent companies tend to exhibit symptoms of financial distress prior to their demise. An auditor must issue a qualified audit opinion, particularly a going concern opinion in the case of an insolvent company in the absence of strong and credible mitigating factors.[625] An experienced and well trained auditor is expected to competently carry out the audit task, to gather sufficient appropriate evidence during the course of the audit and assess a client's ability to continue on as a going-concern. In these circumstances, the joint provision of audit and non-audit services may offer an auditor more relevant information on a client's viability then if the audit service alone were performed. That additional information helps the auditor express an opinion which is reflective of the true state of the audited body's financial position.

Where an audit body's going concern prospects fall into question, an auditor may be reluctant to issue a qualified report, given that to report on solvency problems may become a self-fulfilling prophecy. This argument can however be challenged as it confuses cause with

[625] Auditing and Assurance Standards Board, ASA 570, *Going Concern* (June 2011**)** [17].

effect. Bad management decisions are to blame for a company's demise, while the auditor's role is simply to highlight this cause by qualifying the financial accounts. A prudent auditor would seek to avoid the possibility of reputational damage and legal action from issuing an unqualified audit report which is then followed by corporate failure.

The damage caused to an auditors' reputation from issuing an incorrect report can lead to adverse economic consequences for the firm. Audit fees may decrease together with a decline in market share for accounting services more broadly. Given that a qualified audit opinion will not cause the failure of a client where operational problems are already present, an auditor may in fact be encouraged to qualify an audit report where the imminent failure of a company is public knowledge. The future revenue to be earned from a financially doubtful client is uncertain, so that the possible failure of that client is not a reason to deter an auditor from issuing a going concern qualification from purely an economic viewpoint.

Further to this, although the fees derived from an individual client may not represent a significant proportion of an accounting firms total revenue, these fees may be significant to an individual partner's client portfolio. They may be an important factor in assessing a partner's future prospects in the firm. Thus at the individual level, an audit partner may hold a significant vested interest in a client. Opponents to auditor provided non-audit services contend that incumbent auditors are less likely to issue going concern qualifications to those clients that generate a high proportion of their consulting fees. The auditor is influenced to compromise his or her independence in these circumstances in order to receive ongoing economic rents. There is a strong economic incentive for an auditor to be complicit with their high fee paying clients given that others competing in the consulting services market pose a threat to their client retention. [626]

Factors that Influence an Auditor's Decision

An auditor's decision to qualify an audit report where he or she also supplies consulting

[626] Gore, Pope and Singh, above n 624, 25.

services may be influenced by several factors. Firstly, and as mentioned above, the level of audit client financial distress may influence an audit opinion. In situations where the client is less severely distressed, the auditor may be influenced to perceive a low risk of insolvency. The auditor may be inclined to acquiesce with management's assertions that continued operations of the audit body are probable. As a consequence, auditors who supply consulting services in these circumstances may resist issuing a going-concern qualification or another type of audit qualification.

As previously discussed in this chapter, economies of scope arise from the joint provision of audit services and consulting services, and can potentially deliver cost savings and synergies to an audit firm. Knowledge is exchanged between the audit practice and other service areas of an accounting firm to bring about efficiencies from this broader insight into a client's affairs. Given this transfer of knowledge, an accounting firm that supplies both audit services and non-audit services may rely on information from its consultancy division to form a view on a client's internal controls or financial statements content more generally. In addition, the efficiencies gained through providing consulting services may also give the auditor sufficient comfort to reduce audit testing and the time used to complete the audit. These factors may then add up to an auditor being less likely to issue a qualified report.

In addition, audit client size and the complexity of its operations may influence an auditor's decision whether or not to qualify an audit report. The economic implications when supplying consulting services to a large audit client are potentially greater if an auditor becomes economically dependent on providing services to it. These clients may use structures that comprise several business units, each of which act as potential consulting fee generators. Fee dependence may be created by taking on this additional work. An auditor may be influenced to issue an unqualified audit report in these circumstances, and argue that larger clients have greater access to capital markets with greater capacity to withstand financial adversities. Notwithstanding that argument, company stakeholders and other financial statement users may decide that the auditor has an economic incentive to issue an unqualified opinion given the high level of business services fees being derived from the

audit client.

Large Audit Firms and Non-audit Services

Smaller audit firms tend to adopt a more personal mode of service that may lead to increased opportunities for compromised independence. In comparison, larger audit firms are generally seen to have sound reputations and branding which they seek to preserve, and as such have less incentive to behave opportunistically and impair their independence. On this basis, a 'big four' audit firm is more likely to issue a going concern qualified opinion than other audit practices. If this view is accepted, the capacity for non-audit services to impair an auditor's judgement is a function of auditor size. That is, larger audit firms are less likely to compromise their independence than smaller practices. Auditors that provide a wide range of business services to a large and diversified client base may also argue that they are more independent of their audit clients because of the broader supply of consulting services. On this basis, supporters of auditor provided non-audit services contend that the provision of consulting services will in fact enhance the independence of the auditors who provide them to a large number of diversified clients.[627]

Arguments in favour of large audit practice supplied consulting services are further supported on the grounds of resource mobility. An auditor with specialised resources engaged in consulting services will incur costs if these resources need to be reallocated. The independence of larger audit firms is less likely to be impaired in these circumstances as large practices are expected to have lower resource allocation costs given the relatively constant demand for services from their client bases. Similarly, firms that provide a single service line to their clients, such as audit, will incur greater reallocation costs in the event losing an engagement. These auditors have less capacity to divert resources. The supply of audit services alone will thereby increase an auditor's incentive to compromise his or her independence, relative to those auditors who supply diversified lines of business services with lower resource reallocation costs. As larger audit firms typically supply a wide range of

[627] Ibid 5.

services and greater client numbers, it is expected they will have greater resource mobility and as such are less likely to compromise their independence in the event of a threatened conflict of interest.

Political costs are also said to influence conflict of interest situations and auditor independence. Larger audit practices are generally seen to be more politically sensitive and more likely to make conservative accounting choices. These large firms are highly visible to the public and would be expected to suffer significant costs in the event of audit failure. Auditor conservatism can thereby be said to increase with auditor size given that large audit firms have less incentive to compromise audit quality. Political costs are also relevant in the case of auditor resignation or removal, particularly if the auditor is a partner of a large accountancy practice. Ongoing capital market scrutiny and analyst monitoring of public company reports and disclosures will mean that any change in auditor engagement is likely to be drawn to the public's attention.[628]

The organisational structure of an audit firm may also impact upon an auditor's independence. Larger audit firms will in the main have an advantage over smaller practices in this context, given the greater levels of monitoring over practice procedures and controls they have in place. Mutual partner review is in general more evident in large firms of auditors, as each partner has a strong incentive to observe the performance of his or her fellow partners. Each partner is individually and severally liable to loss in the event of audit failure caused by a fellow practice partner. This means that each partner is liable not only for their share of the partnership debts, but also for those of the other partners. At worst, one partner can be liable for the entire partnership's debts. The effectiveness of mutual monitoring increases in line with audit firm size, as the number of partners and the level of exposure to personal losses also increases.

Several further reasons also help explain why large audit practices are less likely to compromise their independence if a conflict situation presents itself where they also provide

[628] Ibid.

consulting fees. Large practices are more likely to be organised along functional lines. In general this means that the audit function is typically discharged and supervised by a separate division of an accounting practice with clear divisional lines between those providing audit services and those who deliver consulting services. In addition, large audit firms are more likely to have highly structured internal controls and quality assurance controls over audit procedures and the delivery of the audit product. This structuring again suggests there to be a lower likelihood that auditor independence will be compromised by larger practices.

This analysis however seems inconsistent with headlines about large audit firm conflicted interests at times of corporate collapse. In practice though, it is only large practices that are resourced and have capacity to offer audit services to larger public companies. They are expected to feature prominently at the time of failure. There is little doubt that this situation of failed auditor assurance would be exacerbated if smaller practices were involved.

7.6 The Regulatory Response to Non-audit Services in Australia

Australian regulators have maintained the view that the supply of audit and non-audit services to the same client is likely to impair an auditor's independence. That statutory intervention is needed given that fee dependence and damaging conflicts of interest will arise in these situations. This chapter now examines some recent developments in the regulation of auditor provided non-audit services from the perspective of auditor independence in Australia. In particular, the introduction and impact of the Ramsay Report, and the CLERP 9 revisions to the *Corporations Act* will be discussed together with relevant APES guidance.

United States regulators have enforced a partial prohibition on the provision of auditor provided non-audit services under s 201 of the *Sarbanes-Oxley Act 2002*.[629] Australia

[629] Title II—Auditor Independence sec. 201. Services outside the Scope of Practice of Auditors.

(a) Prohibited Activities.—Section 10A of the Securities Exchange Act of 1934 (15 U.S.C. 78j–1) is amended by adding at the end the following:

legislators have not followed the strict laws imposed in the United States, as the *Corporations Act* does not expressly prohibit the provision of non-audit services by an audit practice to an audit client. In addition to *Corporations Act* restrictions, the professional accounting bodies in Australia have recognised that auditor provided non-audit services can threaten auditor independence. Guidance has been issued by these bodies to their members to safeguard against threats to independence or reduce them to an acceptable level under APES 110. The Code states that in certain circumstances, the threat may be so significant that no safeguard is able to reduce the risk to a satisfactory level. In such circumstances either the audit engagement or the non-audit service must be refused. [630]

The Ramsay Report

The starting point for regulatory development of auditor independence in Australia was the Ramsay Report. Professor Ramsay was appointed to examine the adequacy of existing Australian legislative and professional requirements at that time, and make recommendations for change where intervention was necessary. Professor Ramsay consulted a wide range of stakeholders, considered a number of written submissions and examined an extensive range of material published on auditor independence. Professor Ramsay's recommendations covered several key audit independence issues which included

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(g) Prohibited Activities.—Except as provided in subsection (h), it shall be unlawful for a registered public accounting firm (and any associated person of that firm, to the extent determined appropriate by the Commission) that performs for any issuer any audit required by this title or the rules of the Commission under this title or, beginning 180 days after the date of commencement of the operations of the Public Company Accounting Oversight Board established under section 101 of the Sarbanes-Oxley Act of 2002 (in this section referred to as the 'Board'), the rules of the Board, to provide to that issuer, contemporaneously with the audit, any non-audit service, including—

(1) bookkeeping or other services related to the accounting records or financial statements of the audit client;
(2) financial information systems design and implementation; PUBL204
(3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
(4) actuarial services;
(5) internal audit outsourcing services;
(6) management functions or human resources;
(7) broker or dealer, investment adviser, or investment banking services;
(8) legal services and expert services unrelated to the audit; and
(9) any other service that the Board determines, by regulation, is impermissible.

[630] *APES 110, Code of Ethics for Professional Accountants*, para 290.158.

employment relationships, financial relationships and the provision of non-audit services. Recommendations were made by Professor Ramsay to enhance audit independence, with particular focus placed on audit committees and the role of the auditee's board to oversee audit independence issues.

The Ramsay Report proposed that a comprehensive legislative framework be implemented to regulate auditor independence, and that this regulation be supplemented by the professional codes of conduct issued by the professional accounting bodies. For independence issues stemming from auditor provided non-audit services, Professor Ramsay recommended that the regulation of non-audit services be dealt with by the professional ethical rules. The report further recommended that the *Corporations Law* be revised to require disclosure of the dollar amount of non-audit services provided by an audit firm to an audit client according to the category of service supplied, together with an explanation of each service provided.[631]

The Accounting Profession's Rules

Section 290 of APES 110 contains rules that address threats to audit independence arising from the provision of non-audit services by an auditor. The section states that certain activities create self-interest threats that are so significant that the only course of action available is to avoid the activity or refuse to perform the audit engagement. The activities to be avoided or refused include authorising, executing or consummating of a transaction, or otherwise exercising authority on behalf of the audit client. Members of the professional bodies must also not decide which recommendations of the audit practice are to be implemented, or report to an audit client in a management role. [632]

Section 290 sets out the independence requirements for members of the accounting profession who carry out "audit and review engagements". Audit and review engagements

[631] *The Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003* ('Bill') implemented Ramsay Report recommendations into the *Corporations Act*.
[632] *APES 110, Code of Ethics for Professional Accountants*, paras 290.197, 290.198.

are defined as assurance engagements where a member in public practice expresses a conclusion on historical financial information. The section makes particular reference to the provision of non-assurance services to audit clients. It states that firms have traditionally provided a range of non-assurance services that are consistent with their skills and expertise. It continues on to say that the provision of non-assurance services may, however, create threats to the independence of the firm or members of the audit team. These are most often self-review, self-interest and advocacy threats. [633] Before a firm accepts a non-assurance engagement from an existing audit client, a determination must be made on whether providing that service will create a threat to independence. Consideration must be given to any threat that the audit team has reason to believe is created by providing non-assurance services. If a threat is created that cannot be reduced to an acceptable level, the non-assurance service must not be provided by the firm.[634]

Corporate Law Economic Reform Program

The *Corporate Law Economic Reform Program* ('CLERP') commenced in 1997 as a vehicle to review and reform Australia's corporate and business regulation. The program's objective was to provide a modern and responsive legislative approach to promote business activity. The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003* implemented the CLERP 9 measures together with recommendations of the Ramsay Report. The Bill also implemented several *Joint Committees of Public Accounts and Audit's Report* recommendations together with a number of proposals put by the HIH and Cole Royal Commissions. [635]

The underlying objective of the CLERP 9 reforms was to improve the operation of Australian financial markets by promoting transparency, accountability and shareholder

[633] Ibid para 290.156.
[634] Ibid para 290.158.
[635] Explanatory Memorandum**,** Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth) [1.2].

activism.[636] The Program's measures were designed to improve the reliability and credibility of financial statements through enhanced auditor independence and the disclosure of certain non-audit services. The Explanatory Memorandum to the Bill states that the purpose of the revised legislation is to address concerns about audit independence by putting a broad regulatory framework in place to govern audit oversight and independence. The new provisions retained the co-regulatory approach to auditor independence. This was achieved by enacting *Corporations Act* provisions which operate in conjunction with the comprehensive rules laid down by the professional accounting bodies. The revised *Corporations Act* introduced several key auditor independence reforms, which included a general requirement of auditor independence.[637]

The Corporations Law

Although auditor provided consulting services are recognised as having the potential to compromise auditor independence, these types of services are not expressly prohibited by the *Corporations Act.* Instead of prohibiting non-audit services, the *Corporations Act* has opted for a disclosure regime. Disclosures must be made in the annual director's report for a listed company under the heading of "Non-audit services".

The annual director's report disclosure requirements for auditor independence and auditor provided non-audit services are found in s 300(11B) − (11C) of the *Corporations Act*. These disclosures apply for financial years commencing on or after 1 July 2004, and require the directors' report to disclose:

(a) details of the amounts paid to the auditor for non-audit services provided by the auditor during the year. The disclosure must be made in dollar terms for ''each of the non-audit services"; and

[636] Ibid [1.4].
[637] Ibid [4.14].

(b) a statement whether the directors are satisfied that the provision of non-audit services by the auditor is compatible with the general standard of auditor independence in Pt 2M.4 Div 3 Subdiv A of the *Act*; and

(c) a statement of reasons why the directors are satisfied that the provision of non-audit services did not compromise the auditor independence requirements.

These *Corporations Act* disclosures are further supported by company financial reporting disclosure requirements under accounting standard AASB 101, *Presentation of Financial Statements.* That standard applies for reporting periods beginning on or after 1 January 2005, and requires that payments for non-audit services be disclosed, including the nature and amount for each service.

