# SOME CONTEMPORARY ISSUES AFFECTING THE SOUTH AFRICAN AUDITOR

BY

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GRAHAMSTOWN

RHODES UNIVERSITY

1979

# SOME CONTEMPORARY ISSUES AFFECTING THE SOUTH AFRICAN AUDITOR

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BOOKS on speech writing and delivery emphasise that one should be aware of one's audience. What facile advice!

Some of you who have been through this form of initiation may remember, as part of your preparation, referring to the inaugural lectures of your colleagues. How nice to be a Professor of Philosophy and dwell on the age old question "Why are we here?" Or a Professor of Divinity enjoying a full forty-five minutes instead of his normal twenty minute Sunday allocation.

My lecture will focus on the auditor. I shall start by dealing with financial statements and by defining the audit function, before selecting some issues which are affecting the South African auditor and other issues which may affect him in the future. In presenting a wide subject, I must move rapidly over some matters which could be discussed at length.

Firstly then, financial statements.

My main concern tonight is with the financial statements of companies, prepared annually for the information of shareholders and other interested parties. They disclose the financial position at a point in time and the results of operations up to that point for a defined period, usually a year. They contain, as a minimum, in addition to the statements of financial position and results, a report of the directors of the company and the reported opinion of an independent auditor. They are supplemented by extensive notes, explaining various items in the main statements, as required by law or in conformity with good accounting practice. Many contain diagrams and statistics, such as a comparative review of key financial figures from statements of a number of prior years.

The improved disclosure in South African company financial statements over recent years results partly from the more stringent requirements of the Companies Act, 1973, partly from the work of The Accounting Practices Board (APB) and the National Council of Chartered Accountants (SA) (NATCO) and in some cases from the competitive pride of those responsible for their preparation. They are sometimes so beautifully presented that the story they tell disappoints as much as the theme of an imaginatively illustrated paperback book.

They are based on certain fundamental accounting concepts, such as the 'going concern' concept that the entity will continue in operational existence for the foreseeable future; the 'matching' concept, where gains and losses are matched in the period to which they relate, and not as money is received and paid; the concept of 'consistency' within a financial period and in relation to past financial periods, and the concept of 'prudence' where profits are not recorded prematurely and known losses are recorded immediately.

There is wide belief that the accuracy and exactness of all amounts in the financial statements are guaranteed. This is not so. Even in the simplest financial statements there are significant areas where the accountant must exercise judgement and make estimates, such as

- the life of a wasting asset,
- the value of certain sections of stock in trade which are not realizable at or above cost, and
- the likelihood of recovering certain of the debts owed to the company by persons whose financial postition proves to be less sound than at the time the debts were incurred.

These simpler causes of uncertainty in the measurement of financial position and the results of operations have been chosen deliberately to make my point that financial statements cannot be completely free from uncertainty. If we were given the whole life of an undertaking to measure, we would have far less difficulty. It is the division of that life into artificial financial periods that is the cause of most of our measurement problems.

This brings us to the second part of my lecture, namely, the audit function.

In view of the areas of uncertainty in accounting measurement, there is the need for an independent review of the financial statements and the underlying records and systems. The opinion of the independent auditor is communicated to the shareholders as part of the financial statements. In a statement issued in February 1976, NATCO recorded that "the primary objective of the ordinary examination of financial statements by the auditor is the expression of an opinion on the fairness with which they present the financial position at a given date and the results of operations for the period ended on that date of the undertaking to which they relate."[1]

In dealing with financial statements, I mentioned the common misconception of complete accuracy and exactness. The audit function is also widely misunderstood.

Despite pressure for him to assume these responsibilities, it is not the function of an auditor to seek out fraud or defalcations or all weaknesses in every system of internal control. Nevertheless, by the very nature of the work he carries out in performing his primary function in relation to the financial statements, disclosure of such irregularities often results. He is naturally aware that the existence of material error through carelessness, neglect or fraud would affect his opinion on the financial statements, and he should plan his work accordingly.

The existence of an unqualified opinion in an audit report does not guarantee that the financial statements are error free, that fraud is non-existent and that the system of internal control is completely sound. Such audit report should, however, imply the elimination or detection of material error and substantial fraud, and the identification of significant weaknesses in any system of control upon which the auditor has relied in forming his opinion.

In addition to the above misconception, the audit function is commonly confused with the other professional functions of practising accountants. Even persons who obtain no more than periodic tax advice refer to their consultants as "my auditors". It is bad enough when the general public fails to recognise the distinction between the audit function and other professional functions but, when the professional accountant fails to draw this distinction, he is in danger of not recognising conflicts of interest and situations which impair his independence.

The public also fails to distinguish between the responsibilities of management and the auditor in two important areas.

Firstly, financial statements are the responsibility of management.[2] The statements are first and foremost the representations of management, upon which the auditor expresses his opinion, based on the limited knowledge he acquires through his examination. Management is in the best position, from its detailed knowledge of the day to day transactions, to ensure the production of proper financial statements from an adequately controlled accounting system.

