The University of Sydney
NSW 2006 AUSTRALIA

Discipline of Accounting and Business Law
Faculty of Economics and Business

Graeme Dean
Professor
Head of Discipline

Merewether HO4
Telephone + 612 9351 3107
Fax + 612 9351 6638
Email g.dean@econ.usyd.edu.au

23 May 2002
Mr Bob Charles
Committee Chairman,
Joint Committee of Public Accounts and Audit.

RE: Subm**ission to Joint Committee of Public Accounts and Audit Inquiry, “Review of Independent Auditing by Registered Company Auditors”**

Dear Mr Charles,

Attached is our submission to your recently announced inquiry, “Review of Independent Auditing by Registered Company Auditors”. This inquiry followed recent corporate collapses ion Australia and elsewhere which some have claimed (*Chartac*, Vol. 26, 357, April 15, 2002) highlighted audit failure.

The following comments are addressed solely to private sector auditing issues.

Regarding the inquiry, you were reported as saying that: “The spate of recent collapses in Australia and overseas has attracted much public attention and comment. It is a matter of intense concern to the committee, particularly because auditors have been seen to have signed off on the financial health of companies which have subsequently failed.” That same issue of *Chartac* reported that Jim Dixon, CPA Australia’s technical director, ‘told a recent meeting of the consultative group of the Australian Accounting Standards Board, [that] CPA Australia is preparing a paper suggesting ways to improve self-regulatory mechanisms to ensure community has faith in the work of the accounting profession, particularly auditors”. We agree that the matter is of intense concern and that there is need to undertake systemic (rather than cosmetic) reforms if the Community is to retain its faith in the accounting post-Enron, HIH, etc.

It concerns us is that it has been shown repeatedly that similar events have occurred in Australia and elsewhere over many decades. Works that demonstrated the interconnected nature of accounting/auditing in the unexpected company failures over several decades, include: R. Chambers, *Securities and Obscurities: Case for reform of the law of company accounts* (1973), numerous articles by Chambers over forty years (many of which are reproduced in R. Chambers and G. Dean (eds) *Chambers on Accounting, Vol II, ‘Accounting Practice and Education*, 1985), A. Briloff, *Unaccountable Accounting* (1972*), More Debits than Credits* (1976) and *The Truth* *about Corporate Accounting* (1981) and F.L. Clarke, G.W. Dean and K. Oliver, *Corporate Collapse: Regulatory, accounting and ethical failure* (1997, 1998, 2001; revised edition forthcoming, 2002). We outlined and gave copious examples of accounting solecisms in F. L. Clarke and G. W. Dean "Chaos in the Counting House: Accounting Under Scrutiny", *Australian Journal of Corporate Law,* (September, 1992, pp.177-201), and updated the examples and showed that little had changed in "Creative Accounting, Compliance and Common Sense",", *Australian Journal of Corporate Law* (August 1997, pp. 366-386); and P. Wolnizer, *Auditing as Independent Authentication* (1987) and P. Wolnizer, "Are Audit Committees Red Herrings?", *Abacus* (June, 1995, pp. 45-66).

The Inquiry's terms of reference note that the 'Committee wishes to explore the extent to which it may be necessary to enhance the accountability of public and private sector auditing' and further that the 'Committee is keen to determine where the balance lies between external controls through government regulation, and the freedom of industry to self-regulate'. The premise underpinning our submission is that the works cited above have demonstrated the need for systemic changes in accounting and auditing in order to 'enhance the accountability of private sector auditing'. Yet, professional enquiries in Australia over several decades have produced only cosmetic changes to the accounting data required to be presented and audited by firms. This began following Australia's spate of large, often unexpected failures in the late 1950s and early 1960s (like, Reid Murray, Stanhill, HG Palmer) with the 1966 *White Paper* on company failures, *Accounting principles and practices discussed in reports on company failures* prepared by the General Council of the then Australian Society of Accountants. It virtually exonerated accounting – generally management was to blame for the failures. Then, following the so-called "decade of greed" and the 1980s collapses (like Bond, Adsteam and Westmex) there were the two so-called professional "Expectations Gap" studies – the joint ASCPA/ICAA, *Research Study and Financial Reporting and Auditing – Bridging the Expectations Gap*(1993) and the follow up study in 1996. We note that the recently released CPA Australia Discussion Paper, *Financial Reporting Framework – The Way Ahead: A proposal from CPA Australia*, avoids addressing the technical accounting and auditing issues head-on. Repeating the pattern of the earlier (1966, 1993 and 1996) papers, it outlines yet another alternative layer of administration and regulation – nothing there addresses the technical aspects of accounting! There is nothing about improving the technical aspects of accounting and auditing! Yet, we contend that the technical aspects of accounting and auditing are the cause of the present problems and that these are merely repeats of those of earlier decades.