7.6.1 The Disclosure Based Solution

The Australian Government chose not to prohibit auditor provided non-audit services as its solution[638] to compromised auditor independence. In developing its legislative reform of auditor independence, the Government did consider if the provision of non-audit services should be prohibited entirely.[639] Such a blanket prohibition of non-audit services would have provided the maximum assurance to both public company shareholders and regulators that auditor independence is not threatened by the supply of their consulting services. A rule prohibiting audit firms from providing non-audit services to their clients would also have been relatively easy to administer. It would also not preclude an audit firm from providing business services to its non-audit clients. The Federal Treasurer's Explanatory Memorandum to the legislation stated that a ban on non-audit services would have placed Australia out of step with many other jurisdictions. The provision of non-audit services per se does not compromise independence but rather creates the possibility of fee dependence on the non-audit services income. This view was also consistent with the HIH Royal Commission report which did not propose a blanket prohibition on non-audit services.

[638] Ibid [4.43].
[639] Ibid [4.39].

The Explanatory Memorandum also pointed out that the United States did not impose full prohibition, but rather only prohibited specified types of non-audit services.[640] The Australian Government believed that this approach (of full prohibition) if introduced might give rise to a culture of adherence to rules rather than the underlying principle of ensuring audit independence. It would be almost impossible to draft legislation specific enough to prohibit non-audit services based on the substance of work to be performed. In addition, the government saw no solid evidence of a link between audit failures and the provision of non-audit services over the many years that audit firms have provided consulting services to their clients. The Government asserted that a ban on auditor provided non-audit services should not be imposed in the absence of compelling evidence of an independence problem.[641]

As was explained in the previous section, the alternative ultimately adopted by the Australian Government was the disclosure of non-audit services and non-audit services fees within the financial reports of listed companies by inserting new provisions into the *Corporations Act*. The Federal Treasurer contended that this approach would reduce the potential for conflicts of interest and also ensure that any compromise of independence would be made evident to the market. A disclosure approach (rather than prohibition) allows flexibility for auditors to perform a range of services which are in the public's interest, that do not compromise independence, and are beneficial to audit effectiveness. The Treasurer stated that this disclosure based approach seeks to provide information for investors to determine for themselves whether they believe the level of non-audit services consumed by an audit client is reasonable.[642]

Further reasons were also offered by the Treasurer to support the Government's decision in favour of non-audit services disclosure rather than full prohibition. He cited that audit firms are increasingly required to engage technical specialists to provide critical audit support.

[640] Ibid [4.44].
[641] Ibid [4.46].
[642] Ibid [4.50].

Attracting, retaining and motivating these specialists to support the audit function may be hampered if they are prohibited from providing their consulting services to audit clients. He further contended that on some occasions it is advantageous for a company's incumbent auditor to provide non-audit services. This is particularly the case where the provision of that service will benefit from pre-existing knowledge of a company's business. Therefore, an unintended consequence of prohibiting auditor provided non-audit services would be a less effective business advisory service delivery. [643]

The Explanatory Memorandum to the Bill also states that mandatory disclosure of non-audit services fees will assist financial markets identify the extent to which consulting services are supplied to an audit client and the degree of fee dependence that arises from that engagement. In order to comply with *Corporations Act* disclosure requirements, companies are required to keep a separate record of fees paid for audit services and non-audit services. At the time of introducing the legislation, this requirement was not expected to cause significant additional compliance costs for audited bodies as the existing accounting standards already required companies to disclose fees for audit and non-audit services on an aggregate basis. As such, many companies already maintained the necessary records before the legislation was enacted and incurred negligible compliance costs. [644]

The disclosure based solution adopted by Australian Government and enacted in the *Corporations Act* is in keeping with the principles based approach that underlies the Corporate Law Economic Reform Program. The disclosure of auditor provided non-audit services does assist shareholders determine whether the amount and nature of consulting services pose an unreasonable threat to auditor independence, while at the same time giving an audited body the flexibility to gain maximum benefit from engaging its auditor.

7.7 Effectiveness of the Disclosure of Non-audit Service Fees

It is not enough that public company financial statements are accurate; the public must also

[643] Ibid [4.47].
[644] Ibid [4.48].

perceive them to be accurate. The public's faith in the reliability of published financial statements will depend on their perception whether the external auditor has conducted his or her duties in an independent and professional manner. The value of the audit product will be lost if investors view the auditor as merely an advocate of a client. The non-audit services disclosure requirements of the *Corporations Act* were legislated to allay concerns of breached auditor independence. They help rebuild investor confidence in Australian financial markets caused by corporate wrongdoing and failed corporate governance. The transparency of the auditor-consultant-client relationship promoted under the *Corporations Act* allows shareholders, investors, creditors, and other parties, to judge if auditor independence is likely to be compromised.

The basic test for auditor independence emphasises the importance that transparency and knowledge plays, that is:

> ...if a reasonable investor, knowing all relevant facts and circumstances, would perceive an auditor as having neither mutual nor conflicting interests with its audit client, and that the auditor exercises objective and impartial judgment on all issues brought to his or her attention.[645]

Following this view, investors may bid down the value of shares of a company that discloses greater levels of non-audit services. This is because they are expected to perceive the provision of those services compromise auditor objectivity and reduce the probability of credible reporting. Alternatively, investors are likely to place funds with confidence and bid up security prices where they believe an audit client's financial information is reliable and auditor independence is not impaired. Financial markets become less efficient when greater levels of non-audit services fees are disclosed. Similarly, creditors are likely to increase the costs of capital for companies whose auditor independence is questioned. These extra funding costs include the withdrawal of credit, the downgrading of credit ratings, and the

[645] See Office of the Chief Accountant of the U.S. Securities and Exchange Commission, Staff Report on Auditor Independence (March 1994) 12-16.

imposition of higher interest charges.

7.7.1 Disclosure and Agency Costs

As referred to at paragraph 6.2.3 *Agency Theory*, agency costs arise when a principal appoints an agent to carry out a task, and the interests of that agent are in conflict with those of the principal. Such a principal-agent problem exists within the relationship between shareholders of public companies and the directors who manage them. Shareholders require management to operate the company's business in a manner that will maximise the value of their shares. On the other hand, management's objective is generally to build and expand the company business. That course of action may not always produce increased share prices. The joint provision of audit and non-audit services increases the economic bond between an auditor and its audit client to put the appearance of auditor independence at risk. Based upon this reasoning, companies with high agency costs will tend to purchase smaller levels of non-audit services from their auditor. These companies need to signal that an independent audit has been performed in order to reassure investors and creditors that their financial accounts are being properly monitored.

Company auditors must express an independent opinion on the financial statements they examine and monitor. That function verifies the actions and assertions of management in order to reduce agency costs. Failure to deliver a credible and independent audit is likely to increase the cost of a company's capital, restrict its access to capital, downgrade corporate debt, and severely restrict funding options. The audit independence requirement is critical for a company to effectively manage its cost of capital, as any impairment or perceived impairment of independence will increase agency costs. The publication of auditor provided consultancy services information is intended to allow shareholders, investors, and other financial statement users assess whether auditor independence is likely to be compromised. Those stakeholders who fund a company's operations will impose their own costs where

auditor independence is believed to be impaired after considering this information.[646]

As actual audit independence is difficult if not impossible to observe, shareholders may need to rely on an auditor's reputation, the professional accounting body the auditor holds membership of, regulatory agency oversight, and the other signals of independence available to them. One such signal is economic bonding between an auditor and audit client management. If the audit firm is dependent on a client for a substantial amount of its income, that firm is more likely to agree with management's representations and interpretations about accounting matters. The publication of auditor supplied non-audit service fees allows investors assess the impact of joint service provision, rather than resort to subjective estimates based on perceptions.

A company facing high agency costs will thereby demand the delivery of a high quality audit, while also restricting its purchase of non-audit services from its auditor. The requirement to disclose auditor provided non-audit services fees under the *Corporations Act* has given the auditor-client relationship greater transparency. Shareholders, lenders, and borrowers now have more information from which to form their opinions about financial statement credibility. As a result, companies that face higher agency costs are likely to take caution and not risk the appearance of compromised auditor independence, and thereby purchase lower levels of business services from their auditor. [647]

7.7.2 Client Diversification as a Regulatory Objective

The rules for auditor provided non-audit services in Australia under the accounting profession's standards and codes, and regulation aimed at greater disclosure have made some improvements. Lenders, investors, and consumers of audit and profession services can now determine what level of non-audit services is acceptable to them.

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[646] Michael Firth, 'The Provision of Non-audit Services by Accounting Firms to Their Audit Clients' (1997) 14(2) *Contemporary Accounting Research* 6.
[647] Ibid 19.

Notwithstanding the benefits of disclosing non-audit services information in a company's financial accounts, that approach may bring about some negative outcomes. Some professionals are more prepared to give biased advice if they believe the users of that advice are aware it is tainted. In addition, recipients of biased advice may find it difficult to make use of that information in their decision making. Some people are influenced by advice even when they know that it has been designed to manipulate them. Following that view, an accountant may freely go about providing conflicted business and audit services given that financial users are fully aware of these arrangements. Given these types of attitudes continue, more than just greater levels of transparency is needed to treat the independence problem. Client diversification is a further approach that offers protection to financial statement users.

The professional accounting bodies permit their members to determine, and to a large extent agree upon, an acceptable mix of audit and business services in negotiation with their clients. To complement the non-audit services disclosure regime, the professional statements issued by the accounting profession includes a requirement for client diversification. This rule is intended to regulate situations of conflicted behaviour arising from fee dependence. Client diversification is a low intensity regulatory strategy for non-audit services that seeks to safeguard both audit quality and maintain auditor independence.

A fee dependent auditor may be motivated to act in favour of his or her client to avoid the possible loss of income. An auditor will be found dependent if practice fee income is concentrated in a single client. APES 110 provides that where the total fees generated by an assurance client represents a large proportion of a firm's total fees, the dependence on that client (or client group) and the auditor's concern about losing the client may create a self-interest threat. The significance of the threat will depend upon factors such as the accounting firm structure, and if the firm is well established or newly created. The auditor must evaluate the threat found, and apply safeguards to reduce any significant threat to an acceptable level. Such safeguards include discussing the extent and nature of fees charged with the audit body's audit committee and taking steps to reduce dependency on the client. An auditor may also undertake an external quality control review. This can be done by

appointing a third party consultant such as an external professional accountant to review the threat.

More specific safeguards are necessary to reduce a threat to an acceptable level [648]where the fees generated by an assurance client exceed 15% of a firm's total fees. In this case, a professional accountant who is not part of the assurance team must carry out a review of the work performed or to be performed. That person must report his or her findings to the applicable professional body the accountant holds membership of. Where assurance client fees represent an unduly large proportion of practice total fees, the only course of action is to refuse to perform the non-audit service or to withdraw from the assurance engagement.

Encouraging auditor independence through client diversification is a low cost safeguard and is relatively straightforward to monitor. Client diversification in combination with the non-audit services disclosure regime allows for more effective financial market analysis and financial statement user assessment of auditor independence threats. This regime however continues to function within an environment where FSA stakeholder relationships cultivate conflicts of interest. Chapter 8 of this thesis proposes a restructure of those stakeholder relationships by offering a model that aims to ensure that auditor interests are aligned to those of company shareholders.

7.8 Conclusion

The requirement for auditor independence requires that an auditor be free from bias, personal interest, and not be susceptible to undue influence or pressure. Auditor independence is the cornerstone of statutory audits, as actual or perceived impairment of auditor independence is harmful to the credibility of the financial statements that an auditor reports on. One signal of impaired audit independence is the degree to which an accounting firm is economically bonded to a client. A growing percentage of public accounting firm revenues are derived from non-audit services. The provision of consulting services to an audit client increases the

[648] *APES 110, Code of Ethics for Professional Accountants,* para 290.222.

economic attachment between auditor and client, and this in turn has potential to reduce auditor independence or signal a perceived lack of independence.

The arguments against auditor provided consulting services are normally expressed in terms of economic dependency and mutuality of interest. If consulting services income becomes so important to an auditor either in aggregate or in relation to an individual client, the auditor's economic dependency on those services may cause him or her to lose their impartiality. An auditor may be more likely to acquiesce with the audit body's management and become biased when forming and reporting on his or her judgments. Moreover, the increased profitability that non-audit services offer may act as an incentive for auditors to bear higher audit risks and compromise their objectivity. To disagree with an audit client may mean not only the loss of the audit assignment, but also the profitable consultancy business as well.

Australian regulators have expressed concern that auditor provided non-audit services pose a threat to auditor independence. While regulator apprehension appears appropriate in the context of corporate and audit failure, there is little empirical support to sustain this view primarily because of a lack of consensus in research literature on this question. Calls for more informed discussion on auditor independence have not been assisted by the distracting comments made following the collapse of Enron in the United States and those views broadcast more locally. In addition, the remarks made by the Australian Securities & Investments Commission about its survey results on auditor independence have been insightful but not wholly progressive. The Australian Government has reacted to the auditor independence problem through regulatory revision and changes to the *Corporations Act*. Listed companies are now required to disclose the levels of non-audit services consumed, so that financial statement users can better assess auditor independence for themselves. Although auditor provided consulting services do represent a potential threat to auditor independence, this supply has not been expressly prohibited by in Australia to date.

It is difficult to ignore supporters of auditor provided non-audit services who argue that these services reduce professional costs and increase technical competence, while also motivating

competition between service providers. Furthermore, research on the topic does not point to conclusive evidence that auditor provided consultancy services do in fact damage auditor independence or service quality. Those unconvincing results suggest that the total exclusion of non-audit services is not the correct course of action. The audit firm often has the most comprehensive knowledge of an audited body, and has the level of professional expertise needed to perform the consultancy tasks. These supportive arguments however appear to pay little regard to the need to safeguard financial statement users against conflicts of interests. They also ignore the broadly accepted view that auditor independence from an audit subject is needed to ensure confidence in financial markets.

Australia has made some good progress towards managing auditor conflicts of interest to a more satisfactory level, however regulators cannot become complacent in light of the achievements to date. Notwithstanding that progress, rather than blame auditor provided consulting services for corporate failure, regulators must also look to correct the corporate misconduct at its cause. The Australian Government and the accounting profession have addressed the auditor independence problem up till now through regulatory intervention and professional guidance. This thesis proposes a market based remedy as a new way to bring about more superior outcomes to these past approaches. Chapter 8 of this thesis introduces the concept of FSI, and proposes a realignment of financial reporting stakeholder relationships. The FSI approach seeks to neutralise the risk of auditor conflicts of interest that beset the traditional FSA model, as auditors are made employees of FSI insurers under an FSI arrangement. Regulatory concern about auditor independence and the need for costly oversight is diminished as this shift would now require insurers to now decide questions of auditor independence.

Chapter 8: Financial Statement Insurance

8.1 The Insurance Alternative

> Auditors need to be held more accountable, and there needs to be more independence from the companies they report on.
>
> It's a matter of changing the incentives. Loyalty should be to accuracy, not to the company being audited. [649]

The central challenge of corporate governance today is the agency problem: the separation of ownership from control dating back to the Dutch and British East India charter companies four centuries ago. No satisfactory solution to this problem has been found to date. One solution to that problem of separation of ownership from control requires that management report on a corporation's condition and performance to investors using a generally recognised accounting system. A third party auditor then vouches the veracity of those systems and the reports produced from it. Traditional financial statement auditing ('FSA') used in that vouching process is appealing given its historical reliability, familiarity, and political acceptability. Auditors however face inherent conflicts of interest that impair the FSA mechanism's efficacy. The limits of this model are evident in the waves of audit failures which have triggered calls to strengthen this approach to monitoring public companies. [650]

Traditional FSA's ability to deliver the required level of auditor assurance is questionable, especially given the considerable ethical challenges faced by auditors when called to vouch

[649] Elizabeth Dole, *Elizabeth Dole Applauds Senate Approval of Corporate Accountability Bill; Urges More to Change Incentives for Auditors* (Monday, July 15, 2002), NYU Stern University, <http://people.stern.nyu.edu/jronen/articles/Elizabeth%20Dole.htm>.
[650] Lawrence A Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability' (2004) 52(2) *UCLA Law Review* 413, 415.

managerial assertions.[651] FSA relationships may cultivate conflicting incentives, as an audit requires the examination of assertions made by management who engage and remunerate the auditor. The requirement to capture sufficient appropriate audit evidence under that relationship between management and the auditor is not always possible. A lack of auditor independence and conflicts of interest more generally can thrive under the model. That lost independence may prevent an auditor from giving uncompromised objective assurance without influence from a client's management.