The American Institute of Certified Public Accountants (AICPA) Special Advisory Committee has recommended that all financial statements include management reports acknowledging management's responsibility as outlined above.[3] It is estimated that about a quarter of American public companies responded to this recommendation in their 1978 financial statements. In the majority of these reports, after acknowledging responsibility for the financial information presented, management commented on the company's internal accounting control, discussed the role of the independent auditors and outlined the responsibilities of the audit committee (of which I shall say more later), the code of conduct of the company and the work of the internal auditors. The enactment of the United States Foreign Corrupt Practices Act, 1977 and an April 1979 ruling of the Securities Exchange Commission (SEC) have reinforced the internal control aspect of the management report.[4] The SEC will also require auditors of companies under its jurisdiction to report on internal accounting controls.

But I am jumping ahead and must repeat that the financial statements are the representations of management upon which the auditor expresses his opinion. This is the first of the two areas where the public fails to distinguish between the responsibilities of management and the auditor.

The second area is the establishment and maintenance of adequate systems to minimise the possibility of error and fraud. This again is the responsibility of management. The existence of the systems contributes to the auditor's confidence when reporting his opinion but, nevertheless, he must be on guard against the possibility of deliberate misrepresentations by management itself. In the United States (US) the SEC has issued rules making it illegal for any persons directly or indirectly to falsify company books and records and for any officer or director to make a materially false, misleading or incomplete statement to an auditor about an audit of the financial statements. In Britain, the Companies Act of 1976 makes it a criminal offence to mislead the auditors. The South African Companies Act, 1973 makes no such provision. It does make it an offence for any person to make a materially false statement or to falsify a company's books or records,[5] but no specific mention is made of misleading the auditor. In fact the auditor is listed amongst the potential offenders if he is associated with a written statement or report which is "false in any material particular".[6]

Having discussed financial statements and described the audit function as simply as possible, I shall now move on to a selection of issues affecting the South African auditor and touch on some which may affect him in the future. The following is by no means a comprehensive coverage of all the possible issues. It would be very foolish, however, to overlook the question of the setting of standards in auditing and in accounting.

Firstly let us look at auditing standards.

The Americans have for years been defining and re-defining auditing standards. In South Africa, NATCO, through its Auditing Standards Committee is in the process of replacing the statements which were issued from 1964 to 1974 with definitive Statements of Auditing Standards Generally Accepted by the Profession in South Africa. Before being published in their final form, drafts of these statements are exposed amongst regional associations, universities and other interested persons. In formulating these statements the Committee has studied the statements and research reports of other accounting bodies abroad. They cover a wide range of auditing standards and procedures and most auditing students will know that the standards include such matters as

- the adequacy of training of persons supervising the audit examination,
- the independent mental attitude of the auditor, and
- the professional care to be exercised in both the audit examination and in the formulation of the audit report.

All seven of the statements published to date amplify these general standards. In the process, auditors are reminded that they are not only subject to the discipline of their professional body but that the Public Accountants' and Auditors' Board (PAAB), a statutory body, has the right to enquire into their conduct.[7] It would be naive to suggest that the mere existence of the statements will guarantee the standard of all auditing assignments, but it is clear evidence of the determination of the profession as a whole to regulate its members.

In his Presidential message to the Institute of Chartered Accountants in Australia, John Bishop said, "The accounting profession internationally has been the target of considerable criticism in recent years. Much of that criticism is ill-informed and unfair, but, regrettably, some of it is valid and indicative of the need for improved performance on our part as well as a better understanding of our role, both in technical and in social terms, by others." Auditors must improve and they must be better understood.

I hope that my lecture this evening will contribute to a better understanding of the auditor's role.

To improve performance, on the other hand, the AICPA introduced a voluntary system of peer reviews in 1971, whereby one firm of Accountants is examined by another firm of Accountants to ensure that they comply with generally accepted auditing standards. In 1973 the SEC introduced mandatory peer reviews. In the first instance, they enforced the review of a large public accounting firm and later the review of numerous accounting firms. As a result of several corporate disasters in America, some members of Congress have pressed for the establishment of a Government agency to monitor the activities of the accounting profession.

The AICPA has responded positively to the various pressures by forming two peer review sections, one for firms with clients registered with the SEC and another for those firms with private company practices. Each section requires its members to submit to peer review every three years, with the reports of the review Committees being made public. Some describe these actions as 'post-Watergate hysteria' and, in the United Kingdom, despite international connections, the establishment of parallel review mechanism appears unlikely at present. Instead, many firms are reviewing their own systems of quality control, not only by examining their auditing procedures, but also by re-assessing their staff recruitment and training programmes and re-considering the arrangements they make when accepting clients.

It would be wrong to leave this part of my lecture without mentioning another common misconception. When a company fails, the public often asks, "What were the auditors doing?" A company on the brink of failure can receive an unqualified audit report provided the financial statements fairly present the troubled state of its finances. An audit report is not a clean bill of financial health nor a guarantee of a good investment. It is only where the financial statements contain material mis-statement, or where the going concern assumption should not have been made, and non-compliance with generally accepted auditing standards can be shown, that there are grounds for attaching blame to the auditors. Nevertheless, the aggrieved investor or creditor can hardly be blamed for noticing that the auditors of the insolvent company are the only source from which he can hope to recover his losses. The adverse publicity of legal action, whether successful or not, can best be countered by the profession's clear demonstration of the effectiveness of its self-regulation. It may well be that the profession in South Africa will, in due course, be forced to follow the American system of peer reviews, particularly in respect of those firms who audit the South African subsidiaries of American companies.