Our attached submission is drawn from ideas contained in an Editorial in the forthcoming June 2002 issue of *Abacus,* Australia's leading international academic accounting journal. This journal is distributed to over 1000 subscribers in more than forty countries. Titled, 'Auditor independence reforms- recycled ideas', we argue that the current auditing reforms (including calls for splitting audit and non-audit services, mandatory audit committees and auditor rotations) evoke a sense of déjà vu. Those proposals, as was the case with proposals of earlier decades, are premised on the unquestionable need for (i) higher quality information for investors, (ii) making executives more accountable for their actions, (iii) developing stronger more accountable auditing systems.

What we contest strongly however, is that those reforms proposals properly address the fundamental problems facing accounting and auditing. The major problem we contend is that the data emanating from extant (standards driven) accounting is unable to properly audited. Auditors are as was noted in Clarke, et al., *Corporate Collapse* (1997) on "mission impossible", that auditors were "on a hiding to nothing" and were bound to take a big hit. Contiguously Clarke *et al*., (1997) forecast that the current spate of "unexpected (to some in the market) collapses" was inevitable given the framework within which auditors must ply their attestation trade. Prophetically, that work alluded to a "time bomb" waiting to explode. And that when it did accountants and regulators would be the major casualties. Now it has! The financial sagas of Enron and HIH, *inter alia*, have detonated the fuse and all mentioned parties are now feeling the aftershock.

Our view is that the focus of any reforms should recognise that, as professionals, auditors need to have an "independent frame of mind in forming an opinion regarding the 'truth and fairness' of the financial statements". Independence of association is not the major issue to be addressed, albeit in the current paranoia, it probably requires some attention.

Absence fraud, audit failure is a function of the quality of information presented to interested parties — it depends on the quality, the reliability, the comparability, the authenticity of the information set out in the financial statements. This, in turn, depends primarily upon the accounting methods used in their preparation. Our submission notes that "Over time the idea of authenticating the contents of periodical accounts by recourse to independent evidence has, with the exception of cash, receivables and payables, been submerged. Recourse to external evidence has been replaced by professional prescription of the manner in which financial statements are to be prepared without considering whether the data are generally serviceable for the purposes made of them — determining the wealth and progress of the companies to which they relate and deriving indicators of their salient financial characteristics".

Our submission concludes by returning to a theme we have outlined previously (see works cited above):

In the absence of full mark-to-market accounting that has external commercial referents, auditors shall continue to be at the behest of their clients' financial calculations—a situation in which 'independence of mind' can neither exist nor be shown to exist. There is little likelihood that the recycled ideas being proposed will mitigate unexpected corporate collapses and their associated fallout.

Accounting is, and always has been, the core focus of the audit of published financial statements. Reliable financial statements are the very objects of the independence rules! Compulsory compliance with the present crop of accounting standards poses the greatest threat to auditors' *independence*. That constraint ensures that 'surprise' continues to be a prevailing characteristic of corporate failures, and that auditors attract the flak.

We wish to submit the paper, 'Auditor Independence Reforms- Recycled ideas', for your consideration and we ask that this covering letter be incorporated as part of our submission. We would be delighted to participate in any public hearings related to submissions if that were deemed of use to the Committee’s deliberations.

Sincerely,

On behalf of :

Graeme Dean, Professor of Accounting, Accounting and Business Law, School of Business, Faculty of Economics and Business, The University of Sydney (Correspondence author – email: g.dean@econ.usyd.edu.au

Frank Clarke ,Emeritus Professor of Accounting, Central Coast School of eBusiness and Management, University of Newcastle – email:cmflc@cc.newcastle.edu.au

Peter Wolnizer, Professor of Accounting and Dean, Faculty of Economics and Business, The University of Sydney – email: p.wolnizer@econ.usyd.edu.au

Submission by Professor Graeme Dean, The University of Sydney, Emeritus Professor Frank Clarke, University of Newcastle and Professor Peter Wolnizer, University of Sydney,

23 May, 2002.

Terms of Reference Joint Committee of Public Accounts and Audit, "Review of Independent Auditing by Registered Company Auditors

"With the spate of recent noteworthy corporate collapses both within Australia and overseas, the Joint Committee of Public Accounts and Audit wishes to explore the extent to which it may be necessary to enhance the accountability of public and private sector auditing.

In particular, The Committee is keen to determine where the balance lies between the need for external controls through government regulation and the freedom for industry to self-regulate."