This chapter offers financial statement insurance ('FSI') as a solution to counter the ethical challenges faced by Australian audit service providers when auditing public companies. Under the FSI model, a public company purchases insurance to cover a given set of financial statements against misstatement. The insurer engages an auditor to conduct a risk assessment and audit of the company before a decision to extend insurance cover is made. If shareholder loss is incurred as a consequence of materially misstated financials, the insurer pays security holders covered by the policy up to the amount of FSI coverage. In addition to the improved levels of auditor independence expected to result from FSI, new information relevant to financial statement quality is also delivered to finance markets under the model. This includes the disclosure of FSI premium and coverage amounts. This thesis finds the FSI approach is able to neutralise the risk of auditor conflict of interests that have beset traditional FSA. Given that auditors are made employees of FSI insurers under this arrangement, they will no longer be subject to audit client influences. Regulatory concern about auditor independence and the need for oversight is diminished as insurers now decide questions of auditor independence. [652]

8.2 Traditional Financial Statement Auditing – Faults and Flaws

Despite the best efforts of statutory reform, the structural limitations of FSA have failed to

[651] These challenges are caused by factors that include limitations when testing managerial assertions together with the qualitative character of certain accounting principles. See Michael Power, *The Audit Society: Rituals of Verification* (Oxford University Press, 1997) 133.
[652] Lawrence A. Cunningham, 'Financial Statement Insurance Act: 2004' (2004) 11 *Connecticut Insurance Law Journal* 69, 71.

stop the growing incidence of public company financial report restatements.[653] The genesis of these calamities can be traced back to investor "irrational exuberance" as was famously warned by Federal Reserve Chairman Alan Greenspan's in 1996, as the manifestation of "infectious greed [that] seemed to grip much of our business community".[654] Greenspan believed that company officer ambition together with the allure of greater profits contributed to intentional misstatements in public company accounts. Auditors have been found complicit with this behaviour. For example, they have accepted the use of accounting devices to create special purpose entities to hide debt and losses, and agreed with management to improperly record transactions. Both of these examples were evident in the case of the Enron Corporation ('Enron') collapse. This scarcity of auditor ethical conduct and the lack of values discussed in this thesis in earlier chapters finds that perverse incentives compel some auditors to become facilitators of irrational exuberance, corporate officer greed, and ultimately facilitate corporate demise.

The perverse incentives that drive auditor behaviour under FSA can be rectified by a shift in stakeholder relationships so as to produce more unbiased financial reporting. Although shareholders vote on management's recommendation to engage an auditor under s 250R *Corporations Act 2001 (Cth)* ('*Corporations Act'*), that decision is effectively handed to management given the dispersed nature of share ownership and a proxy voting mechanism that favours a vote for management's choice of auditor appointment.[655] This arrangement can cause conflicts of interest to develop within the audit client and auditor relationship. The client-principal (management) who appoints the auditor also remunerates the auditor for the services provided. As such, management is positioned to structure auditor compensation to elicit opinions that best serve its interests. The fear of losing future audit fees even without the added allure of non-audit services in these circumstances may persuade an auditor to

[653] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 40.
[654] Testimony of Chairman Alan Greenspan *Federal Reserve Board's Semiannual Monetary Policy Report to the Congress,* before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate July 16, 2002.
[655] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 41.

comply with management's wishes.[656]

Traditional FSA is an assurance mechanism that operates within a tripartite principal-agent-beneficiary model under which an auditor provides third party assurance in the form of a written opinion on managerial financial statement assertions. Auditors purchase professional indemnity insurance to cover themselves against claims for negligently performed audit engagements resulting in shareholder loss. These policies indemnify an accountant against claims in aggregate and are not tailored to the risks of a particular audit engagement. [657]

The threat of legal liability is not always a sufficient deterrent to stop auditors complying with auditee management directions. Prosecution and punishment may also not adequately discourage wrongdoing. The intentional misrepresentation of financial reports is difficult to discover in the first place let alone to prove. Given that little can be done in the short run to cultivate ethical personalities, the idea of overhauling the Australian regulatory structure to add yet more layers of government supervision and monitoring over the FSA regime would likely prove inadequate and socially wasteful. No regulatory force, including enforcement and litigation can satisfactorily resolve the intractable conflicts of interest that exist under FSA relationships. The solution instead lies in restructuring the audit services market to eliminate the conflicts of interest faced by auditors, and to properly align these incentives to those of shareholders.[658] Only severing the agency relationship between client-management and the auditor can satisfactorily bring about auditor independence. This can be achieved by creating a new agency relationship between the auditor and a non-conflicted principal. That relationship then aligns an auditor's economic interests with investors, who are the ultimate intended beneficiaries of the auditor's attestation. [659]

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[656] Ibid 47.
[657] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 419.
[658] Joshua Ronen, 'A Proposed Corporate Governance Reform: Financial Statements Insurance' (2006) 23, *Journal of Engineering and Technology Management* 130, 137.
[659] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 48.

This chapter nominates an innovative solution to counter the problem of breached auditor independence by proposing FSI as an alternative to traditional FSA and auditor liability. This solution is hoped to counter the menacing combination of optimistic and sometimes greedy investors, and compromised gatekeeper behaviour that oxygenates unethical conduct that can sometimes lead to corporate collapse. Ethical behaviour cannot be corrected in the short term, and it desirable to still encourage investor enthusiasm under whatever assurance model is used so as to allow for the proper functioning of liquid securities markets. Financial statement insurance works within these constraints as a market driven assurance approach that protects shareholder interests.

The FSI remedy is a market mechanism that aligns stakeholder incentives and motivates company gatekeepers to pursue ethical courses of action and reject perverse incentives that might otherwise infect their behaviour. FSI removes conflict risk that would otherwise exist in the relationship between auditor and management. It instead puts auditors in the employment of independent insurers who have a vested interest in financial reporting quality. This shift more closely aligns auditor motivations with investor interests.

FSI is an alternative to the traditional FSA model. The choice of FSI could be recommended by management and subject to investor approval. Financial statement insurance policies would cover loss from audit failure (that is, damages from financial misstatements not discovered by a public company auditor) to replace auditor liability. Financial statement insurance would not however replace the liability of other parties such as directors and officers, or corporate legal representatives. Existing securities laws governing FSA would remain in place if FSI is introduced, although some corporation law and insurance law revision would be needed. [660]

This chapter will show that the FSI model compares favourably with FSA assurance, and that

[660] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650.

this new insurance product addresses many auditor independence challenges that recent reforms have struggled to fix. FSI is designed to provide signals to investors about the reliability of company financial statements, and provides a reliability index using published premium-coverage policy data.[661] FSI is a market mechanism that aligns stakeholder incentives and offers higher quality audits, more transparent and truthful financial statements, fewer shareholders losses, more accurate pricing of securities, and more efficient resource allocation. This chapter will show insurance carriers to be suitable providers of FSI within an open market for insurance products, and serve in the role of principal under a FSI scheme.[662]

Several problems however challenge FSI's efficacy, and raise some doubts as to whether FSI should be introduced to Australia. Issues around FSI product novelty, the administrative arrangements needed, and the complexities associated with insurance law and corporation law modification would need to be addressed. On balance, although the FSI model is not perfect, it does offer the promise of product superiority over FSA. One way to start to unlock FSI's potential could be to offer it on an experimental basis to shareholders as an alternative to FSA, with FSA to remain as the default model.

The charge to introduce the FSI model in the United States of America as a remedy for auditor ethical misconduct has been lead by Professor Joshua Ronen at New York University Stern School of Business. This chapter now examines the model offered by Professor Ronen, and considers its suitability for application to ethical difficulties faced by auditors in the Australian context.

8.3 The Financial Statement Insurance Model

The introduction of an FSI model to Australia would bring about significant change when compared to the FSA principal-agent relationship. Rather than engage and remunerate

[661] Ibid 438.
[662] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 48.

auditors, public companies would now purchase a FSI policy to cover investor loss caused by misrepresented financial reports. The insurance carrier would initially engage an auditor to attest to the accuracy of a prospective insurance client's financial statements. The FSI insurance cover taken by the auditee together with the premiums levied for that coverage are then published for finance market consumption and analysis. In particular, suppliers of debt and equity could use this information for their capital allocation decisions. Companies that are able to present relatively higher coverage limits in conjunction with smaller premiums will distinguish themselves from an investor viewpoint as those entities with high quality financial statements. Conversely, those companies with relatively less or no coverage and higher premiums will expose their financial statements as being of relatively lower quality. [663]

FSI is unlike any existing type of insurance and is unique in its character. This unique aspect may enhance the appeal of the FSI product, as new FSI regulation can be written on a clean slate. At the same time, administration and oversight of the product can leverage off existing insurance law principles and insurance market practices. [664] The steps involved in the FSI model are now explained, together with how they might be applied for Australian public companies.

8.3.1 The FSI Model Steps

The FSI process proposed by this chapter is intended to align with the present Australian insurance and regulatory environment and capital market assurance requirements. Given the scale of this change, only relatively minor regulatory modifications to current infrastructure would be needed. The steps of the model suggested below generally follow those advocated by Professor Ronen for application in the United States of America. A summary of Dr Ronen's model together with a figure showing his process is set out in Appendix One for additional clarity.

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[663] Ibid.

[664] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 442.

1. A Public Company Requests an Insurance Proposal From an FSI Insurer

Firstly, a public company wishing to take the FSI option and purchase insurance will request insurance proposals from one or more insurance carriers. The proposals must contain the maximum amount of insurance offered and applicable premium amount. They would typically include a schedule of alternative premium amounts at coverage levels below the maximum figure.[665] Insurance coverage is determined by the insurer by reference to the company's average market capitalisation and estimated market value in the event where the financial statements are misstated. Coverage amounts are thereby linked to market value, while premiums are a function of financial statement reliability.[666]

At this point in the product's delivery, the insurer engages a risk assessor (who is likely to be the auditor) to perform a preliminary risk review of the company requesting FSI. Traditional FSA auditor experience gained in performing compliance and substantive activities, and the requirement for auditor compliance with Australian auditing standards see them well equipped to provide this underwriting service. For example, Auditing Standard ASA 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* requires that auditors obtain an in-depth knowledge of the audited entity, including knowledge of the organisation and operating characteristics, the types of products and services it supplies, and its capital structure. Under this approach, auditors obtain a comprehensive knowledge of each audit client's business. Furthermore, it is common for individual audit practitioners to be engaged by several audit clients concurrently, thereby giving that auditor a comprehensive knowledge of different business entities and their activities across diverse industries.

Auditors are uniquely qualified and experienced to provide the FSI risk assessment services needed to determine policy terms. That preliminary assessment would necessarily include a

[665] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 50.
[666] Cunningham, 'Financial Statement Insurance Act: 2004', above n 652, 73.

review of accounting internal controls, the company's external competitive environment. More specifically, the review would include an examination of relevant risk indicators including: [667]

- the nature, stability and degree of competition, and general economic health of the industries in which the public company operates;
- the reputation, integrity, operating philosophy, financial state, and prior operating results of the public company's management;
- the nature, age, size, and operating structure of the public company;
- the public company's control environment and significant management and accounting policies, practices, and methods.

On the basis of this investigation, the insurer will then furnish a proposal to the applicant company specifying the policy terms, including coverage amounts and premium details. The company's audit committee then selects a FSI proposal from those offered. The relevant policy information is then included in a shareholder meeting notice for circulation to the company members. A meeting must be held and shareholder vote taken before the year the coverage is contemplated. Typically, the matter will be considered at the annual general meeting ('AGM') which decides the appointment of an auditor for the following year.[668] The meeting notice would be filed with the Australian Securities and Investments Commission ('ASIC') together with a company notice if shareholders have resolved to adopt FSI in preference to FSA for a given year. [669]

[667] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 57.
[668] Cunningham, 'Financial Statement Insurance Act: 2004', above n 652, 73.
[669] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 430.

2. Shareholders Approve the FSI Policy

Section 250R (1) (c) (1) of the *Corporations Act 2001* provides that the business of an AGM may include the appointment of an auditor. Section 249L (1) requires that a notice of meeting of members must state [670]the general nature of the meeting's business and [671]contain a statement setting out voting information if a member is entitled to appoint a proxy. Information about the FSI option could be included on the notice sent to shareholders under these provisions before it is put to a vote.

As the FSI model requires shareholder approval, a public company audit committee must firstly resolve to adopt FSI before seeking a shareholder vote in support of that decision. This requirement is designed to ensure that the FSI policy taken out will protect investors and capital markets to the same extent as FSA. The insurance offer put to shareholders is likely to give alternative levels of FSI cover at different premium amounts. These will necessarily include the maximum amount of FSI cover and premium offered under the insurance proposal, together with the FSI cover amount and premium recommended by management. No FSI cover would also be an option for shareholders to vote on,[672] given that the security holder approval requirement is intended to principally allow shareholders decide if FSI is to be chosen. FSA is the default position under the proposed model. Traditional FSA procedures and auditor liability would remain in place if a company decides not to take FSI cover.

The choice of FSI would give relief from corporation law requiring that company financial statements be audited under the FSA framework. The corporation's law would need to be amended to enable this relief. [673] Instead of FSA, the FSI insurer would now engage an auditor to perform a review function and provide the requisite opinions. The main legal

[670] *Corporations Act* s 249L(b).
[671] Ibid s 249L(d).
[672] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 50.
[673] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 431.

effect of this arrangement is to limit investor recovery against auditors for financial misstatements which would now be covered by an FSI policy. [674]

This voting mechanism could also be broadened to include voter entitlement in cases where a company's capital structure includes several share classes. The model could be widened again to allow the vote of other security holders (including debt holders) and shareholders not otherwise eligible to vote on general company matters but nonetheless hold an interest in the FSI decision. This shift would protect the capital they have committed to the company. This entitlement for other interested parties could be attended to at the drafting time of debt instruments, to specify that the creditor or other potential claimants are entitled to vote on the FSI option.[675] The company constitution and corporation law would also need to allow this broader right to vote.

3. Audit Scope

The risk assessor who conducts the preliminary risk review and auditor engaged to carry out the examination then plan the audit for the financial year to be covered by FSI. [676] Although the plan is designed by the assessor and auditor, it is subject to the insurer's oversight and approval. The audit would be conducted and concluded in the early months following the financial year to be covered by FSI. The audit plan and its execution are likely to be governed by existing auditing standards issued by the Auditing and Assurance Standards Board ('AUASB'). The resulting audit findings and opinion are critical, given that FSI policies will contain a condition that the policy only becomes effective if the auditor issues an unqualified audit opinion. Otherwise the company remains subject to the FSA regime and the liability rules that apply to it. [677]

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[674] Cunningham, 'Financial Statement Insurance Act: 2004', above n 652, 74.
[675] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 431.
[676] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 51.
[677] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 432.

4. Issuing a Policy - The Audit Condition

Where the auditor renders an unqualified audit opinion, the policy is issued and the proposed coverage and its terms become binding upon the insurer and public company. Coverage will not however commence if a qualified or adverse ("qualified") audit opinion is issued, unless the company renegotiates its policy terms with the insurer. Any renegotiated term would be influenced by the audit findings and reasons for issuing the qualified report. Under the transparency approach taken by the FSI model, any revised terms and modified policy information would be published for market consumption and analysis. [678]

Those companies issued with an unqualified audit opinion and covered under a FSI policy are now able to deliver new messages about financial statement quality to capital markets. But it is also possible to go beyond this. The audit opinion can be extended beyond its basic format to also disclose the details of FSI coverage and premiums levied. In addition, the notes accompanying financial statements could provide information about the more material policy details for market consideration. If these changes were accepted, Australian accounting standards and the ASX reporting rules would need revision to mandate these new FSI disclosures. [679]

A qualified audit opinion signals that financial statement irregularities were discovered during the course of an audit. That outcome suggests there is good reason for investor concern about managerial integrity and company financial statement reliability. If accounting irregularities were present under the FSI model, investors can take legal action against company management and other parties who are responsible, although no action would be available against the auditor who has raised the concerns.