The extent of the problem and the strength with which it can be faced by the accounting profession must not be underestimated. Reference is often made to the 'Big Eight' international accounting firms. Just how big these firms are has recently been shown by the disclosure that the total revenues world wide of the two biggest firms for 1978 were five hundred and ninety-five million dollars and five hundred and eighty-six million dollars respectively.[8]

In my interview for the Chair I was asked if I agreed with the description of Accountants as "just a bunch of bean counters". Those firms must have counted a lot of beans!

Let us now move from the setting of standards in auditing to those in accounting.

The expression "generally accepted accounting practice" is not a new one. It has recently received far more attention in South Africa as a result of the work of The Company Law Committee of NATCO who requested its inclusion in those sections of the Companies Act, 1973 dealing with the preparation of annual financial statements, which must now be fair presentations "in conformity with generally accepted accounting practice".[9] Coupled with the successful representations of The Company Law Committee was the formation of the APB, whose function it is to consider the statements drafted by NATCO and to circulate these widely for comment. I will show you a transparency listing the bodies represented on the APB,[10] because I want to emphasise how much importance the accounting profession in South Africa attaches to the statements being "generally accepted" by a wide range of interested users of financial statements and not merely by the profession itself. With this wide support and linked as they are to the requirements of the Companies Act, 1973, the South African Statements of Generally Accepted Accounting Practice are authoritative. The company which ignores their requirements must expect its auditors to qualify their audit opinion unless it can be shown that, in the particular circumstances of that company, the selected accounting treatment results in fairer presentation in the financial statements.

South Africa is not alone in this field. Many other countries' accounting bodies are actively engaged in developing accounting standards and so is the International Accounting Standards Committee (IASC).

The multi-national nature of many of the large companies whose financial statements are published and the international structure of many of the large accounting practices are bringing to bear on South Africa the influence of the countries from which they originate.

I have shown the pressures of the SEC and Congress, to name only two, on the American profession. In addition, we have a situation in Europe where the European Economic Community (EEC) is issuing directives which will affect the accountancy profession in the United Kingdom. It will take time for member nations to debate the directives but, once finalised, they will be binding and Britain will have to introduce legislation complying with them; not only legislation dealing with the form and content of financial statements, but also legislation regulating auditing. As was stated in the Leader to the February 1979 issue of Accountancy,[11] "the mills of Brussels grind exceeding slow. But once in motion they grind relentlessly". It is inevitable that the effects of the EEC directives on British accounting and auditing will be felt by the international community and will make their impact on the published financial statements in this country and on the auditors of those statements.

As if this were not enough, we have the Secretary General of the United Nations endorsing the recommendations of a "Group of Experts on International Standards of Accounting and Reporting"[12] which will mainly affect the reporting of multi-national companies. After concern was expressed in the United Nations Economic and Social Council with the impact of multi-national companies on the economic development and international relations of their host countries, an initial survey encountered difficulty in obtaining usable, comparable information and the Group of Experts was formed. The Secretary General was not satisfied with voluntary action on the part of multi-national companies but is seeking to obtain international agreement amongst Governments to make the necessary legislative changes to enforce international uniformity.

I believe that there is a far greater chance of achieving international accounting harmony through the various national accounting bodies and through the work of the IASC than through the medium of political organisations. In fact, I would go so far as to say that sound accounting practice can only be established in a forum in which political pressures have been minimised.

Having said that, I am not underestimating the difficulties in achieving international harmony. Not only are there social and cultural differences which are reflected in the different business communities but there is also a serious lack of expertise in interpreting and applying the agreed accounting standards in many parts of the world. I am not optimistic about the chances of success of effective international agreement, but this does not mean that South Africa cannot achieve harmony with the mainstream of international thought and practice.

Accounting is an evolving art. Some of the signs of evolution are as follows:-

1. Inflation accounting

   The debate on how best to record the effect of inflation in financial statements has been long and tedious. Various courses of action are advocated around the world. In South Africa, NATCO has limited its detailed recommendations, which are not mandatory, to the disclosure of the effect of inflation on financial results. Those who heed the recommendations will prepare a supplementary current cost income statement. NATCO has also suggested "experimentation and development in the area of a current cost balance sheet and related statements".[13] The South African auditor is expected to report on the supplementary current cost statement and will have to carry out sufficient work to enable him to do so. We have one foot on the bottom rung of the ladder!

But what about the proprietor of the small business who neither understands nor values such additional information and who will certainly not take kindly to paying a conscientious practitioner who wishes to follow his professional body's guidance? Such guidance, I might add, applies "equally to reporting on the financial statements of unincorporated business enterprises".[14]

It is not only in connection with inflation accounting that this conflict between professional pressure and economic necessity can be observed and the profession, as a whole, will have to face up to the differing needs of the large and the small undertaking. This leads naturally to the second sign of evolution.

2. The abolition of small company audits

There are those who believe that the price of limited liability is an annual audit fee. This is one of the more frequent responses to those who advocate the alteration of the Companies Act to remove the audit requirements for small companies, where the directors and shareholders are one and the same or where an outside shareholder has agreed in writing to dispense with the annual audit. This is not a new thought but, in Britain, considerable attention was given to the matter during 1978. The problem is becoming acute with the publication of auditing standards, some of which, it is argued, can only be applied to the larger company with adequate systems of internal control and not to the small family business where, as one author put it, "Dad runs the business and Mum keeps the books".[15] In addition to abolishing the audit of small companies, it is suggested that they should be relieved of some of the disclosure requirements of both the legislation and the Statements of Generally Accepted Accounting Practice. Lest I be misunderstood, let me emphasis that I said "some of the disclosure requirements", not "all" the requirements.