Executive Summary of submission, “Auditor Independence Reforms – Recycled Ideas” by Professor Graeme Dean, The University of Sydney, Emeritus Professor Frank Clarke, University of Newcastle and Professor Peter Wolnizer, The University of Sydney.

Comments are restricted to private sector auditing.
It is critical that the accountability of private sector auditing be enhanced by considering the critical nexus between accounting and auditing.
Auditors currently are on ‘mission impossible’ as the extant accounting system produces data that cannot be verified or corroborated by any external referents.
Whilst there is a need to address the provision of non-audit services, our concern is that overemphasising this aspect confines the independence debate to the ethical dimensions of the auditor-client relationship. It has deflected the debate from the real issue, namely that auditor independence entails consideration of ‘independence of mind’.
The current proposals to enhance private sector auditing accountability are déjà vu – the calls for mandatory auditor rotation and mandatory audit committees, splitting the provision of audit and non-audit services are examples of recycling ideas, not resolving problems. They will not address the fundamental problem, namely the inherent deficiency in the data being audited.
With a Standards-based regime auditors are unable to act as “professionals” – rather than applying their expertise, accumulated wisdom and judgement to particulars - they must comply with what the Accounting Standards dictate.
Companies that have collapsed unexpectedly have done so with their financial statements prepared, primarily in accord with the prescribed accounting rules, conventions and standards of their time. They have failed to provide reliable indications of the drift in their wealth and financial progress.
We feel strongly (as does apparently KPMG and several commentators, like Sir Bryan Carsberg, foundation member of the IASB) that the ‘true and fair view’ dictum should regain its primary override status.
In the absence of a full mark-to-market accounting that has external commercial referents, auditors shall continue to be at the behest of their clients’ financial calculations – a situation in which ‘independence of mind’ can neither exist nor be shown to exist. There is little likelihood that the recycled ideas being proposed will mitigate unexpected corporate collapses and their associated fallout.

AUDITOR INDEPENDENCE REFORMS—RECYCLED IDEAS

Recent financial imbroglios at Enron in the U.S. and HIH in Australia have involved the same major auditing firm and resulted in much talk of a need for immediate reforms. These déjà vu *proposals include: a desire for better (higher* quality*, in the new-millennial jargon) information for investors, making executives more accountable, and developing stronger more accountable auditing systems (see Chambers, 1973 and Clarke,* et al. *1997). To this end currently there are specific calls to prohibit joint provision of audit and non-audit services, to mandate audit committees and auditor rotations.*

The tenor of those demands mimics the rhetoric surrounding like sagas in previous decades. These include in the U.S.: the Penn Central and Equity Funding affairs of the 1970s and the S&L fiascos in the 1980s and '90s; the unexpected collapses of Minsec and Cambridge Credit Corporation in Australia in the 1970s, of Bond Corporation and Adsteam – for example in the 1990s, and of One.Tel and Ansett in the new millennium; and in the U.K. collapses of Pergamon in the 1970s, the Maxwell Corporation and BCCI debacles of the 1990s. On each occasion accounting and auditing practices have been criticized. Reform has been demanded and promised, only to lapse once the outrage has been aired.

Unease and calls for reform invariably have followed large unexpected failures not long after the reporting of their financial results with clean audit reports attached. Recent revelations related to HIH and Enron have again led many to question the usefulness of audited accounting data as a sound basis for financial assessments and evaluations by investors, regulators and other interested parties. The particulars of the collapses and perceived accountability deficiencies have caused some to argue that there has been a loss of confidence in the securities market being a 'fair game'. Others have observed that accounting and auditing is in a 'state of crisis' (Volker, 2001 as cited in Dean, 2002). The reprises are certainly familiar.

The myriad déjà vu *responses to the current (almost identical) claims against the profession, and the concomitant similar regulatory and professional reform proposals being canvassed, are essentially cosmetic. They are likely to have minimal effect in preventing the types of large unexpected collapses and associated wealth redistributions that were the catalysts for the demand for reform.*

The size and continuity of the unease expressed in the financial press and from witnesses called before the numerous inquiries in the U.S. and Australia following the Enron and HIH collapses confirm that auditors are definitely under scrutiny. The US Grand Jury indictment of Andersen, LLP on 'Obstruction of justice' charges confirms that.