[678] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 51.
[679] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 435.

A difficulty will arise when shareholders vote in favour of the FSI option, however the audit condition (that an unqualified audit opinion be issued) is not met. Dr. Ronen's FSI model proposes that the insurer and the company renegotiate the policy terms in these circumstances, where those revised terms are shaped according to the reasons why a qualified opinion was issued. However, as noted at Step 2 of the FSI process, the company's shareholders must approve the policy terms. Management would not have investor authorisation for any such renegotiated terms unless a vote is taken to approve them. Company management must thereby seek shareholder approval of a revised policy, and most likely offer the modified policy for approval at a special shareholder meeting vote. This process may prove cumbersome and time-consuming.[680]

Auditors would face different incentives and pressures under FSI in comparison to the FSA model. An interesting feature of the FSI 'audit condition' is that an auditor will not know if FSI or FSA will govern their engagement at the start of the audit task. That outcome is only determined once the audit is completed and when the opinion is issued. Knowledge of which model applies (FSA or FSI) at the audit's commencement may otherwise influence audit quality and the conclusions drawn by the auditor in the course of his or her testing. Conflict pressures are likely to persist if FSA was known to apply from the outset. In comparison, the knowledge that the audit is being conducted for FSI purposes would override those conflicted forces. An insurer has a strong incentive to have a diligent and superior audit investigation carried out to avoid the prospects of claims against it.

Auditors would remain primarily liable for audit failure if they issue a qualified opinion. This is because they will be then subject to the FSA regime if FSI is not offered. The possibility of this outcome may lead them to make more conservative assessments when forming their opinions. The FSI model shifts liability from auditors to insurers, so that auditors may be predisposed to issue unqualified opinions and escape the FSA rules and liability. Notwithstanding that inclination, any bias towards FSI is offset by the auditor's duties to his or her employer insurer. Audit failure under FSI will expose the auditor to liability brought

[680] Ibid 433.

against it by the insurer for professional transgression. In addition, the insurer maintains control of the process. Its intimate knowledge and familiarity with the insurance products it sells would not allow its auditor employee to issue and unqualified opinions unless is comfortable with that conclusion. The combination of these factors are expected to encourage auditors to work with company management and influence them to produce financial statements that faithfully reflect business reality. Management that cannot meet an auditor's demands may not be able to procure auditor services or FSI cover. [681]

As previously discussed in this chapter, insurance auditing appears superior to FSA because it more closely aligns the auditor interests to those of investors. Auditors may succumb to management preferences under FSA when called to exercise judgment when carrying out testing and when forming an audit opinion. They may encounter conflicting incentives when reviewing the assertions of management who engage and remunerate them, and may be influenced to not effectively capture audit evidence under that protracted relationship. While the FSI model still calls for auditor judgment to be exercised, it shifts the dynamics between management and auditors to make that level of engagement more distant. The level of company management influence over an auditor is alleviated given that auditors become employees of the insurers rather than the auditee. An absence of conflicts of interest and lower likelihood of audit evidence capture risk is expected to encourage auditors to work more closely with management and question the assertions made by them, rather than give the benefit of the doubt.

FSI superiority over FSA is likely to hold true even if more regulation were introduced to shore-up the tradition assurance model. Auditors would continue to plan and perform audits to maximise their remuneration under a compromised arrangement. [682] Further to this, a single engagement is at stake for FSA auditors, while a FSI auditor may put an entire portfolio of audit engagements sponsored by a single insurer at risk. This aspect of fee dependence on an insurer is also expected to lead to superior audits under the FSI regime as

[681] Ibid 434.
[682] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 56.

the auditor is motivated to deliver a higher quality review.[683]

5. Premium-Coverage Mix and Related Disclosure

The decision to adopt FSA or FSI is mutually exclusive. It requires a public company to use either assurance model, but not both. The FSI approach offers more flexibility when compared to FSA and is able to relieve conflict risks inherent in FSA financial statement attestations. [684] This is helped by disclosure of FSI policy cover, premium details and policy terms. The FSI audit report proposed by this thesis would include details of insurance cover and premium amounts in the accompanying financial statements. [685] This published premium-coverage mix information could increase capital market efficiency. [686] This is particularly the case where consumers of financial information treat the information as important to their investment decisions and make their choices based on it.

Capital market optimality is most likely to be achieved where high quality risk assessments and audits are carried out on public companies. FSI premium pricing would be influenced by the accuracy of risk assessments performed. Greater coverage levels and lower insurance premiums are the product of high quality financial statements. As a result, premium and coverage disclosure helps facilitate meaningful intercompany comparisons, where efficient markets are able to accurately price securities using these indicators. [687] This FSI data can also provide a financial statement reliability index. That data may also bring about positive auditee managerial behaviour change given that managers may sense pressure to improve financial reporting quality under this new measure of their performance.

While the FSI premium-coverage mix is an integrated expression of risk and a signal of

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[683] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 435.
[684] Ibid 415.
[685] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 58.
[686] Ibid 57.
[687] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 438.

financial statement reliability, the other insurance policy terms are relevant to an auditee's risk profile. Individual FSI policy terms may vary, including the use extensive endorsements and policy tailoring rather than relying upon a standardised form. Tailored terms are inevitable and are needed to maximise premium-risk accuracy. Notwithstanding that, some standardisation is desirable to promote efficacy. Disclosure of tailored terms to capital markets will deliver context to the premium-coverage reliability index[688]and allow for a more accurate interpretation of the premium-coverage blend. [689] All FSI policies would however be required to contain some standard provisions. Legislation to deem all policies to contain these operational provisions, together with a provision to disclose any tailored policy terms in the auditee's financial reports, would be required.[690]

6. The Claims Process

The final step of the FSI process is the claim recovery procedure. Traditional FSA relies upon civil litigation to advance security holder claims. This approach has not always proven to be a successful means of deterring and preventing wrongful behaviour. Dr. Ronen's FSI model sketched out a claims-settlement process that differs markedly from corporations law litigation and current insurance claim processes. That mechanism requires the insurer and the insured public company to cooperatively select a fiduciary organisation[691] to represent investor interests. The claims-settlement process begins when financial misstatement is alleged and loss is claimed.

Dr. Ronen does not explain how shareholders or other security holders solve the problems of collective action or rational apathy when claims are initiated. The process in these circumstances may however follow the more traditional securities law model where large investors take action, or class action lawyers assemble claimants and act on their behalf. In

[688] Cunningham, 'Financial Statement Insurance Act: 2004', above n 652, 79.
[689] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 438.
[690] Cunningham, 'Financial Statement Insurance Act: 2004', above n 652, 79.
[691] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 51.

any event, Dr Ronen's model requires that the fiduciary organisation be alerted to the potential claim, to then notify the insurer of the triggering occurrence. At this point, the insurer and the fiduciary select an independent expert to determine the claim's validity and amount. Within a short time after receiving the expert's report, the FSI carrier compensates the fiduciary up to the face amount of the policy for the damages, who then pays the proceeds to investors according to their individual loss.[692]

FSI policies are occurrence-based policies which cover the financial statements of an insured company for a particular year. This coverage also extends to discoveries made in future financial periods. In insurance parlance, this means FSI is retroactive coverage as it is provided on an occurrence basis. There will invariably be a time lag between the event causing damages (a material financial misstatement) and the manifestation (revelation with value-destroying effects on securities) of that occurrence.[693]

New regulation would be needed to assist the FSI claims process given the unique nature of the product. Most insurance policies impose notice requirements as a strict compliance condition before an insurer is obligated to pay a claim. A typical requirement is that prompt notice be given by the insured party after the occurrence of an event covered by the policy. Notice of a FSI claim could however come from one of several sources including the insurer's auditor or auditee company management. It may also follow an independent ASIC investigation. As notice to commence the claims process is made by this broader group, legislation may be needed to deem FSI policies to include more liberal notice provisions than those applying to other types of insurance.

In addition, insurance policies commonly contain no-action clauses that restrict rights of third-party loss victims from recovering directly from the insurer. They instead require third party victims to obtain judgment against the insured. This route to recovery restricts the FSI model's ability to protect shareholders from insurer misconduct when making a claim. To

[692]Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 441.
[693] Cunningham, 'Financial Statement Insurance Act: 2004', above n 652, 76.

avoid that outcome, new legislation would be needed to deem that FSI policies contain provisions allowing for direct action against FSI insurers by investors or their fiduciary representative.[694]

Under traditional insurance law and practice, the process used to measure and pay claims follows a rigid pattern which is rather more simplified than Dr Ronen's claims process. The insured party must notify the insurer of a claim, the insurer investigates that claim, and the insurer becomes liable only when the insured party is held liable. The insurer typically defends the claim and either a settlement is reached or the case proceeds to a court hearing. Although Dr Ronen's FSI claim procedure as explained in this chapter is a functional solution, it could be streamlined to more closely resemble this traditional insurance claim process and better suit Australian circumstances.[695]

8.4 FSI Impact Upon Stakeholders

The FSI model is able to align the self-interests of all stakeholders involved in the reporting process. If introduced, it would have a significant impact on the decisions of those parties. Although new regulation together with stakeholder and administrative costs are to be expected under the FSI approach, many of these costs are either initial start up expenses or costs that replace those already incurred under the current FSA assurance model.[696] The potential advantage gained by stakeholders under the FSI model appears to outweigh the costs associated with it. The implementation of FSI would change stakeholder's relationships and the legal environment under which they engage.[697] Financial statement insurance would impact on the decision-making processes of insurers, auditors, capital market participants, and the regulators of Australian insurance and corporation's law. That

[694] Ibid 77.
[695] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 441.
[696] Sudip Bhattacharjee, Kimberly Moreno and James Yardley, 'Auditors as Underwriters: An Alternative Framework' (2005) 9(1) *International Journal of Auditing* 1, 4.
[697] Ronen, 'A Proposed Corporate Governance Reform: Financial Statements Insurance', above n 658, 142.

impact and the interrelationships between these parties are now discussed.[698]

8.4.1 The Insurer

The FSI insurer's objective is to minimise claims made against it, and so an insurer's interests are aligned to those of the insured company's shareholders who also wish to minimise their potential losses. It follows that an auditor who aligns his or her interests with those of the insurer will by extension also act in the best interests of shareholders. This recalibration of self-interest represents a significant and positive shift from the present FSA arrangement. Competitive pressures between insurance industry rivals to minimise premiums in conjunction with insurer survival induced motivation will force insurance carriers to compute market driven FSI premiums. In this environment, an insurer would seek the optimal effort from the auditors and risk assessors that it engages. The auditor and reviewer are more likely to take on the insurer's perspective under FSI and perform their respective tasks with that level of diligence necessary to discover omissions or misrepresentations that threaten loss to their employer. [699]

FSI insurance premiums would be priced within a competitive Australian insurance markets already governed by sound prudential oversight. Market forces will compel insurers to assess low premiums for a given FSI coverage amount, as insurers would seek to maintain and expand their client bases. Notwithstanding those market forces, an insurer must levy a premium amount that will cover expected claims made against it and the administrative expenses incurred by it to remain in business. An industry margin for insurer entrepreneurial profit and management services must also be costed into that premium. A FSI premium amount costed in this way will help ensure that revenues are sufficient for the insurer to continue in business while receiving an acceptable financial return for their entrepreneurial effort and risk taken. [700]

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[698] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 51.
[699] Ibid 54.
[700] Ibid 53.

The introduction of a FSI regime as proposed by this thesis is not expected to bring about perverse incentives beyond those currently faced by insurers. The Australian insurance industry is already highly regulated, and the present administrative and monitoring functions that govern insurers would be expected to continue to deliver sound administration for a FSI regime. A significant advantage of FSI as proposed is that it relies on this existing insurance industry regulation and so obviates the need for further layers of audit services regulation and administration.[701]

The FSI model offers a new business opportunity to the insurance industry. Although FSI represents a departure from the more traditional insurance liability products, insurers have shown themselves to provide innovative services and liability products in the past. These types of products include insurance liability cover for litigation threats and class actions against company directors.[702] The Australian insurance industry regulatory framework is expected to provide a sound foundation if the FSI model were introduced. New regulation would be introduced in some areas to ensure that insurance industry competition is maintained, and to lessen the risk of monopolies built on the FSI product.

The business and risk aversion strategies already used by insurers are likely to expand under the FSI model given that the new approaches are available to hedge risk and exposure. Firstly, the model offers two layers of procedure to both monitor and protect the insurer. An initial risk review and assessment is conducted in order to determine the policy coverage and the premium amounts, and then the 'audit condition' outcome will ultimately decide whether the policy will become effective.

Secondly, an insurer is also able to employ other hedge strategies to fund FSI claims. An FSI event is contingent upon the realisation of financial statement omission or misrepresentation causing lost share value to the shareholders of the insured company. That loss can be hedged

[701] Ibid 52.
[702] Bhattacharjee, Moreno and Yardley, above n 696, 10.

in capital markets using derivatives, where for example the exercise of a put option is dependent upon the insurance loss event taking place. More specifically, the insurer can buy a put option with a term that corresponds to the FSI policy period of cover. That put can be exercised if the insured company's share price falls because of financial statement misrepresentation or omissions. The price of these put options is expected to be less than publicly traded puts given that the insurance event condition must be met before the option can be exercised. By using this form of hedge, an insurer is able to manage the extent of reinsurance and the cost and risk that it is willing to bear. Put option sellers can also minimise their exposure to the insured by constructing diversified derivative portfolios based upon the risk of misrepresentation and omission. That assessment of risk can be made using published policy index information supplied under the FSI disclosure rules. [703]

A further risk aversion strategy makes use of insurer underwriting standards and key performance indicators to assess prospective FSI clients. The auditor and insurer would agree on standards to ensure only companies with an acceptable financial history, and only those able to achieve key reporting balance thresholds would be offered FSI cover. This strategy calls for insured company portfolios to be constructed according to risk profiles, and FSI cover and premiums are then levied against these to ensure that a group of insured companies is financially viable. In effect, these insured companies are classified into pools or exposure units, with premiums then assessed according to risk profiles.[704]

8.4.2 The Auditor

Under the current FSA arrangement, an auditor's interests are not aligned with those of shareholders but instead take on the perspective of management who have engaged them. That connection influences the auditor to adopt the client's viewpoint when called to examine financial statement balances which are inherently subjective and cannot be objectively verified.

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[703] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 54.
[704] Bhattacharjee, Moreno and Yardley, above n 696, 9.

Management is responsible for the generation of financial data and the preparation of the financial reports. That financial information is then evaluated and tested for accuracy by the auditor who forms an opinion on it. The accuracy of underlying data is generally not the cause of accounting irregularities, but rather the classification of that data and its presentation in the auditee's financial statements is. For example, credit balance amounts representing liabilities maybe incorrectly recorded as revenues, or debit expense amounts similarly booked as assets. Also, while the underlying accounting data may be accurate, an auditor may be unable to substantiate projections based on it, so that he or she does not have a sufficient basis to dispute the client's subjective valuation. [705]

Financial statements commonly include accruals and provisions for future transactions, and may require that cash flows be estimated in order to book these balances. These estimates may be largely subjective and allow for a broad range of values to be recorded as a balance sheet item rather than an absolute figure. Assumptions are generally needed to make these estimates, which are based on past experience or by using models that forecast the probability of given outcomes. These models may be capable of yielding relatively objective numbers in stable environments; however misleading figures may result in the case of volatile financial settings to impede the auditor's ability to test these judgements. Management are also likely to argue that their assumptions are valid until proven wrong in these situations. The auditor may be influenced to give the client the benefit of the doubt in fear of losing the audit engagement, and so agree with these assumptions.[706]

In contrast, the FSI regime proposed by this thesis aligns auditor incentives to those of the insurance carrier. The auditor's central FSI task is to investigate and accurately assess the risk of material misstatement within public company financial statements. As the auditor shares the insurer's motivation to deliver optimal audit quality, he or she identifies with those persons or entities that would suffer loss in the event that misrepresentation or omission

[705] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 56.
[706] Ibid 57.

exists in the reports. Within this FSI setting, an auditor is more likely to insist that sufficient appropriate evidence is obtained before acquiescing to management's valuations. This greater level of insistence to verify account balances may deter management from undertaking ventures that require subjective evaluations to be made in order to account for future transactions. The earnings forgone on these high value projects may then be offset by a premium placed on the company shares. Value will be imputed by capital markets if financial statements are understood to be more reliable and contain less questionable balances. [707]

Insurers will seek more accurate FSI premium assessments. As such, they may engage the same auditor to perform both the initial risk assessment review and then audit the financial statements. That auditor is ideally positioned to observe the risk of misstatement during the premium assessment phase, and identify those areas that require greater audit focus. An audit product planned around a risk assessment and performed by the same accountant is more likely to provide higher quality assurance because of the knowledge derived from the auditor's earlier involvement. That enhanced economic information is made available to the insurer to help it decide if FSI coverage will be offered to an FSI applicant, and at what level of coverage.