Protaganists of the status quo argue that small company audits are of use to persons other than the shareholders e.g. banks, the Receiver of Revenue, and that the loss of the small company audit would be crippling to the small practitioner. Proponents of change argue that the small company will still wish to have its financial statements examined by a practitioner, will look to him for additional assistance and advice in other areas and that he will be as busy as ever. This was certainly my experience when practising in a country where the shareholders of a private company could resolve to dispense with the annual audit. Those who are interested in the debate will enjoy Alex Harrison's article "What price freedom" in The Accountant of 2 February 1978.

I believe that, if the future development of accounting and auditing in South Africa is coupled with attempted disciplinary action by NATCO or PAAB, the abolition of the small company audit will again be proposed and pressure will be put on the APB to limit the application of certain accounting standards to public companies, as they have done already in connection with the disclosure of earnings per share.[16]

3. The formation of audit committees of the Board of Directors

The third trend I detect is the formation of audit committees of the Board of Directors. Although the Board of Directors relies on management to carry out the detailed work on financial statements, to implement internal control and to deal with the auditor's routine enquiries, the ultimate responsibility in these areas is theirs. In the United States, audit committees of the Board of Directors have existed in some companies for more than 40 years. In the 1970's, one-third of American public companies had audit committees and, since July 1978, all companies listed on the New York Stock Exchange have been required to have not only audit committees, but the composition of those committees has had to comprise directors independent of management, the so-called non-executive director. The availability of sufficient numbers of truly independent non-executive directors who have the necessary qualities, as well as the time to do a proper job, has been cited as the major obstacle to forming such committees in countries outside the United States. The Governor of the Bank of England has expressed support for the formation of audit committees but the present pre-occupation in Britain appears to be with the appointment of sufficient non-executive directors to the boards of large public companies. In Australia a survey indicates that about one in four large public companies have audit committees, the majority of which are composed either entirely of external directors or of external directors with a minority of executive directors. These committees improve communication between the external auditor and the full board. They also enhance the board's awareness of management's performance, the work of the internal auditors and the company's financial and accounting problem areas.

From enquiries I have made, it would appear that few, if any , audit committees have been formed in South Africa. It seems to me that a survey similar to the Australian survey could be conducted profitably in this country to test my impression, to ascertain the extent of companies' knowledge of the function of audit committees and to feel out the possible reaction to the suggestion that such committees be formed here as a private sector response to the profession's endeavours to improve audit performance.

I note that the American profession is coming under considerable pressure to take the initiative to ensure the formation of audit committees. I believe that they should respond by emphasising that the private sector should be expected to make the first move in response, as I have said, to the profession's endeavours to improve audit performance.

4. Mandatory auditor rotation

The next nudge to auditors may come in the area of mandatory auditor rotation. Although this is not a new suggestion, it gained publicity in the US in 1976 when members of the Corporate Accountability Research Group, which included Ralph Nader, called upon the US Congress to legislate to change public company auditors every five years, and told the Senate Committee on Commerce that this would enable auditors to "check each other's work"![17]

The Metcalf Report on "The Accounting Establishment" to the Senate Sub-Committee on Reports, Accounting and Management in December 1976 also spoke of mandatory auditor rotation.

The Accounting profession argues that auditor rotation is costly and would reduce the quality of audits. The legislators suggest that it may well be in the public's interests to change auditors when the public company is most satisfied with them. The opposite has certainly been the case on several occasions where the company directors have sought to remove the auditors when they were best serving the interests of the shareholders by confronting the directors with the threat of substantial qualification of their opinion.

If the pressures in the US are not resisted successfully by the profession, they will have a ripple effect in South Africa through the multi-national companies.

5. Fraud detection

The final sign of change I wish to discuss, is public pressure to extend the audit function to include the searching for fraud and other irregularities. This pressure results from a number of well publicised instances of major fraud, illegal political contributions and bribes.

The profession in Canada has held a symposium on the detection of fraud and one of the 'Big Eight' has made funds available for academic research in this area by accountants, sociologists and psychologists. The AICPA has yielded to the pressure by issuing two statements of auditing standards[18] which require the auditor "to search for errors or irregularities that would have a material effect on the financial statements".

In describing the main functions of the auditor, I conceded that "the existence of material error through carelessness, neglect or fraud would affect his opinion on the financial statements" and that it followed "that he should plan his work accordingly". I believe that our own existing auditing standards cover this aspect adequately and hope that NATCO will not issue superfluous statements similar to those of the AICPA who have nevertheless had the good sense to warn that errors and irregularities discovered with the vision of hindsight do not necessarily indicate inadequate audit performance.

Conclusion

I have tried to give you an outline of a few of the issues which our auditing students must understand and debate before they can move on to assume the onerous responsibilities of the professional accountant. There are attitudes they must develop. There are skills they must master. There is knowledge they must acquire; and this is not restricted to the field of auditing.

That a university is the appropriate place for such debate, for the development of attitudes, for the mastery of skills and for the aquisition of knowledge, I have no doubt. This presents a tremendous challenge to our teaching staff. I am confident that we can meet the challenge at Rhodes University.