Where auditors are found to be dishonest, allow inducements to compromise their work, or are dilatory or incompetent, they deserve to be punished. For their default is a matter of not being professional. Yet, incongruously, auditors can be as honest as possible, have impeccable integrity, be competent, intrepid to the hilt, but if they follow the conventional accounting rules in framing their judgement, they almost certainly will be signing off on what mostly is financial nonsense! The lynchpin of auditing has (for the most part) been left out of the discussion to date—for the necessity that accounting data are serviceable *in the uses ordinarily made of them lies at the core of the audit function. As it is, auditors are on 'a mission impossible' (Clarke* et al.*, 1997), arguably more victims than villains*. Letters in the Australian press, numerous editorials about HIH and Enron, articles like Brown's 'The Rough Side of Smoothing' (*Australian Financial Review* [*AFR*], 7 February 2002), Kohler's 'Horrible Numbers' (*AFR*, 4 February 2002) and the numerous expressions of unease over U.S. companies' use of pro forma earnings statements to allegedly mislead (see references in Dean, 2002) have highlighted concerns about auditing and accounting. 'Taking Stock of Auditors' (Editorial, *AFR*, 29 January 2002) is a reasonable call, as is Ferguson's search for 'The Culprits in Corporate Collapses' (*Business Review Week*, 12 December 2001). More apt is Jaworski's claim that 'Accounting Is the Critical Issue', (*AFR*, Letters, 8 February 2002).

'Audit failure' is currently depicted as primarily a matter of a lack of auditor independence. This is contestable. In Australia the Ramsay Report on 'auditor independence',[1] like its predecessors commenting on the quality of audits and the public's expectations of them, confines the independence debate to the ethical dimensions of the auditor–client relationship. The proposed reforms ignore the constraints imposed by accounting rules upon the auditor's ability to form an 'independent opinion' on financial statements? Thus, they have little likelihood of being successful.

While the auditing independence debate resurfaced in Australia soon after the HIH, One.Tel and Ansett collapses, unwarranted parallels have been drawn between them and the Enron saga in the US. Of course, insofar as HIH is concerned, the Andersen firm is a common element. So is the appointment of past Andersen auditors of Enron to its board and the apparent provision of non-audit services (NASs) by Andersen to their audit clients HIH and Enron. Nonetheless, it is sobering to note that there does not appear to be any statistical relationship between the provision of NASs and the form audit reports take, and we are unaware of any compelling anecdotal evidence of cases where those dual activities have been *shown* to have compromised the independence of the auditors. The Enron case is curious in this respect: US$27 million in NASs has been rated against US$25 million in audit fees. Perhaps it might be that the amount of the audit fees compromises the quality of non-audit advice provided. It is argued in the U.S. that the NAS income is 'more valuable' than the audit fee because it has a greater potential to increase. Be that as it may, a US$25 million audit fee is no small matter. With that at stake, the existence of NASs would seem insufficient reason to cry a lack of independence—the audit fee itself is enough to have pinched Andersen were it to have been lost.

More to the point is the matter of professionalism—whether an auditor within the current accounting/audit structure can have an 'independent frame of mind' in forming an opinion regarding the 'truth and fairness' of the financial statements, on whether those statements are truly indicative of the financial performance and financial position of the company. Here, auditors are faced with a no-win situation. They are required to form their opinion regarding whether the Statement of Performance and the Statement of Financial Position are 'true and fair' indicators of the company's financial performance over the stipulated period and its financial position at the stipulated date. Yet, this is to be conditioned by (a default) recourse to (so the pervading belief seems to be) whether the

[1] A. Ramsay, *Report into Auditor Independence*, AGPS, November 2001.

company has complied with the Accounting Standards, Australia's GAAP. Yet, a company's compliance with the standards virtually ensures that the income statement will not show its actual financial performance or the balance sheets its actual financial position in any meaningful, serviceable, way.

HIH's published financials at 30 June 2000 brought to account nearly one billion dollars of Future Income Tax Benefits, Goodwill and various capitalized expenses, all in accord with the prevailing standards. Those balances are of highly contestable relevance to any assessment of the company's solvency at the time or of its overall financial position. That scenario is not unique to HIH. It has been the story in respect of so many of the other companies that have collapsed unexpectedly—their financial statements, though primarily in accord with the prescribed accounting rules, conventions and standards of their time, have failed to provide reliable indications of the drift in their wealth and financial progress. Nor is it unique to companies that have failed. It is endemic of the form and content of the published financial statements of all companies complying with the approved, compulsory Accounting Standards.

On numerous occasions we have drawn attention to how the artefacts of conventional accounting prevent financial statements from disclosing dated commercial realities while making auditors substantially dependent upon the preparers of accounts for the dubious financial information reported in them (Clarke *et al*., 1997; Wolnizer, 1995). For example, it is worth asking what is the financial significance of accounting artefacts such as tax effect balances?, the tax effect calculation of income tax expense charged against revenues to quantify financial performance?, the capitalisation of expenses?, booking a variety of intangibles and goodwill as assets?, not 'marking–to-market' physical assets?, amortizing historical costs?, applying the 'accrual principle' on a temporal basis?, recognizing only 'realized gains', but both realised and unrealised losses?, preparing consolidated financial statements?, and the like?