Under FSA, a poor quality audit may cause the loss of a single audit client engagement while a negligent auditor may face litigation costs and damages. In comparison, FSI auditors are less likely to be liable for investor claims and there is a lower chance of litigation success against them. FSI auditors would be perceived as having less incentive to cooperate with management to intentionally produce misleading financial reports. Auditors are now employees of the insurer, and so a plaintiff is less likely to prove that the auditor knowingly acted in concert with management. An FSI auditor may instead be directly liable to the insurer for audit failure where he or she has breached their contractual relationship. Auditor legal liability thereby shifts under the FSI approach to make auditors (as agents) contractually obligated to the insurance carrier (as principal) rather than their traditional

[707] Ibid 58.

audit clients. [708]

A recent ASIC survey found that a significant number of registered company auditors have not met community expectations. The chief accountant of ASIC, David Niven, revealed that 31 percent of accounting firms and 17 percent of large firms had failed to obtain sufficient information to support key aspects of their audits.[709] The care exercised by an auditor may be heightened under the FSI model given the threat of removal from all engagements by an insurer due to poor performance. That incentive may help reverse the poor level of performance highlighted by ASIC. FSI auditors would no longer face the threat of audit engagement loss from auditee management if they issue a qualified opinions, nor would they be subject to claims against them by misled investors. However, audit services providers may experience a far more significant loss as a consequence of their move away from an auditor-client relationship. Several auditees may be assigned to the auditor by one FSI insurer, so that the threat of losing all audit engagements from a single incidence of audit failure is possible.[710]

8.4.3 Capital Markets

The FSI approach proposed in this chapter seeks to compensate investors for negative share price movements of listed Australian public companies because of financial report misstatement. The model requires the market to play its role, to be strong, efficient, and able to quickly deliver information relevant to share price decisions to the investing public in an unbiased manner. The published details of shareholder FSI approved coverage and premium amounts offer a credible signal to the marketplace on financial statement strength and quality. Lower quality financial statements are likely to be assessed at a higher premium rates. Alternatively, those companies that maintain strong and effective internal accounting

[708] Ronen, 'A Proposed Corporate Governance Reform: Financial Statements Insurance', above n 658, 142.
[709] Patrick Durkin, 'Regulator raises red flag on auditors', *The Australian Financial Review* (Melbourne), 30 June 2011, 59.
[710] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 57.

and corporate governance systems are expected to be assessed as a low risk compared to assessments made of their competitors.

Shareholder approved insurance coverage details offer periodic and comparative information to the marketplace. An effective Australian share market will allow these FSI qualities to be priced into public company securities. Security pricing would take on greater complexity and precision under FSI, given that pricing is now impacted by financial statement quality. Pricing would account for two additional dimensions; that is the amount of cover given in the event of loss from a misrepresentation or omission, and the underlying financial statement reliability as reflected in the premium for that coverage. Those companies that undertake sound business ventures are more likely to deliver more reliable and credible information about their operations to finance markets. That information may then result in lower costs of funding together with more favourable share price movements as a consequence. Resources can then be allocated more efficiently to these companies, with better informed financial markets yielding higher returns as a consequence of this new information.[711]

8.4.4 The Public Company

Under the FSI model, a company with high quality financial statements can signal its superiority to the marketplace by reporting that greater insurance coverage has been obtained at lower premiums relative to similar companies in its industry. That message of financial statement quality is likely to create investor demand that increases the company's share price while also decreasing the cost of its capital. Conversely, a company with poor quality financial statements must reveal the low quality and unreliable nature of its financial reports to the market. Those inferior companies are compelled to reveal the true state of their financial reports and pay higher premiums, or not purchase FSI at all. In addition, those companies with lower quality financial reports [712]may be subject to an insurer's corrective

[711] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 58.
[712] Ibid 59.

action. For example, a management review or internal control review may be imposed as a condition by the insurer before it will undertake a premium risk assessment or extend coverage.

Given the likely market reaction to published FSI information, company management would be expected to seek to maximise financial statement quality. An insured company will receive a positive market pricing response if notice of its high quality financial systems is delivered to the markets. That information about an auditee's superior internal accounting and auditing controls when combined with relatively high levels of FSI cover at lower premiums would support share price increases. Competition between rival companies is also expected under the FSI model, where they attempt to signal internal control systems superiority and more favourable risk assessor appraisals. Company officers can rightfully claim they are motivated to produce superior quality financial statements in order to reduce costs of capital. The model thereby allows company management to clearly demonstrate to their stakeholders that the auditee has been subject to vigorous underwriting review and effective audit examination. [713]

8.4.5 The Regulators - Australian Insurance Law

If introduced to Australia, the administration of FSI is expected to be shared between ASIC, which administers corporation regulation, and the Australian Prudential Regulation Authority ('APRA'), which has responsibility for the administration of insurance regulation. These regulatory bodies are effective and functional, and currently perform critical roles in statutory administration. Under their regulatory oversight, the administration and harmonisation of FSI with corporation and insurance law is expected to be manageable using only modest regulatory overlay. The FSI regime is an ambitious alternative to FSA that breaks away from corporation law emphasis on auditor regulation, to directly draw on the functionality of insurance markets and insurance law.[714] Given that reliance on existing

[713] Ronen, 'A Proposed Corporate Governance Reform: Financial Statements Insurance', above n 658, 142.
[714] Cunningham, 'Financial Statement Insurance Act: 2004', above n 652, 80.

insurance infrastructure, the regulation and administration of the industry is now discussed.

Australian insurance law is that body of law which regulates the insurance industry and insurance contracts within Australia. Commonwealth Parliament has the authority to make laws with respect to insurance and insurance companies under section 51 XIV and XX of the *Commonwealth of Australia Constitution Act 1900* (Cth). Generally, the *Insurance Act 1973* (Cth) and *Insurance Contracts Act 1984* (Cth) are the main acts which make up the statutory law, however there are a number of other pieces of legislation enacted by the states, private codes and case law which when taken together form this body of law.

That existing insurance industry regulatory framework together with contract law remedies is well placed to serve and protect FSI policyholder interests. A viable and competitive insurance industry is important to the success or otherwise of FSI. A sound insurance industry is an important social institution and vested with public interest. The industry is often viewed as a quasi-public utility where the regulator seeks to assure insurance provider financial solvency and the fair treatment of claimants. [715] The FSI model relies upon that investor protection and public confidence in insurance carrier solvency for its application.

APRA stands as the likely authority to administer FSI regulation in Australia. That active compliance role could see it use a range of compliance strategies across the insurer population, from reviewing FSI insurer qualifications to ensuring that insurance providers meet the prerequisite standards of financial capacity and independence. [716] The intricacies of Australian insurance law and practice will require that some regulatory modification be made before implementation of FSI can take place; however, the success of the FSI model will ultimately rely upon confidence in insurance industry solvency and the liquidity of those who underwrite FSI policies. Insurer solvency is a central concern of existing insurance law, with *Insurance Act 1973* (Cth) and APRA prudential standards generally providing the

[715] Bhattacharjee, Moreno and Yardley, above n 696, 9.
[716] Cunningham, 'Financial Statement Insurance Act: 2004', above n 652, 71.

regulatory mechanisms to ensure community expectations are met. [717]

At present, an insurance company must establish reserves that explicitly recognise their obligations to policyholders and claimants. Section 28 of the *Insurance Act 1973* (Cth) requires that a general insurer must hold sufficient assets. It provides that a general insurer commits an offence if:

(a) it does not hold assets in Australia (excluding goodwill and any assets or other amount excluded by the prudential standards for the purposes of this section) of a value that is equal to or greater than the total amount of its liabilities in Australia other than pre-authorisation liabilities; and

(b) APRA has not authorised the insurer to hold assets of a lesser value; and

(c) there is no determination in force under subsection 7(1) determining that this subsection does not apply to the insurer.

The Australian insurance industry regulatory framework thereby seeks to ensure that insurers are solvent and able to pay valid claims on time. The primary concern of the insurance regulator is the early detection of insurer insolvency to protect claimants against loss from unpaid claims. In addition to protection offered by section 28, new legislation may be needed to promote competition between FSI insurance providers if the model is introduced. These rules may for example give APRA authority to refuse FSI policy applications from an insurer that lacks financial capacity, or[718] impose periodic inspection requirements on FSI insurance carriers where appropriate.

Concern about insurance industry solvency has been raised in the FSI policy context, given that competition among insurers may yield loss leading premiums and loss payouts that

[717] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 469.
[718] Cunningham, 'Financial Statement Insurance Act: 2004', above n 652, 84.

exceed premiums collected. [719]To remedy this, minimum FSI premium amounts could be prescribed by regulation, or alternatively, the insolvency risk could be left to competition between insurers to manage themselves. A market based approach that relies upon competition could satisfy the insurer solvency requirements by imposing capital adequacy standards, transparent periodic reporting requirements, and the audit and monitoring of insurance carriers.

The management of insurance market solvency risks was considered by Dr. Ronen who suggested that financial derivative instruments be used to hedge and distribute the risk of FSI payouts faced by insurers. This strategy was touched on at section 8.4.1. It would require that insurers buy tailored put options in respect of the insured company which have an expiration date that matches the FSI policy period.[720] Those put options become exercisable upon a share price fall resulting from misrepresentations or omissions in the insured company's financial statements.[721] Although this strategy to distribute FSI risk to the broader financial community would reduce the overall risk of insurer insolvency, the realisation of significant multiple claims may cause liability to cascade amongst market participants who have accepted the risk, to then result in systemic market breakdown in a worst case situation.

8.5 Financial Statement Insurance - Advantages and Imperfections

On its surface, the FSI model can deliver improved financial statement quality, improved quality audits, less incidence of shareholder loss caused by omissions or misrepresentations and for smaller amounts, and more efficient resource allocation. [722] However, the benefits of FSI extend beyond these advantages to more broadly refashion the auditing industry, and install the insurance industry as the force that brings both structural and competitive benefits

[719]Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 432.
[720] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 54.
[721] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 472.
[722] Ronen, 'A Proposed Corporate Governance Reform: Financial Statements Insurance', above n 658, 131.

to financial reporting in Australia.

Most importantly for this thesis, the FSI approach remedies the problems identified in Chapter 4 which discussed accounting as a profession. That is, accountants have successfully closed the market for audit services, and that this ability to control the delivery of audit services has adversely infected the ethical conduct of the audit profession. Accountants have positioned themselves as registered company auditors to be the sole suppliers of public company audit services, which in turn has allowed for conflicts of interests and the contamination of auditor behaviour. That breach of independence can be remedied by FSI through its market based approach so that the problems of traditional FSA no longer continue. [723] That benefit together with the wider improvements offered by the model are now discussed.

8.5.1 Eliminate Auditor Conflicts of Interest

It is unavoidable that a conflict of interest will arise where an audit client remunerates its auditor. The German proverb *whose bread I eat, his song I sing* is a colourful expression that helps describe the loyalty and service that an FSA auditor gives its corporate sponsor. Breaking this link by using FSI will improve audit quality, as auditors will now be appointed and compensated by an insurer rather than the auditee. FSI auditors would have stronger claim to status as watchdogs,[724] and have more power to influence company management to properly apply accounting policies to produce more reliable financial statements.

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[723] Lawrence A Cunningham, 'Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels' (2006). *Boston College Law School Faculty Papers.* Paper 165, 64 <http://lawdigitalcommons.bc.edu/lsfp/165>.

[724] The court concluded that an auditor is seen as a watchdog and not as a bloodhound; per Lopes LJ in re *Kingston Cotton Mill Co (No 2)* [1896] 2 Ch 279 at 289, 290. The courts have since come to recognise that the standards of care and skill required of an auditor are now more stringent than they were in 1896, as is seen in the colourful expression articulated by Moffitt J in *Pacific Acceptance Corporation v. Forsyth* (1970) 92 WN (NSW) 29 at 65:

> If fraud has taken place and is undetected by the auditor he is blameworthy in the eyes of the law [but] only so far as he has been negligent in determining the scope and character of his.

FSI is an innovative alternative to FSA that eliminates the moral hazard of breached independence. As detailed in this chapter, the steps of the scheme require an auditee to purchase an FSI insurance policy and the insurance provider then engages and remunerates an auditor to carry out an audit before deciding if a policy will be issued. The insurer now becomes the auditor's employer in place of company management or an audit committee.[725] The inherent conflicts of interest previously faced by the auditor are thereby removed by severing the company management and auditor agency relationship. An insurance carrier now serves as principal to shift the auditor engagement decision away from company management. [726]

8.5.2 Financial Statement Insurance as a Market Based Solution

Market forces have an obvious impact when negotiating FSI policy details. The model exploits market forces to set policy holder coverage, premium amounts and tailored policy terms. Market competition will facilitate accurate premium pricing calculated on the probability of claims and the expected size of those claims. The insurance market would be expected to accurately price premiums given that competitive forces between insurers will act to minimize premiums between rivals but not to a level that threatens the insurer's continuation in business as a going concern.[727] The FSI model's impact upon markets goes beyond just this insurance price setting, it can also influence the types of professional services offered by auditors while at the same time channelling a greater volume of more relevant information to capital markets.

Chapter 4 of this thesis presented an analysis of accountant claims to profession status and discussed the strategies used by accounting bodies to close the market for accounting

[725] Cunningham, 'Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels', above n 723, 61.
[726] Ronen, 'A Proposed Corporate Governance Reform: Financial Statements Insurance', above n 658, 138.
[727] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability', above n 650, 439.

services. These approaches included the construction of registered company auditor status so that this qualification was open only to accountants. Accountants alone are authorised to deliver this audit product.[728] The conclusions drawn in that discussion was that market closure clearly benefited those registered auditors that controlled audit services, but did not necessarily assist the interests of audit services users. To counter this, FSI is a market driven solution and remedy against professional closure, where instead of appointing and paying auditors, companies can now purchase FSI that covers investors against losses suffered as a result of misrepresented financial reports.[729] Registered auditor status is diminished under that arrangement, while the role of audit service provider is broadened to allow entry by other participants.

Financial statement insurance gives investors freedom to make capital allocation decisions with the assurance that they are protected from loss arising from inadequate financial disclosures or the inappropriate accounting standard choices made by company management.[730] If introduced to Australia, public companies could be given a choice to adopt FSI or FSA, together with options on which FSI insurer they engage and the level of policy coverage purchased. The market for auditing services may also broaden as the role of auditing transitions towards more emphasis on risk assessment tasks. Other professional groups with more specialised expertise may be better placed to comment on particular financial statement balances and take on a greater role than before. An expansion of the FSI

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[728] Australian Securities and Investments Commission (April 2010) *Regulatory Guide 180 Auditor registration* sets out the current Eligibility requirements for registration as a registered company auditor in:

> Table 1:
>
> Qualifications: s1280(2)(a) You must: have the prescribed academic qualifications AND have completed a prescribed course in auditing; OR have other qualifications and experience that ASIC considers equivalent to both these requirements Skills: s1280(2)(b) You must: satisfy all the components of an ASIC-approved competency standard (see RG 180.3– RG 180.5); OR have the prescribed level of practical experience OR experience that ASIC considers equivalent. Capable, fit and proper: s1280(2)(c) You must: be capable of performing the duties of an auditor; AND be a fit and proper person to be registered as an auditor.