## THE FOLLOWING ABBREVIATIONS HAVE BEEN USED

| | |
|---|---|
| The Accounting Practices Board ............ | APB |
| The National Council of Chartered Accountants (SA) ......................... | NATCO |
| The American Institute of Certified Public Accountants .............. | AICPA |
| The United States of America .............. | US |
| The Securities Exchange Commission ....... | SEC |
| The Public Accountants' and Auditors' Board . | PAAB |
| The International Accounting Standards Committee ..................... | IASC |
| The European Economic Community ........ | EEC |

## REFERENCES


1. Statement of Auditing Standards 3.001 paragraph .04
2. Statement of Auditing Standards 3.001 paragraph .07
3. The Journal of Accountancy, January 1979, page 17
4. Securities Exchange Commission release No 34 - 15772 of 30 April 1979
5. The Companies Act, 1973 (Act No. 61, 1973) Sections 249 - 251
6. Section 251
7. Statement of Auditing Standards 3.001 paragraphs .08 & .09
8. Management Accounting (USA), January 1979, page 5
9. Sections 286(3); 288(2); 300(i)
10. The Association of Chambers of Commerce of South Africa
    The Chamber of Mines of South Africa
    The Public Accountants' and Auditors' Board
    The South African Federated Chamber of Industries
    The Steel and Engineering Industries Federation of South Africa
    The Afrikaans Business Association
    The Institute of Cost and Management Accountants (South Africa Council)
    The Johannesburg Stock Exchange
    The National Council of Chartered Accountants (SA)
    The South African Institute of Chartered Secretaries and Administrators
11. "Accountancy" is the official monthly journal of the Institute of Chartered Accountants in England and Wales
12. The Group was established in 1976.
13. Guideline on Disclosure of Effects of Changing Prices on Financial Results (No 4.003) issued in 1978 by the National Council of Chartered Accountants (SA)
14. The National Council of Chartered Accountants (SA) circular NC 1/79 of April 1979.
15. An article by Jeffery English in the May 1978 issue of Accountancy entitled "Abolish the Mandatory Audit for the Family Company".
16. Statement of Generally Accepted Accounting Practice 1.004 issued in September 1976.
17. U.S. Senate Committee on Commerce "Corporate Rights and Responsibilities Hearing", 94th Congress, 2nd Session, 17 June 1976 page 211
18. AICPA Statements on Auditing Standards Nos 16 and 17 "The Independent Auditor's Responsibility for the Detection of Errors or Irregularities" and "Illegal Acts by Clients" issued in January 1977.

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The American Institute of Certified Public Accountants (AICPA) Special Advisory Committee has recommended that all financial statements include management reports acknowledging management's responsibility as outlined above.[3] It is estimated that about a quarter of American public companies responded to this recommendation in their 1978 financial statements. In the majority of these reports, after acknowledging responsibility for the financial information presented, management commented on the company's internal accounting control, discussed the role of the independent auditors and outlined the responsibilities of the audit committee (of which I shall say more later), the code of conduct of the company and the work of the internal auditors. The enactment of the United States Foreign Corrupt Practices Act, 1977 and an April 1979 ruling of the Securities Exchange Commission (SEC) have reinforced the internal control aspect of the management report.[4] The SEC will also require auditors of companies under its jurisdiction to report on internal accounting controls.

But I am jumping ahead and must repeat that the financial statements are the representations of management upon which the auditor expresses his opinion. This is the first of the two areas where the public fails to distinguish between the responsibilities of management and the auditor.

The second area is the establishment and maintenance of adequate systems to minimise the possibility of error and fraud. This again is the responsibility of management. The existence of the systems contributes to the auditor's confidence when reporting his opinion but, nevertheless, he must be on guard against the possibility of deliberate misrepresentations by management itself. In the United States (US) the SEC has issued rules making it illegal for any persons directly or indirectly to falsify company books and records and for any officer or director to make a materially false, misleading or incomplete statement to an auditor about an audit of the financial statements. In Britain, the Companies Act of 1976 makes it a criminal offence to mislead the auditors. The South African Companies Act, 1973 makes no such provision. It does make it an offence for any person to make a materially false statement or to falsify a company's books or records,[5] but no specific mention is made of misleading the auditor. In fact the auditor is listed amongst the potential offenders if he is associated with a written statement or report which is "false in any material particular".[6]

Having discussed financial statements and described the audit function as simply as possible, I shall now move on to a selection of issues affecting the South African auditor and touch on some which may affect him in the future. The following is by no means a comprehensive coverage of all the possible issues. It would be very foolish, however, to overlook the question of the setting of standards in auditing and in accounting.

Firstly let us look at auditing standards.

The Americans have for years been defining and re-defining auditing standards. In South Africa, NATCO, through its Auditing Standards Committee is in the process of replacing the statements which were issued from 1964 to 1974 with definitive Statements of Auditing Standards Generally Accepted by the Profession in South Africa. Before being published in their final form, drafts of these statements are exposed amongst regional associations, universities and other interested persons. In formulating these statements the Committee has studied the statements and research reports of other accounting bodies abroad. They cover a wide range of auditing standards and procedures and most auditing students will know that the standards include such matters as

- the adequacy of training of persons supervising the audit examination,
- the independent mental attitude of the auditor, and
- the professional care to be exercised in both the audit examination and in the formulation of the audit report.