Since the UK Companies Act of 1844, company directors have been charged with the responsibility to *prepare* financial reports. Auditors have been charged with the duty to *authenticate* the contents of them. The perception that company directors and officers, more familiar with company affairs than auditors could possibly be, might influence the opinions formed by auditors provoked the notion that auditors should be free of non-trivial commercial dealings with clients and their officers and free of family ties with those officers. The recommendations of the Australian Federal government-initiated Ramsay Report into auditor independence thus draw upon long-standing thought. Those freedoms were to be the guarantors of the reliability of the financial accounts—the substance of what is now implied by the notion of audit independence.

With the exception of cash, receivables and payables, the idea of authenticating the contents of periodical accounts by recourse to independent evidence has been submerged. External evidence has been replaced by professional prescription. The manner in which financial statements are to be prepared has been dictated by the Standards, without considering whether the data are generally serviceable for the purposes made of them—determining the wealth and progress of the companies to which they relate and deriving indicators of their salient financial characteristics.

That the compulsory accounting infelicities noted above exist equally in the accounts in those companies that have not collapsed undermines the objective of corporate regulation. The evidence is that compliance with the accounting standards is a pervading cause of misleading, *creative*, accounting data (see evidence in Clarke, *et al*., 1997). On that count, the financials of most of the companies that have not failed are frequently as unreliable as those that have. Auditors are caught in the accounting 'GAAP trap'. They are denied the opportunity to exercise an independent 'mental attitude' when forming an opinion that is 'independent' of those who prepare financial statements. Apart from cash, cash-like items and those few assets that are required to be marked to market, auditors do not have recourse to commercial evidence outside of the reporting entity when forming an opinion on the accounts. In a most important respect, by no fault of their making, auditors are 'dependent'. This is not because of malpractice on their part, but by virtue of the demonstrably defective (in terms of serviceability) accounting and reporting system in which auditing functions.

Ramsay's Auditing Independence Supervisory Board and mandatory audit committee and auditor rotation recommendations (and similar reform proposals being mooted internationally by IFAC and in the U.S. in response to the Enron collapse), address the 'independent status' of auditors rather than their 'independence of mind'. Unlike the law where the independence of judicial opinion is buttressed by the laws of evidence, the independence of auditors' judgments has no corresponding safeguard. Unless and until auditors are required to obtain commercial evidence of financial facts outside the reporting entity the independence debate is likely to continue to rage without satisfactory resolution, as has been the case for several decades.

In the absence of full mark-to-market accounting that has external commercial referents, auditors shall continue to be at the behest of their clients' financial calculations—a situation in which 'independence of mind' can neither exist nor be shown to exist. There is little likelihood that the recycled ideas being proposed will mitigate unexpected corporate collapses and their associated fallout.

Reliable financial statements are the very objects of the audit independence concept. Yet, compulsory compliance with the present crop of accounting standards presents as the greatest inhibition to auditors achieving *independence*. That constraint ensures that 'surprise' continues to be a prevailing characteristic of corporate failures, and that auditors attract the flak.

REFERENCES

Brown, K., 'The Rough Side of Smoothing', *Australian Financial Review*, 7 February 2002.

Chambers, R.J., *Securities and Obscurities: The need to reform the law of company accounts*, Cheshire, 1973

Clarke, F. L., G. W. Dean and K. G. Oliver, *Corporate Collapse: Regulatory, Accounting and Ethical Failure*, Cambridge University Press, 1997.

Dean, G. W., Editorial, *Abacus*, February 2002.

Editorial, 'Taking Stock of Auditors', *Australian Financial Review*, 29 January 2002.

Ferguson, A., 'The Culprit in Corporate Collapses', *Business Review Week*, 12 December, 2001.

Kohler, A., 'Horrible Numbers' A*ustralian Financial Review*, 4 February 2002.

D. Potts, 'Hey presto! The magical world of creative accounting, *The Sun-Herald*, 24 February, pp.6-7

Jaworski, C., ‘Accounting Is the Critical Issue’, *Australian Financial Review*, Letters, 8 February, 2002.

Ramsay, A., *Report into Auditor Independence*, AGPS, November 2001.

Wolnizer, P. W., ‘Are Audit Committees Red Herrings?’, *Abacus*, March 1995.