[729] Ronen, 'A Proposed Corporate Governance Reform: Financial Statements Insurance', above n 658, 130.

[730] Bhattacharjee, Moreno and Yardley, above n 696, 11.

model is considered below, to explore the idea of eliminating the traditional registered auditor role and audit opinion altogether, and to open the supply of audit services to those most capable of carrying out the function.

In addition, less distortion of the professional services market can be expected under the FSI approach. Accountants would now be free to provide auditor provided non-audit services ('APNAS'). The model does not preclude an audit firm from performing consulting services for an insured auditee, but does require the auditor to obtain the insurer's permission before those services can be supplied. Where APNAS is provided, the knowledge spillovers gained by an auditor are likely to benefit the insurer. The performance of APNAS will make use of an auditor's knowledge of auditee systems, controls and operations when carrying out the audit and risk assessment procedures. [731]An auditor who performs APNAS will improve his or her risk assessment decisions without concern that such work types will compromise their independence. Auditor benevolence and integrity, once conflicted under the FSA assurance model, are now corrected so that investors will perceive auditors to act in favour of financial statement users. [732]

Although an audit report is the traditional audit product output, it provides no comparative or statistical information about financial statement reliability. All audit reports offer the same limited message on company performance, with the exception of those less frequent instances where a qualified or adverse opinion is rendered. A financial statement reliability index that uses public company FSI cover and premium data will offer more useful information then that contained in standardised FSA audit report. The financial statement reliability index in combination with financial report disclosures would give more timely and relevant information on financial performance then that available under the current practice that relies on a set of monotonic paragraphs listed in the auditor report.[733]

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[731] Ronen, 'A Proposed Corporate Governance Reform: Financial Statements Insurance', above n 658, 139.
[732] Bhattacharjee, Moreno and Yardley, above n 696, 12.
[733] Cunningham, 'Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels', above n 723, 61.

Reliability index data is not however drawn from a perfect source, given that companies can decide on what level of FSI they wish to buy. The policies taken out in practice are likely to span the range of cover offered, and that discretion will introduce an element of inconsistency into the index. It can also be argued that an insurer may pressure their employee auditors to favour those clients with higher value policies when issuing their reports. To help solve these problems, an independent rating agency could be interposed to assure and evaluate FSI data. That agency could then alert the market as to any unusual results that may indicate a compromised audit process has taken place. [734]

8.5.3 Promoting Auditor Competition

FSI offers improved competition within the Australian auditing industry. The industry is presently characterised by high professional liability exposure and high insurance costs that act as barriers of entry to competition. High professional indemnity insurance costs are largely caused by the pooling and diversification model used by insurers that implicitly assumes an auditor cannot influence audit quality, financial statement reliability, or the risk of audit failure. To help remedy this issue, FSI offers a more targeted insurance approach that recognises that auditors are able to influence these outcomes. Financial statement insurance is centred upon a risk assessment and the audit of an individual auditee. Policy terms are determined at that individual public company level.[735]

If FSI were introduced to Australia, FSI insurers are likely to commence their operations by engaging auditors from the current population of audit firms. Large audit firms are likely to retain their existing engagements, however the auditing landscape may evolve to change this allocation. Audit service provider competition may push up the number of alternative auditors beyond the present numbers.[736] This may be brought about by new entrants to the audit services market, where the audit function is carried out internally by insurers or

[734] Bhattacharjee, Moreno and Yardley, above n 696,11.
[735] Cunningham, 'Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels', above n 723, 62.
[736] Ibid 64.

performed by professional groups other than accountants. The possible expansion of audit to other professions as service providers is discussed further at section 8.6 which explores the idea of eliminating the registered auditor role and audit opinion altogether.

To a large extent, FSI insurers would determine if the barriers of scale and expertise that currently restrict auditor participation will continue under the model. They could for example choose to assemble in-house audit teams or establish a network of captive audit firms. Insurers could inject competition directly to the audit services market by establishing internal audit units that operate at the scale and level of expertise required to audit public companies. Liability insurers have historically operated in a market which is far more competitive than that of audit service providers. That experience and willingness to respond to market demands may see insurers take more involvement in audit activities to deconstruct the barriers built over time by FSA auditors. A more reliable and independent audit profession may result from FSI's introduction, given the model is expected to expand the auditor population and break down present day auditing oligopolies. Increased competition between audit service providers and with more large scale provider participation will ensure less audit services market disruption into the future.[737]

8.5.4 A Risk Based Model

Professional indemnity insurance policies provide cover for claims against policyholders as a result of their professional negligence. Insurers apply conventional actuarial models using risk pooling and diversification strategies to underwrite this cover. The risks covered are substantially independent so that risk is distributed across participants which have been pooled according to similar risk profiles. Under this approach, aggregate losses become more predictable and insurers have a greater degree of confidence that premiums collected will exceed loss payouts. The effectiveness of risk pooling used for auditor professional indemnity insurance products is however diminished where auditor's of company financial statements are perceived to lack independence. Also, if a particular auditor is judged to

[737] Ibid 65.

present a relatively higher insurance risk, a rational insurer using pooling and diversification strategies will be risk averse and not offer policies to cover his or her losses, or will impose such large premiums which in some cases may exceed the policy's expected value. In these circumstances, an auditor will not be able to obtain professional indemnity insurance and not be able to carry on an audit services business. [738]

The risk pooling and diversification actuarial models used for professional indemnity insurance however wrongly assume that auditors lack the ability to influence audit quality and financial statement reliability. Audits and audit risk are subject to human control and so these models cause the market for professional indemnity insurance to operate under false assumptions. A superior approach would be to customise each insurance policy according to each audit engagement, so that the policy is based upon the risk assessment of a particular public company. Risk management using insurance to support the audit function is of significant social importance given that the audit function is the gateway to capital formation and allocation decisions. Full insurance functionality is not presently achieved by distributing risk using pooling and diversification under the FSA approach. Risk can be more precisely allocated to its probable source using FSI, that is, the individual audit engagement covered by the insurance. [739]

As already touched on above, the professional indemnity insurance system used by FSA bears little relationship to the quality of the particular audit performed. Professional indemnity insurance policies are generally umbrella type policies that cover a broad range of accountant activities, including audit engagements. In contrast to this, each FSI policy would be tailored to a particular audit engagement to more accurately assess risk and adjust policy terms according to premium amounts and coverage levels offered. The FSI alternative does not involve insurance underwriting by risk classification using general actuarial tools. By insuring financial statements in preference to an audit firm, the FSI model uses specific information and profiling rather than inference from abstract generalities. A more layered risk approach is adopted requiring completion of a risk assessment before a FSI policy is

[738] Ibid 59.
[739] Ibid 60.

offered, followed by a more rigorous investigation at the audit stage. This methodology eliminates the problem of the uninsurable auditor. Instead of using pooled-risk and diversification models, the FSI's risk model is based on individual policy holder investigation. FSI better equips insurers with real time monitoring so that specific financial statements may be found uninsurable under FSI, but the entire auditing industry is not.[740]

8.5.5 An Effective Claims Process

The FSI claims mechanism improves upon the current situation requiring that claims be made against an auditor for damages. That approach can result in highly variable outcomes when determining FSA damage amounts to either over or under compensate as an imperfect deterrent.[741] Instead, the FSI model gives shareholders the legal right to claim recourse for their loss against the insured company due to materially misstated financial statements. It is structured to encourage litigant settlement in the event of a claim, as the insurer and insured must agree on a fiduciary organisation to represent financial statement user interests. That fiduciary organisation and the FSI carrier appoint an independent expert to report to them if an omission or misrepresentation is claimed, and whether that event has caused shareholder loss. If the expert reports a valid claim has been made, the FSI insurer then compensates the fiduciary for damages to the face amount of the policy.[742]

The incidence of litigation taken by investors is not expected to increase under FSI, and the present trend for insurers to settle out-of-court is likely to continue. To further streamline the process, FSI policies may contain provisions that give the insurer the right to seek out of court dispute resolution. Consequently only a small percentage of total claims that involve disputed facts would be expected to be argued in the courts. The shift to alternative dispute resolution to settle financial misstatement cases has the added advantage of reduced

[740] Ibid 64.
[741] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability', above n 650, 432.
[742] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 51.

litigation costs.[743] If an FSI claim is settled out of court, the successful litigant is compensated for its loss by the insured company, which is subsequently reimbursed by the insurer to the extent of its FSI coverage.

As has been previously discussed in this chapter, the FSI process requires security holders to firstly approve the FSI option. In a strict sense, that approval does not necessarily limit investor recovery against an auditor to the FSI policy coverage amount. Shareholder approval may be taken to imply that security holders have been given notice and knowledge of a proposal to purchase FSI. It can be argued that shareholder approval is an implicit contractual agreement and should serve to limit FSI claim recovery to the extent of the policy. In addition, the share market had notice of the policy details. It thereby can be assumed that the extent of that policy coverage would be factored into security pricing under efficient market conditions.[744] Although financial markets are notified of the FSI coverage, a plaintiff may still be able to sue for damages beyond those policy limits. That outcome may be less likely given that investors are made aware of the policy details before they acquire their shares, and are expected to have paid less for shares that carry lower FSI coverage. [745]

The chance of a recovery in the case of a creditor's liquidation is also improved under FSI. Investors would no longer take priority behind creditors to share in residual assets upon liquidation. This often leads to investor claims against auditors, given the resources and professional indemnity insurance held by them may be the only funds available for recovery. Under the FSA framework, investors claim against the appointed liquidator for their loss.[746] in comparison, investors covered by FSI insurance would no longer recover under an auditor's professional indemnity insurance. Legislation may be necessary to ensure that insurance proceeds are protected in the case of a liquidation, so that the company's creditors cannot claim FSI recovered by a liquidator before the company shareholders recover their

[743] Bhattacharjee, Moreno and Yardley, above n 696, 11.
[744] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 438.
[745] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 58.
[746] Cunningham, 'Financial Statement Insurance Act: 2004', above n 652, 77.

loss.[747]

8.5.6 Incentives and Disclosure

The incentives and pressures faced by auditors under the FSA assurance model may influence them to conceal prior period irregularities. Although the FSI model compares favourably with FSA, it also carries its share of imperfections including opinion shopping and the incentive to conceal past errors. Some other ethical concerns will continue under FSI but in different forms, for example the need for companies to rotate FSI carriers, and insurer independence from the insured company.[748] The model is however designed to reduce the occurrence of these imperfections and incentives by producing a more independent auditing environment. In particular, FSI insurer audit fees are likely to account for a large part of an audit firm's revenue. As such, FSI auditors face significant pressure from insurers given the potential to lose fees from a single source. FSI auditors are beholden to insurers so that the employment pressures exerted by these employers are likely to have a positive effect on their behaviour. [749]

Audit opinion shopping under the FSA regime could also arise under FSI if insurers seek to increase premium volumes by offering more lenient audits. That potential weakness would be addressed by auditor compliance with their professional code of ethics. FSI insurers that wish to engage in this type of practice are likely to be restrained from doing so by its auditor. Accounting professionals will still be required to comply with their professional standards of conduct as well as ASIC and APRA requirements. Auditors who hold membership of professional accounting bodies will risk the loss of personal assets and reputation if they follow their employer's direction without question. The threat of professional sanction will make auditors effective monitors of FSI insurer behaviour. [750]

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[747] Bhattacharjee, Moreno and Yardley, above n 696, 11.
[748] Cunningham, 'Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels', above n 723, 66.
[749] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 437.
[750] Cunningham, 'Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry

A further FSI imperfection put forward is that FSI auditors may have an incentive to conceal accounting irregularities rather than expose them. An FSI policy commences when an unqualified audit opinion is issued by an auditor. As such, the insurer has an incentive to discover, correct, and disclose all irregularities for a given year of cover. Auditors may have an opposite incentive to this to conceal prior year misstatements which are discovered in subsequent periods, and mask irregularities that require adjustment in the current year reports.

FSI supporters however argue that the incentive for auditors to conceal misstatements and omissions under FSI is weak given the structural improvements the model brings to negate these. [751] The structure of the FSI model controls auditor behaviour and encourages full disclosure to reduce the incidence of concealment. Misstatements of previous periods will in fact be more likely to be detected and disclosed. FSI risk reviews and premium pricing are conducted on an annual basis, and so an insurer's pricing must reflect the realities of the prior year audit whether or not irregularities were disclosed. FSI premiums are calculated based on risk assessments for both the current year and prior year financial statement risk. A variance in insurance premiums over time may signal that prior irregularities exist.

In addition, insurance companies have a greater incentive to voluntarily disclose past errors than FSA auditors. [752]Unlike FSA auditors, insurance companies are in the business of assessing risks, collecting premiums, and routinely paying claims. Given their actuarial approach to business, insurers are inclined to perceive that accounting irregularities may create larger loss payout exposure then if that recognition and disclosure was deferred. Insurers are removed from the conflicted cultures that engender accounting irregularities, and are better equipped to discover and disclose accounting irregularities than FSA auditors. These neutralising factors when taken as a whole help make FSI the superior model when it

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Before it Unravels', above n 723, 67.

[751] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 436.

[752] Bhattacharjee, Moreno and Yardley, above n 696, 11.

comes to disclosing mistakes of the past. [753]

The FSI approach is expected to bring greater levels of assurance transparency and lower barriers of entry to the audit services market. It will help alleviate[754] temptations faced by auditors that exist under the present system. New legislative would give even more support to the FSI regime. For example, penalties may be imposed for an FSI insurer whose auditor fails to disclose post-policy issuance discoveries, including monetary penalties set as a multiple of losses otherwise payable had concealment not taken place. Criminal sentences could be imposed for those persons employed by the FSI insurer who are judged responsible for facilitating deception. [755]

8.6 Eliminating the Traditional Registered Auditor Role and Audit Opinion

8.6.1 An Alternative Assurance Function

The choice between adopting FSI or using traditional FSA is mutually exclusive. A public company may adopt either approach, though not both. FSI is a market based alternative to FSA that offers financial reporting assurance with less conflicts of interest risks that might otherwise infect financial statement attestation. The FSI model alters the traditional FSA principal-agent-beneficiary relationship. It shifts auditor liability, given that the auditor becomes an employee of the insurer. He or she is now subject to termination and legal claims made by the insurer for breach of contract, negligence, fraud, and other transgressions. FSI in effect replaces an auditor's public liability, but does not alter the liability position of the other participants in the financial reporting process, including company directors and their legal representatives.[756]

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[753] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 437.
[754] Cunningham, 'Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels', above n 723, 66.
[755] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 437.
[756] Ibid 416.

The FSI model helps to address financial reporting policy challenges without needing to enact an extensive raft of new regulation and administrative oversight over auditor independence. The mechanism shifts the decision about an auditor's independence to the insurer, who decides questions of auditor conflicts including those linked to the provision of APNAS.[757] The FSI model as proposed by Dr. Ronen offers the prospect of new stakeholder relationships together with novel strategies to resource auditor and assessor services to change the nature of the audit product itself. The quality of the investigation used by an insurer to decide if a policy is offered (or not), and the terms of that policy become the chief concern of the insurer and those investors who will benefit under it.