All seven of the statements published to date amplify these general standards. In the process, auditors are reminded that they are not only subject to the discipline of their professional body but that the Public Accountants' and Auditors' Board (PAAB), a statutory body, has the right to enquire into their conduct.[7] It would be naive to suggest that the mere existence of the statements will guarantee the standard of all auditing assignments, but it is clear evidence of the determination of the profession as a whole to regulate its members.

In his Presidential message to the Institute of Chartered Accountants in Australia, John Bishop said, "The accounting profession internationally has been the target of considerable criticism in recent years. Much of that criticism is ill-informed and unfair, but, regrettably, some of it is valid and indicative of the need for improved performance on our part as well as a better understanding of our role, both in technical and in social terms, by others." Auditors must improve and they must be better understood.

I hope that my lecture this evening will contribute to a better understanding of the auditor's role.

To improve performance, on the other hand, the AICPA introduced a voluntary system of peer reviews in 1971, whereby one firm of Accountants is examined by another firm of Accountants to ensure that they comply with generally accepted auditing standards. In 1973 the SEC introduced mandatory peer reviews. In the first instance, they enforced the review of a large public accounting firm and later the review of numerous accounting firms. As a result of several corporate disasters in America, some members of Congress have pressed for the establishment of a Government agency to monitor the activities of the accounting profession.

The AICPA has responded positively to the various pressures by forming two peer review sections, one for firms with clients registered with the SEC and another for those firms with private company practices. Each section requires its members to submit to peer review every three years, with the reports of the review Committees being made public. Some describe these actions as 'post-Watergate hysteria' and, in the United Kingdom, despite international connections, the establishment of parallel review mechanism appears unlikely at present. Instead, many firms are reviewing their own systems of quality control, not only by examining their auditing procedures, but also by re-assessing their staff recruitment and training programmes and re-considering the arrangements they make when accepting clients.

It would be wrong to leave this part of my lecture without mentioning another common misconception. When a company fails, the public often asks, "What were the auditors doing?" A company on the brink of failure can receive an unqualified audit report provided the financial statements fairly present the troubled state of its finances. An audit report is not a clean bill of financial health nor a guarantee of a good investment. It is only where the financial statements contain material mis-statement, or where the going concern assumption should not have been made, and non-compliance with generally accepted auditing standards can be shown, that there are grounds for attaching blame to the auditors. Nevertheless, the aggrieved investor or creditor can hardly be blamed for noticing that the auditors of the insolvent company are the only source from which he can hope to recover his losses. The adverse publicity of legal action, whether successful or not, can best be countered by the profession's clear demonstration of the effectiveness of its self-regulation. It may well be that the profession in South Africa will, in due course, be forced to follow the American system of peer reviews, particularly in respect of those firms who audit the South African subsidiaries of American companies.

The extent of the problem and the strength with which it can be faced by the accounting profession must not be underestimated. Reference is often made to the 'Big Eight' international accounting firms. Just how big these firms are has recently been shown by the disclosure that the total revenues world wide of the two biggest firms for 1978 were five hundred and ninety-five million dollars and five hundred and eighty-six million dollars respectively.[8]

In my interview for the Chair I was asked if I agreed with the description of Accountants as "just a bunch of bean counters". Those firms must have counted a lot of beans!

Let us now move from the setting of standards in auditing to those in accounting.

The expression "generally accepted accounting practice" is not a new one. It has recently received far more attention in South Africa as a result of the work of The Company Law Committee of NATCO who requested its inclusion in those sections of the Companies Act, 1973 dealing with the preparation of annual financial statements, which must now be fair presentations "in conformity with generally accepted accounting practice".[9] Coupled with the successful representations of The Company Law Committee was the formation of the APB, whose function it is to consider the statements drafted by NATCO and to circulate these widely for comment. I will show you a transparency listing the bodies represented on the APB,[10] because I want to emphasise how much importance the accounting profession in South Africa attaches to the statements being "generally accepted" by a wide range of interested users of financial statements and not merely by the profession itself. With this wide support and linked as they are to the requirements of the Companies Act, 1973, the South African Statements of Generally Accepted Accounting Practice are authoritative. The company which ignores their requirements must expect its auditors to qualify their audit opinion unless it can be shown that, in the particular circumstances of that company, the selected accounting treatment results in fairer presentation in the financial statements.

South Africa is not alone in this field. Many other countries' accounting bodies are actively engaged in developing accounting standards and so is the International Accounting Standards Committee (IASC).

The multi-national nature of many of the large companies whose financial statements are published and the international structure of many of the large accounting practices are bringing to bear on South Africa the influence of the countries from which they originate.

I have shown the pressures of the SEC and Congress, to name only two, on the American profession. In addition, we have a situation in Europe where the European Economic Community (EEC) is issuing directives which will affect the accountancy profession in the United Kingdom. It will take time for member nations to debate the directives but, once finalised, they will be binding and Britain will have to introduce legislation complying with them; not only legislation dealing with the form and content of financial statements, but also legislation regulating auditing. As was stated in the Leader to the February 1979 issue of Accountancy,[11] "the mills of Brussels grind exceeding slow. But once in motion they grind relentlessly". It is inevitable that the effects of the EEC directives on British accounting and auditing will be felt by the international community and will make their impact on the published financial statements in this country and on the auditors of those statements.

As if this were not enough, we have the Secretary General of the United Nations endorsing the recommendations of a "Group of Experts on International Standards of Accounting and Reporting"[12] which will mainly affect the reporting of multi-national companies. After concern was expressed in the United Nations Economic and Social Council with the impact of multi-national companies on the economic development and international relations of their host countries, an initial survey encountered difficulty in obtaining usable, comparable information and the Group of Experts was formed. The Secretary General was not satisfied with voluntary action on the part of multi-national companies but is seeking to obtain international agreement amongst Governments to make the necessary legislative changes to enforce international uniformity.

I believe that there is a far greater chance of achieving international accounting harmony through the various national accounting bodies and through the work of the IASC than through the medium of political organisations. In fact, I would go so far as to say that sound accounting practice can only be established in a forum in which political pressures have been minimised.

Having said that, I am not underestimating the difficulties in achieving international harmony. Not only are there social and cultural differences which are reflected in the different business communities but there is also a serious lack of expertise in interpreting and applying the agreed accounting standards in many parts of the world. I am not optimistic about the chances of success of effective international agreement, but this does not mean that South Africa cannot achieve harmony with the mainstream of international thought and practice.

Accounting is an evolving art. Some of the signs of evolution are as follows:-

1. Inflation accounting

The debate on how best to record the effect of inflation in financial statements has been long and tedious. Various courses of action are advocated around the world. In South Africa, NATCO has limited its detailed recommendations, which are not mandatory, to the disclosure of the effect of inflation on financial results. Those who heed the recommendations will prepare a supplementary current cost income statement. NATCO has also suggested "experimentation and development in the area of a current cost balance sheet and related statements".[13] The South African auditor is expected to report on the supplementary current cost statement and will have to carry out sufficient work to enable him to do so. We have one foot on the bottom rung of the ladder!

But what about the proprietor of the small business who neither understands nor values such additional information and who will certainly not take kindly to paying a conscientious practitioner who wishes to follow his professional body's guidance? Such guidance, I might add, applies "equally to reporting on the financial statements of unincorporated business enterprises".[14]

It is not only in connection with inflation accounting that this conflict between professional pressure and economic necessity can be observed and the profession, as a whole, will have to face up to the differing needs of the large and the small undertaking. This leads naturally to the second sign of evolution.

2. The abolition of small company audits

There are those who believe that the price of limited liability is an annual audit fee. This is one of the more frequent responses to those who advocate the alteration of the Companies Act to remove the audit requirements for small companies, where the directors and shareholders are one and the same or where an outside shareholder has agreed in writing to dispense with the annual audit. This is not a new thought but, in Britain, considerable attention was given to the matter during 1978. The problem is becoming acute with the publication of auditing standards, some of which, it is argued, can only be applied to the larger company with adequate systems of internal control and not to the small family business where, as one author put it, "Dad runs the business and Mum keeps the books".[15] In addition to abolishing the audit of small companies, it is suggested that they should be relieved of some of the disclosure requirements of both the legislation and the Statements of Generally Accepted Accounting Practice. Lest I be misunderstood, let me emphasis that I said "some of the disclosure requirements", not "all" the requirements.

Protaganists of the status quo argue that small company audits are of use to persons other than the shareholders e.g. banks, the Receiver of Revenue, and that the loss of the small company audit would be crippling to the small practitioner. Proponents of change argue that the small company will still wish to have its financial statements examined by a practitioner, will look to him for additional assistance and advice in other areas and that he will be as busy as ever. This was certainly my experience when practising in a country where the shareholders of a private company could resolve to dispense with the annual audit. Those who are interested in the debate will enjoy Alex Harrison's article "What price freedom" in The Accountant of 2 February 1978.

I believe that, if the future development of accounting and auditing in South Africa is coupled with attempted disciplinary action by NATCO or PAAB, the abolition of the small company audit will again be proposed and pressure will be put on the APB to limit the application of certain accounting standards to public companies, as they have done already in connection with the disclosure of earnings per share.[16]

3. The formation of audit committees of the Board of Directors

The third trend I detect is the formation of audit committees of the Board of Directors. Although the Board of Directors relies on management to carry out the detailed work on financial statements, to implement internal control and to deal with the auditor's routine enquiries, the ultimate responsibility in these areas is theirs. In the United States, audit committees of the Board of Directors have existed in some companies for more than 40 years. In the 1970's, one-third of American public companies had audit committees and, since July 1978, all companies listed on the New York Stock Exchange have been required to have not only audit committees, but the composition of those committees has had to comprise directors independent of management, the so-called non-executive director. The availability of sufficient numbers of truly independent non-executive directors who have the necessary qualities, as well as the time to do a proper job, has been cited as the major obstacle to forming such committees in countries outside the United States. The Governor of the Bank of England has expressed support for the formation of audit committees but the present pre-occupation in Britain appears to be with the appointment of sufficient non-executive directors to the boards of large public companies. In Australia a survey indicates that about one in four large public companies have audit committees, the majority of which are composed either entirely of external directors or of external directors with a minority of executive directors. These committees improve communication between the external auditor and the full board. They also enhance the board's awareness of management's performance, the work of the internal auditors and the company's financial and accounting problem areas.

From enquiries I have made, it would appear that few, if any , audit committees have been formed in South Africa. It seems to me that a survey similar to the Australian survey could be conducted profitably in this country to test my impression, to ascertain the extent of companies' knowledge of the function of audit committees and to feel out the possible reaction to the suggestion that such committees be formed here as a private sector response to the profession's endeavours to improve audit performance.