An audit must be completed before an FSI policy can be offered. That assurance process is central to whether or not an insurer agrees to issue a policy or not. The relevance of traditional audit practice to the FSI approach can be questioned, and whether FSA processes are in fact still needed. For example, FSI processes could be developed requiring that the insurer offers a list of approved auditors for a public company to select from. Using a pre-approved list in this manner would allow an auditee to match the character of its business to an auditor's skill set. The client's intimate knowledge of its business means that it is better informed than the insurer about the professional expertise, experience, and qualities that its auditor must possess. When deciding upon the list of auditors, an insurer might also include an in-house resource to conduct its audits. Under this approach, FSI insurers can decide the optimal mix of internal and external auditors, together with which auditors it offers to an audit client. [758]

The future modelling of FSI may see the concept of a registered company auditor disappear altogether. This may come about where insurers decide to source service providers who are expert in substantiating financial statement balances. This move may effectively replace the traditional audit function. Rather than employing an auditor for that role, the insurer may

[757] Ibid 434.
[758] Ronen, 'A Proposed Corporate Governance Reform: Financial Statements Insurance', above n 658, 138.

project manage the assurance process to coordinate a group of professions with the most relevant expertise in an auditee's business. For example, engineers, valuers and forensic accountants may be chosen by the insurer to carry out a review of particular balance sheet items. These experts would report their findings before the insurer decides if an adequate level of assurance exists for it to offer an FSI policy to the applicant. If the insurer decides not to issue a policy based upon these expert reports, instead of furnishing a traditional audit report with a few explanatory paragraphs, the insurer's report would instead state the reasons for declining the FSI application.

8.6.2 Eliminating the Need for an Audit Opinion

An FSA audit opinion (particularly a qualified opinion) has significant consequences for a public company. The fate of an auditor pressured to retain client fees and audit engagements may be determined by the opinion that he or she gives. This thesis has clearly established that the audit function is susceptible to management influence. Some financial statement users have little trust in an auditor's ability to provide an objective opinion in any situation. Persisting with the audit opinion requirement under an FSI regime may not be the best means to deliver investor confidence where this view is broadly held.[759]

The FSI framework is designed to meet investor needs by providing public company information to the marketplace to reduce investor risk. Not only is investor confidence and trust in financial reporting restored by the approach, but some FSI advocates also suggest the need for a traditional audit function is no longer be required. As previously explained, the FSI model requires that public companies purchase insurance to indemnify their financial statements against material misstatement. By doing so, financial statement users are able to substantially reduce or even eliminate information risk.[760] Under the FSI framework, the need for a traditional FSA product and audit opinion may become redundant given that public companies now engage insurance companies to indemnify their financial reports

[759] Bhattacharjee, Moreno and Yardley, above n 696, 15.
[760] Ibid.

against misstatements. This idea to abandon the audit opinion is an expansion on the Ronen model which requires a FSA opinion be given in order to satisfy the 'audit condition' requirement.

Under this development of the FSI model, the need to form and issue an audit opinion is eliminated as the auditor performs an underwriting type service for the insurer. The insurer rather than the public company takes the audit client role to determine the combination of insurance premiums and coverage for each insurance client. The insurer in these circumstances only requires an auditor to perform underwriting services. The auditor would issue a risk assessment and make an evaluation rather than form an audit opinion. Therefore, an audit opinion is of little use to an insurer when deciding how much insurance cover it will provide to an applicant. Further, the mix of insurance premiums and coverage are signals of financial reporting quality. The provision of this information only requires a financial statement risk assessment be performed, without the need for an audit report being issued.

Moreover, although different public companies have different levels of financial report misstatement risk, most of these will be issued an unqualified audit opinion under FSA. The issue of an FSI risk assessment evaluation report alone (without an unqualified audit report being issued) would be of greater information value. Financial statement users would now be able to separate these generally compliant entities which would otherwise be depicted as having the same information risk. If an audit opinion were required, the likely combination of unqualified opinion and risk assessment evaluation would send a mixed signal to investors on financial reporting quality. Imposing an audit opinion condition under FSI adds an unnecessary level of complexity. Dispensing with the audit opinion requirement relieves the auditor from making a pressured dichotomous decision. Auditors would instead give a risk assessment evaluation in their underwriting capacity that reflects the risk of public company financial statement misstatement in the accounts they have examined. [761]

Elimination of the audit opinion requirement will also address a FSA model fundamental

[761] Bhattacharjee, Moreno and Yardley, above n 696, 14.

weakness. The auditor is contracted by the insurance company to risk assess a public company's financial statements and assist in the underwriting process. The auditor no longer needs to provide a decision that ultimately places undue pressure upon him or her to agree with the auditee. The value of the audit product under FSI will ultimately be determined by its ability to assist the insurer's risk management and assessment process. Given the insurer is free to contract with the auditor, the quality of the underwriting services will be the primary determinant in their continued association. Under this reconstructed assurance and insurance relationship, the FSI framework is expected to restore investor trust. Investors are more likely believe that the auditor will have acted with integrity and was able to carry out the audit function free of conflicts of interest. This free market model is intended to enhance the trustworthiness of financial statements by aligning all stakeholder interests.[762]

8.7 Conclusion

A valuable audit is an audit that effectively deals with the inherent conflicts between those seeking capital in the marketplace and those providing it. While those seeking capital wish to raise funds on the most favourable terms, those providing capital wish to make allocation decisions based on the most reliable information available to them. A conflict exists as capital seekers generally possess company information which is unknown to investors. Capital seekers are well positioned to mislead capital providers on the prospects of future success, returns and the likelihood of recovery of capital. Therefore, capital providers are inherently disadvantaged in their ability to control, negotiate, and evaluate the terms of offerings and the trading prices of securities. The accounting function in contemporary public company corporate governance uses third-party auditor attestation to balance that relationship. Notwithstanding the benefits of auditor assurance, weaknesses in this system of vouching have been evidenced by the instances of corporate collapse as highlighted in this thesis. Under the current FSA framework, auditors can add value to capital markets and protect capital provider interests, but only if they are independent of capital seekers in both

[762] Ibid.

fact and appearance. [763]

Financial statement insurance is a bold innovation that harnesses insurance industry practices. Insurance law replaces the traditional auditor engagement and liability model. The FSI model has been designed to restore confidence in capital markets and improve the quality of financial reporting. Auditors are alleviated from their legal liability to shareholders and take a new insurance underwriter role, while insurers are able to expand their business options to sell the new FSI product. This thesis has concluded that information risk can be significantly reduced if FSI were introduced. Investors would now recover for materially misstated financial statements, while public companies are protected from those losses by taking out an FSI policy. The strategic use of share put options by insurers would then help to reduce their exposure by hedging risk and dispersing liability across a wider section of the financial markets.

Public company financial statement quality is also signalled through published FSI policy information. This information allows capital market participants to compare investment opportunities and assess improvements (or declines) in company performance over several accounting periods. The publication of coverage and the premium mix would present a credible signal of a public company's financial statement superiority. These messages are then priced into a company's equity and debt by investment decision makers. As a result, more worthy projects can be chosen, public company financial statement quality is improved, and an enhanced social dividend is derived. Fewer instances of misrepresentation and legal action against auditors are expected in the longer term, as[764]shareholder losses are expected to decrease with improved investment decision making over time.

Rather than taking a strict legislative offensive against auditor conflicts, FSI is a free market mechanism which can govern auditor ethical behaviour. Nonetheless some legislative change and new contractual arrangements for insurers, public companies, and risk assessors

[763] Ibid.
[764] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 68.

will be necessary to implement the scheme if introduced into Australia. If FSI is brought in, an interim regulatory initiative may be needed before establishing long term infrastructure. For example, the federal government may legislate that minimum FSI coverage is required by all public companies. That amount is determined with reference to the insured's company earnings results over a period of time. A government insurer could be established to carry this minimal cover to commence with. An assessment of these interim measures could then be used to guide the market on risk and pricing. Insurance market institutions would then replace these temporary government agency arrangements over time. [765]

FSI stakeholder costs would generally replace existing FSA costs. For example, public companies will replace their current audit costs with the cost of acquiring insurance. In addition, insurance providers will incur costs to enter the new market for FSI, and also incur the business as usual costs of issuing policies including auditor underwriter fees. Many of these FSI model costs are either start-up expenses or they replace current assurance model costs. Notwithstanding these costs, the advantages of the proposed FSI model outweigh the costs associated with it, especially the less tangible benefit of restored investor confidence in the financial reporting system. [766]

Past measures to reform auditor ethical misbehaviour in Australia have proved inadequate. Another approach is needed. FSI is a market-based solution that properly aligns auditor incentives. The mechanism yields multiple advantages, including a remedy for neglected auditor independence. [767] The FSI machinery fixes the fundamental limitations of the traditional auditing model by removing the risk of auditor conflicts of interest, and would provide superior financial statement examination when compared to FSA. FSI's theoretical promise warrants implementation at least on a partial basis. If the Australian government takes the adventurous decision to implement FSI, one of the first steps would be to develop a regulatory framework that permits FSI to be used as an alternative to FSA. This introductory

[765] Ibid.
[766] Bhattacharjee, Moreno and Yardley, above n 696, 3.
[767] Ronen, 'Post-Enron Reform: Financial Statement Insurance and GAAP Revisited', above n 69, 67.

phase may be restricted to those companies of a certain size or type. The feedback from that experience would then reveal FSI's efficacy and appeal, to assist the ultimate decision on whether the product is to be rolled out across the Australian public company population more broadly. [768]

[768] Cunningham, 'Choosing Gatekeepers: The Financial Statement Insurance Alternative To Auditor Liability', above n 650, 441.

Chapter 9: Conclusion

9.1 Introduction

A robust financial reporting and auditing framework is critical to business and investment decision making. An independent and high quality audit provides an external check for information users on the integrity of financial statements. Transparent and credible financial reporting in combination with an effective audit function is needed to underpin confidence in the Australian financial system and capital markets, and is essential for sound economic growth.

The subject matter of this thesis has centred on the audit function in Australia, and the assurance it delivers under the current regulatory regime. On the surface, the audit function appears to be working well and has delivered on its purpose most of the time. The Australian Treasury recently stated that the Australian audit regime compares well in terms of international best practice and that no fundamental reform is required.[769] The Treasury is of the view that Australia's financial reporting system and audit regulation is both robust and stable, and that this level of effectiveness is critical to the efficiency of Australia's financial systems and the country's economic growth.

Notwithstanding these statements in support of the audit function and its effectiveness, concerns about the risk of audit failure are frequently heard. The global expansion of large audit firms and increased complexity of both accounting standards and financial instruments have fuelled this apprehension. Challenges to the approaches used by accountants to estimate and record asset values were also heard during the recent global financial crisis. These concerns have reinforced the need for financial statement user confidence in the quality of

769 Commonwealth of Australia, *Audit Quality in Australia A Strategic Review*, above n 526, Forword iii.

audit processes that support an auditor's opinion.[770]

The HIH collapse stunned the Australian nation with news of a shocking series of accounting irregularities. Several culprits were nominated as the cause of this collapse and other recent instances of corporate failure in Australia. These include investor irrational exuberance, greed, and the impoverished morality of company directors. In some cases, these factors have joined forces with unethical auditor behaviour, to encourage these auditors to acquiesce in accounting manipulation. This thesis has identified auditor independence as being critical to the audit function, and has paid particular attention to conflicts of interest and breached independence as a cause of corporate demise.

This thesis has examined the theoretical foundations of the professions and ethics, to consider ethical theory in the context of professional institutions. These broad principles have been analysed and applied to instances of ethical dilemmas particular to the accounting profession. In addition, this thesis has explained the operation of the *Code of Ethics for Professional Accountants* ('APES 110', or 'the Code') as it applies to members of the accounting profession in public practice. Ethical frameworks were found to be useful tools that can identify, evaluate and resolve the ethical issues encountered by an accountant, and give direction on company auditor behaviour.

Prosecution and punishment do not adequately deter the wrongdoing of accountants, while intentional misrepresentations made by them are difficult to discover and or prove. Although ethical theory and codes of conduct offer direction and help shape ethical attitudes, this thesis finds that they do not overcome the structural problems inherent in the Australian audit regime. Problems of conflicted interests exist in the relationship between a registered company auditor and the company management that engages him or her. The solution put by this thesis lies in a market mechanisms that seeks to eliminate the perverse incentives that influence an auditor. After examining the nature of the accounting profession and ethical problems faced by it, this thesis finds financial statement insurance ('FSI') is a solution able

[770] Basel Committee on Banking Supervision, *External Audit Quality and Banking Supervision*, (December 2008) Bank for International Settlements, 1 <http://www. bis.org/bcbs/>.

to improve this situation. It is a market driven approach which aligns stakeholder incentives and is able to deliver better quality independent audits.

9.2 The Structural Power Imbalance Between Management and the Auditor

Unbiased and transparent financial reporting can provide important information about the economic performance and economic condition of a business. Accurate financial reporting is critical to financial market decision making on resource allocation and for government agencies that administer legislative policy. Chapter 2 of this thesis discussed the importance of financial reporting integrity to user confidence, global financial stability and sound economic growth.

The public company management model adopted in Australia is based upon control by a board of directors with supporting lower tiers of management. That management structure is a powerful social and economic institution which both directly and indirectly affects the wellbeing of the Australian people.[771] Yet the forces of capital markets that guide this powerful institution are shrouded in commercial confidentiality rather than democratic principles of openness and public accountability. Instead of promoting openness, government legislators and regulatory agencies have created a system of corporate financial disclosure overseen by a largely self-regulated audit profession. Through this approach, the Australian government has conferred a special and lucrative franchise on the auditing profession. In return, the conduct and behaviour of auditors are governed by a professional code of ethical conduct that emphasises objective judgment independent of all influences.[772]

The thesis has found the auditor's role is not well understood, and that auditors perform the assurance function within a conflicted environment. The Australian accounting profession takes a leading role in financial statement design through its development of standards and its input to legislative change. Yet at the same time, accountants maintain a business

[771] Marjorie Kelly, *The Divine Right of Capital: Dethroning the Corporate Aristocracy* (Berrett-Koehler Publishers Inc, 2001) 7.
[772] Robert Mautz, 'Public Accounting: Which Kind of Professionalism? (1988) 2(3) *Accounting Horizons* 121, 123.

relationship with the auditee company that employs them while being subjected to accountant made rules. In addition, although company shareholders legally have the power to appoint auditors, the executive directors or senior management as representatives of the shareholders will more often than not negotiate the conditions of auditor engagement. The commercial viability of an audit firm relies on fees negotiated with its client management. This arrangement leaves audit practitioners in a conflicted position, and vulnerable to the wishes of their client. Within this environment, the short term economic gain of the audit firm is likely to take precedence over the long-term good of the accounting profession.

This thesis has found that the power and control enjoyed by public company management in Australia is facilitated by a largely self-regulated accounting profession. The co-regulatory approach adopted in Australia allows for a profitable and comfortable monopoly in the provision of accounting and audit services. But rather than break the nexus between the self-serving economic relationship of auditor and management, regulatory intervention against conflicted interests[773] has instead focused on behavioural aspects of auditor independence. This reaction to corporate regulatory failure has not addressed the central issue of auditor economic dependence on the auditee. The lofty idealism of professional obligation is at odds with the practicality of an audit business looking to satisfy its client's needs.

9.3 The Professions and Closure

This thesis has examined the professionalisation strategies used by occupational collectives to attain professional status. The concept of market closure was found to be an important element in gaining social status and privileged position. Notwithstanding that positive outcome for the members of an occupation, the restricted entry to a profession (for example, registered company auditors in Australia) is the principal cause of conflicted duties and breached independence.

[773] Colleen Hayes, 'The Ramsey Report and the Regulation of Auditor Independence in Australia' (2002) 12(27) *Australian Accounting Review* 3, 4.