I note that the American profession is coming under considerable pressure to take the initiative to ensure the formation of audit committees. I believe that they should respond by emphasising that the private sector should be expected to make the first move in response, as I have said, to the profession's endeavours to improve audit performance.

4. Mandatory auditor rotation

The next nudge to auditors may come in the area of mandatory auditor rotation. Although this is not a new suggestion, it gained publicity in the US in 1976 when members of the Corporate Accountability Research Group, which included Ralph Nader, called upon the US Congress to legislate to change public company auditors every five years, and told the Senate Committee on Commerce that this would enable auditors to "check each other's work"![17]

The Metcalf Report on "The Accounting Establishment" to the Senate Sub-Committee on Reports, Accounting and Management in December 1976 also spoke of mandatory auditor rotation.

The Accounting profession argues that auditor rotation is costly and would reduce the quality of audits. The legislators suggest that it may well be in the public's interests to change auditors when the public company is most satisfied with them. The opposite has certainly been the case on several occasions where the company directors have sought to remove the auditors when they were best serving the interests of the shareholders by confronting the directors with the threat of substantial qualification of their opinion.

If the pressures in the US are not resisted successfully by the profession, they will have a ripple effect in South Africa through the multi-national companies.

5. Fraud detection

The final sign of change I wish to discuss, is public pressure to extend the audit function to include the searching for fraud and other irregularities. This pressure results from a number of well publicised instances of major fraud, illegal political contributions and bribes.

The profession in Canada has held a symposium on the detection of fraud and one of the 'Big Eight' has made funds available for academic research in this area by accountants, sociologists and psychologists. The AICPA has yielded to the pressure by issuing two statements of auditing standards[18] which require the auditor "to search for errors or irregularities that would have a material effect on the financial statements".

In describing the main functions of the auditor, I conceded that "the existence of material error through carelessness, neglect or fraud would affect his opinion on the financial statements" and that it followed "that he should plan his work accordingly". I believe that our own existing auditing standards cover this aspect adequately and hope that NATCO will not issue superfluous statements similar to those of the AICPA who have nevertheless had the good sense to warn that errors and irregularities discovered with the vision of hindsight do not necessarily indicate inadequate audit performance.

Conclusion

I have tried to give you an outline of a few of the issues which our auditing students must understand and debate before they can move on to assume the onerous responsibilities of the professional accountant. There are attitudes they must develop. There are skills they must master. There is knowledge they must acquire; and this is not restricted to the field of auditing.

That a university is the appropriate place for such debate, for the development of attitudes, for the mastery of skills and for the aquisition of knowledge, I have no doubt. This presents a tremendous challenge to our teaching staff. I am confident that we can meet the challenge at Rhodes University.

## THE FOLLOWING ABBREVIATIONS HAVE BEEN USED

| | |
|---|---|
| The Accounting Practices Board ............ | APB |
| The National Council of Chartered Accountants (SA) ......................... | NATCO |
| The American Institute of Certified Public Accountants .............. | AICPA |
| The United States of America .............. | US |
| The Securities Exchange Commission ....... | SEC |
| The Public Accountants' and Auditors' Board . | PAAB |
| The International Accounting Standards Committee ...................... | IASC |
| The European Economic Community ....... | EEC |

## REFERENCES


1. Statement of Auditing Standards 3.001 paragraph .04
2. Statement of Auditing Standards 3.001 paragraph .07
3. The Journal of Accountancy, January 1979, page 17
4. Securities Exchange Commission release No 34 - 15772 of 30 April 1979
5. The Companies Act, 1973 (Act No. 61, 1973) Sections 249 - 251
6. Section 251
7. Statement of Auditing Standards 3.001 paragraphs .08 & .09
8. Management Accounting (USA), January 1979, page 5
9. Sections 286(3); 288(2); 300(i)
10. The Association of Chambers of Commerce of South Africa
    The Chamber of Mines of South Africa
    The Public Accountants' and Auditors' Board
    The South African Federated Chamber of Industries
    The Steel and Engineering Industries Federation of South Africa
    The Afrikaans Business Association
    The Institute of Cost and Management Accountants (South Africa Council)
    The Johannesburg Stock Exchange
    The National Council of Chartered Accountants (SA)
    The South African Institute of Chartered Secretaries and Administrators
11. "Accountancy" is the official monthly journal of the Institute of Chartered Accountants in England and Wales
12. The Group was established in 1976.
13. Guideline on Disclosure of Effects of Changing Prices on Financial Results (No 4.003) issued in 1978 by the National Council of Chartered Accountants (SA)
14. The National Council of Chartered Accountants (SA) circular NC 1/79 of April 1979.
15. An article by Jeffery English in the May 1978 issue of Accountancy entitled "Abolish the Mandatory Audit for the Family Company".
16. Statement of Generally Accepted Accounting Practice 1.004 issued in September 1976.
17. U.S. Senate Committee on Commerce "Corporate Rights and Responsibilities Hearing", 94th Congress, 2nd Session, 17 June 1976 page 211
18. AICPA Statements on Auditing Standards Nos 16 and 17 "The Independent Auditor's Responsibility for the Detection of Errors or Irregularities" and "Illegal Acts by Clients" issued in January 1977.