The closure of a profession to competition comes about from a process of negotiation. In the case of audit services, standardised audit approaches have been generally accepted by capital markets to ensure their credibility. That credibility is then reinforced by registration, regulatory support and accreditation systems. Professionalisation projects involve the articulation of expert tasks and jurisdictional claims to these tasks. These areas of expert knowledge are then confirmed by a legitimising authority of the state as a profession. Even low level systems of examination and the mundane codification of practical knowledge help construct professional legitimacy and influence community acceptance of that professional knowledge.[774]

In all cases, the advancement of professional credibility and normalisation of occupational practices relies upon eradicating contested views. To achieve success, the outcomes of professionalisation strategies must be agreed to under a process of collaboration and co-design, and appear natural, obvious and uncontested. In the case of accountants, conflicted views were suppressed while formal audit techniques were developed to spell out the nature of the audit function and bring about authorship and ownership of these processes and occupational knowledge. Against this effort by accountants to restrict competition, counter strategies moved to reopen controversy and to disturb that closure.[775] According to most accounts, the accounting profession has successfully defended itself against these efforts to stand as a powerful social institution. Professional standing has been claimed by accountants, who have declared themselves as qualified audit experts within the boundaries of the audit knowledge that they themselves have prescribed.[776]

This thesis found the audit function to have sustained the growth of business practices in Australia by providing a solution to problems of control. Audit displaced costly inspection technologies with more distant audit review activity. It functions to replace direct control practices of supervision and real time inspection. This thesis has shown that accountants

[774] Power, 'Auditing and the Production of Legitimacy', above n 346, 392.
[775] Michael K Power, 'Expertise and the Construction of Relevance: Accountants and Environmental Audit. Accounting' (1997) 22(2) *Organizations and Society* 123, 123.
[776] Power, 'Auditing and the Production of Legitimacy', above n 346, 392.

have used strategies of closure and collective social mobility to enhance their power and defend the rewards and resources they have gained over time. The significance of audit is not centred in its role and operational practices, but rather how new audit opportunities are appropriated and mobilised.[777] Accountants were found to develop and expand the audit function as a self-interested collective, to achieve this expansion by employing professionalisation strategies to control the audit services market in Australia.

As new markets for professional and audit services have been established, the potential for conflicted duties also increases together with a greater likelihood of damage to both the audit function and the profession's reputation. A market driven insurance solution to the problems of market closure has been suggested by this thesis, which calls for the restructure of audit function relationships to thereby lessen the potential for conflicted dealings.

9.4 Restoring Public Trust

The Australian Stock Exchange, government administrative agencies, institutional investors and financial statement users more broadly demand transparency and accountability in corporate governance, business ethics and financial reporting. The response of governments to corporate scandals worldwide has in the main been to institute more regulation. Although that response has been made to protect the public's interest, these legislative reforms to corporate reporting, accounting and auditing regulation have not brought about all intended outcomes. [778]

This thesis examined the regulation of auditor independence in Australia, and the success of these rules in ensuring that ethical practices are observed. In spite of these legislative efforts, it was found that rule making is not the only answer, and that regulation will not by itself regain community trust. Confidence in capital markets requires that community confidence be instilled in reporting and regulatory processes through accountability and transparency. That assurance is built on integrity and strong individual ethical beliefs and behaviours. It is

[777] Power, *The Audit Society: Rituals of Verification*, above n 119, 300.
[778] Edge, above n 61, xiii.

thereby essential that audit firms entrench a culture that fosters ethical behaviour in their people to restore public trust.[779]

Ethical behaviour was found by this thesis to not simply result from compliance with legal and professional rules, but requires a state of mind and culture of doing the right thing. Auditors face ethical questions and conflicts of interest on a daily basis. In these situations, auditors must balance their client duties against their profession duties, and those owed to auditee stakeholders and society more broadly. Actual conflicts of interest or the perception of them leads to public distrust. Conflicted behaviour has become a familiar problem in recent years. Chapter 7 of this thesis discussed how financial market confidence is quickly lost but slowly regained in instances of breached auditor independence.

9.5 Ethical Codes of Conduct

An auditor will face ethical decisions on a regular basis during the course of his or her work. It is fundamentally important that appropriate and professional decision-making protocols and behaviours are ingrained in the culture in which they practice. One option used by the professions to achieve this is to implement a code of professional and personal ethical guidelines. This approach seeks to embed ethical behaviour at the individual level and within audit practice. The accounting bodies in Australia have instituted a code of conduct that provides authoritative guidance on professional conduct. The rules of APES 110 represent a significant body of ethical guidance for the accounting profession, and has been examined in detail in this thesis.

The Code sets out general guidelines on concepts such as independence, competence and honesty, as well as statements that address specific issues applicable to professional behaviour. Compliance with these guidelines are monitored by the profession, and non-conforming members are subject to sanction. This thesis concluded that APES 110 provides comprehensive and clear rules that are essential for good governance and the ethics

[779] Ibid xiv.

of the accounting profession in Australia. The Code was found to adequately state the accounting profession's position on ethical and compliance matters, although it does not represent an exhaustive list of rules for member guidance.

Although the Code provides clear ethical guidance, the accounting profession must continue to embed ethics and ethical compliance into its culture and core business activities to regain public trust and safeguard its reputation. That being said, a fundamental defect continues under the current regime. That is the auditor is retained by the client, and that engagement makes the auditor beholden to the client and its management. Although conventional wisdom may find this situation acceptable, that relationship in reality causes the auditor to see things through the lens of management, sometimes not even realising this influence is upon him or her. This thesis suggests that it now time to sever the auditor-client employment relationship, and to restructure the market for audit services. Financial statement insurance has been proposed as a suitable alternative to the financial statement auditing approach and the auditor liability model as currently used.

9.6 Restructuring the Auditing Market

The issue of breached auditor independence is widely acknowledged as the chief problem facing the audit function today. This thesis pointed to problems of auditor conflicts of interest and client dependence by reference to high-profile corporate failures, including Enron Corporation ('Enron') and WorldCom Incorporated ('WorldCom'), and most notably HIH Insurance Ltd ('HIH') in Australia. The company auditor is an easy blameworthy target in these circumstances and is most often singled out as the offender even though other parties have contributed to the damage caused. [780] That perception of auditor culpability can be traced back to the belief that, had the external auditor properly carried out his or her function, corporate failure would have been prevented and shareholder and creditor loss would not have been incurred. Such a belief however creates false expectations on the part of financial

[780] Joshua Ronen and Julius Cherny, 'A Prognosis for Restructuring the Market for Audit Services' (2003) 73(5) *The CPA Journal* 6, 6.

statement users. It is further aggravated by regulators who do not fully understand the purpose and scope of the audit function and environment in which it functions.

This thesis conducted an examination of corporate failure in the context of auditor provided non-audit services. It considered the commonly put argument that without the temptation of large professional service fees; an auditor would presumably have done the right thing. Counter to this view, it was concluded that an auditor who supplies consulting services to an audit client will have a more in depth knowledge of the auditee's systems and its operations. These so called knowledge spillovers are particularly important at times of information technology change and increased sophistication in business practices. This greater level of client process and procedural knowledge is a key to audit effectiveness and the delivery of a sound assurance product.

Auditor-client conflicts of interest in combination with the confused nature of financial statement quality has been found by this thesis as a likely cause of accounting irregularity and audit failure. Auditors must be independent and maintain an objective state of mind in order to deliver an unbiased opinion on the veracity of the financial reports they examine. Auditor independence thereby relies upon the auditor making decisions as an objective and conflict free community gatekeeper. This thesis finds that objectivity is fundamental to auditor independence, and that requirement has been reinforced by sec. 120 of APES 110 which defines objectivity as:

> 120.1 The principle of objectivity imposes an obligation on all Members not to compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others.
>
> 120.2 A Member may be exposed to situations that may impair objectivity. It is impracticable to define and prescribe all such situations. Relationships that bias or unduly influence the professional judgment of the Member should be avoided.

Legislative intervention to promote auditor independence followed the HIH accounting

scandal. That response has proven to be somewhat ineffective given that the present structure of audit relationships actually encourages auditor reliance on his or her client. An auditor is remunerated by the client and is naturally tempted to adopt those positions commanded by the auditee. It is not surprising that breached auditor independence is commonplace under this current model. Given that structural problem, this thesis proposed a solution to improve auditor independence, to uphold the audit profession's integrity, and most importantly, improve the quality and content reported in audited financial accounts.

Financial statement insurance was proposed as a solution to change the principal-agent relationship between the auditor and the client. Instead of the company appointing and remunerating the auditor, the company would now purchase insurance. This insurance is intended to provide financial compensation for investors and creditors to the extent that misrepresentations appear in the financial statements and those capital providers suffer loss. Under the FSI approach, the insurance carrier would engage and remunerate the auditor.

The benefits of the FSI approach have been covered off in this thesis at length. Amongst these, shareholders are expected to be more active in corporate governance matters given that their loss recovery is limited to the FSI coverage amount. In addition, the maximum available coverage and premium cost, together with the amount of coverage purchased would be made public under the approach. This information signals the inherent risk of particular financial statements to financial statement users.[781] That indication of financial risk can be used by capital markets to cost their funds. Some companies that purchase FSI would expect to receive a reduction in capital costs if they have a favourable risk profile as presented by this data. The opposite holds true for company's showing relatively poor FSI data.

Most importantly under the FSI model, auditors can be truly perceived as independent from their client. Financial statement insurance is a market-based solution that that restructures audit function relationships. The auditor engagement decision is transferred from company

[781] Ibid 9.

management to an insurer, so that this scheme lessens the chance of an auditor conflict of interest with the audit body. The FSI model was found by this thesis to offer a way forward to offset the explicit and implicit client pressures placed on today's auditors under the traditional audit approach.

9.7 Conclusion

If the Australian audit framework were designed from the ground up today, most people would find it illogical to invent a system where the audit subject engages its auditor, bargains the size of the audit fee, and is permitted to purchase other management services from its auditor. In addition to this, the auditor then influences audit rule setting, decides how these rules are enforced, and has responsibility for applying sanctions in the case of a contravention. Nevertheless this is the case in Australia where auditors are required to behave independently of management as mandated under the accounting professional's code of conduct. This thesis has found the current auditing regime is flawed and that it must be redesigned to restore capital market trust.

Inherent conflicts of interest are allowed to develop and flourish within present auditor-client relationships. The current system relies upon auditor legal liability to ensure truth telling in financial reporting; however this approach has not delivered the level of assurance required by financial statement users. This situation can however be markedly improved through the introduction of FSI. This insurance approach offers a market-based solution to more effectively deal with bias existing in financial statements, to ensure fewer misrepresentations and smaller shareholder losses. Financial statements insurance has been shown by this thesis to be an effective market mechanism, that if introduced would bring about significant change to the structuring of working relationships and auditor incentives. This shift would align auditor and client management incentives with those of shareholders, to ensure better quality audits and that better quality financial statements are produced.

Although the FSI model is not perfect, it does promise considerable advantages over the

current auditor liability model. While some existing system imperfections are sustained or reappear in different guises under FSI, none of these are aggravated and most are mitigated. While FSI does hold considerable promise, it is bold and somewhat radical proposal given the present construction of audit stakeholder relationships, and the significant change necessary to realign these. No matter what the future holds for the audit function, in the end, there should never be a black box of unquestioned audit processes or conflicted relationships. [782] Regulators and researchers must be vigilant and question concepts and discourse that might otherwise shutdown the market for auditor services to others at the expense of information users.

[782]Power, 'Auditing and the Production of Legitimacy', above n 346, 392.

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APPENDIX ONE – FINANCIAL STATEMENT INSURANCE OVERVIEW

The FSI procedure as proposed by Professor Ronen[783]

Step 1

The potential insured requests an insurance proposal from the FSI carrier. The proposal contains, at a minimum, the maximum amount of insurance being offered and the related premium. Typically, it also specifies a schedule of amounts of coverage below the maximum along with associated premiums. The proposal request is made before the preparation of the potential insured's shareholders' proxy on the basis of the underwriting review. The reviewer can be the same auditor who will eventually audit the financial statements.

Step 2

The proxy offers the following alternatives:

- The maximum amount of insurance and related premium as offered in the insurance proposal.
- The amount of insurance and related premium recommended by management.
- No insurance.

Step 3

If either of the insurance options set forth in Step 2 is approved, then the reviewer and the auditor cooperatively plan the scope and depth of the audit to be conducted.

[783] Ronen, 'A Proposed Corporate Governance Reform: Financial Statements Insurance', above n 658, 144.

Step 4

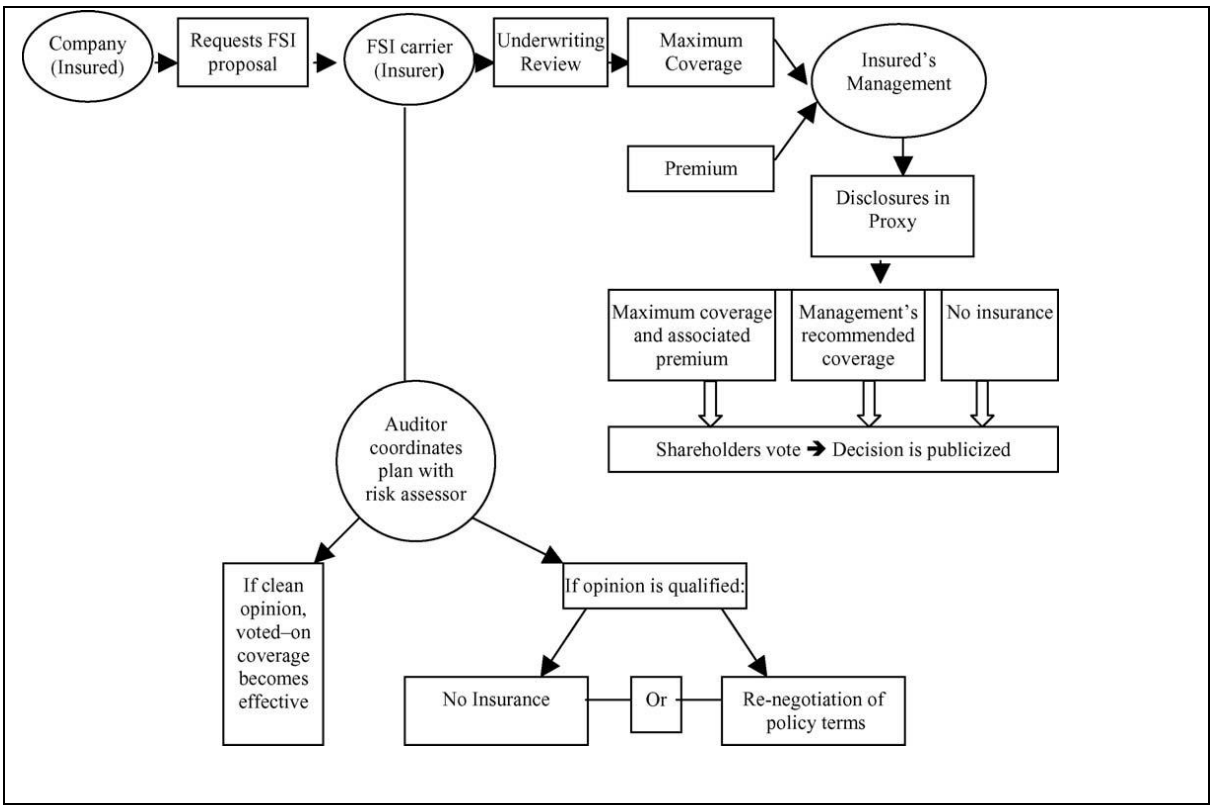
If, after the audit, the auditor renders a clean opinion, the insurer issues the policy. That is, the originally proposed coverage and premium will be binding on the insurance carrier if the auditor's opinion is clean. If the auditor's opinion is qualified, the insurer provides no coverage unless the company can renegotiate different terms, which depend on the auditor's findings and the reasons for qualification. The renegotiated policy terms are be publicized. Since shareholders are on notice that with some probability the opinion will be qualified and no insurance will be provided, they factor this eventuality into the price of the stock, bidding it down by an amount that reflects the probability of a qualified opinion. The larger this probability, the greater the price discount. This magnifies the incentives of a firm seeking insurance to improve the quality of its financial statements and consequently avoid a qualified opinion.

Step 5

The auditor's opinion contains a paragraph disclosing the amount of insurance that covers the accompanying financial statements and the associated premium. [784]

The FSI process.

[784] Ibid.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No insurance
Shareholders vote ➔ Decision is publicized
Auditor coordinates plan with risk assessor
If clean opinion, voted–on coverage becomes effective
If opinion is qualified:
No Insurance
Or
Re-negotiation of policy terms