

Regulatory responses to auditor independence dilemmas – who takes the stronger line?

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ABSTRACT:

A key part of corporate governance reforms in Australia, as represented by CLERP 9, addresses concerns over the audit function and the role of independent auditors in monitoring managers and providing useful information to stakeholders about the financial position of the company. In comparing the regulatory responses to auditor independence dilemmas, there have been claims that CLERP 9 is less 'stringent' than the reforms imposed by the Sarbanes Oxley Act in the US. This paper looks at three particular situations that have been the subject of recent reform to strengthen independence: the mandatory rotation of auditors, recruitment of former auditors as board members, and provision of non-audit services to clients. In each case, we compare the similarities and differences of the regulatory response between Australia and US, to distil the efficacy of the CLERP 9 approach.

Regulatory responses to auditor independence dilemmas – who takes the stronger line?

1.0 Introduction

Financial statement audits are seen as an integral part of the corporate governance landscape. Although this statement is a ‘given’, it is reflected in the Ramsay report¹ and the ASX Principles of Good Corporate Governance, principle 4: Safeguard integrity in financial reporting, which requires listed companies to

“Have a structure to independently verify and safeguard the integrity of the company's financial reporting.

This requires the company to put in place a structure of review and authorisation designed to ensure the truthful and factual presentation of the company’s financial position. The structure would include, for example:

- review and consideration of the accounts by the audit committee
- a process to ensure the independence and competence of the company’s external auditors.”

As highlighted in the ASX principles, a fundamental tenet of the audit is that is conducted by an external auditor who is competent and independent. However, in performing their professional function, an auditor is clearly subject to countervailing pressures, for example, simply in maintaining their relationship with their current client. The auditor is paid a professional fee for the service, and does not want to be in a position to jeopardise future fees in relation to the audit service or indeed other professional services the audit firm can offer the client.

Formal government inquiries including the US Senate Commerce Committee 2002 and HIH Royal Commission Report 2003 and the Ramsay Report in Australia were a result

¹ Ian Ramsay. *Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform*, Report to the Minister for Financial Services and Regulation, 2001. At paragraph 4.01 “Audited financial statements are an important part of the financial information that is available to the capital markets and an important part of effective corporate governance”.

of investigations into the reasons behind particular corporate collapses in the respective jurisdictions.² Overall, the reports referred to the quality of financial reporting and the effectiveness of corporate governance mechanisms as being unsatisfactory.³ The Sarbanes Oxley Act 2002 in the US (“SarbOx”) and the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 (“CLERP 9) were the respective legislative responses, aimed at ‘rebuilding’ the integrity in audit by emphasising independence.

While both Acts cover several different aspects of the audit function and independence to restore confidence, the main focus of this paper is to examine specific reforms and provide comparative analysis on the approach to independence. Whilst commentators in Australia have made wide ranging comparisons between CLERP 9 and SarbOx,⁴ our approach is to target specific threats to independence and examine the regulatory response.

There is a generally held perception that the CLERP 9 reforms are *less stringent* than the SarbOx reforms in the US.⁵ This has been attributed to the differing impetus – SarbOx is a direct response to economic events, whereas Australia’s reform, whilst in a backdrop of supervening events, was in the context of an ongoing reform agenda under the auspices of the Corporate Law Economic Reform Program.⁶ This reform agenda commenced in Australia in an auditing context as far back as the 1997 report of the Ministerial Council for Corporations on auditor independence and discipline.⁷

² Although the Ramsay Report was commissioned in this context, it is accurate to point out that its terms of reference did not relate to specific events.

³ B.O’Connell, L.Webb & H Schwarzbach, ‘Batten down the hatches! US Accounting Standards and lessons for Australia’ (2005) 15 *Australian Accounting Review* 52.

⁴ Notably but not limited to P.von Nessen, ‘Corporate governance in Australia: Converging with international developments’ (2003) 15 *Australian Journal of Corporate Law* 1; J.Hill, ‘Regulatory Responses to Global Corporate Scandals’ (2005) 23 *Wisconsin International Law Journal* 367.

⁵ Notably media commentary, for example, S Oldfield, ‘ASX warns brokers on independence’ *The Australian Financial Review* 16/6/2004.

⁶ O’Connell, op cit n 3.

⁷ MINCO Working Party of the Ministerial Council for Corporations recommended in its *Report on Review of Requirements for the Registration and Regulation of Company Auditors*, 1997. (Referred to as MINCO) <http://www.treasury.gov.au/documents/294/PDF/compaud.pdf> accessed 17 Jan 2007.

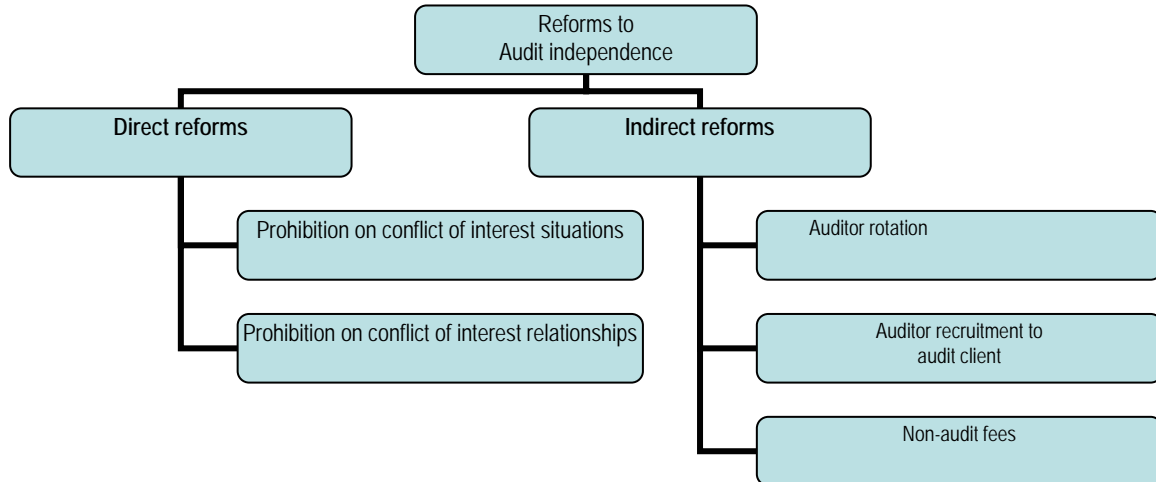
Both jurisdictions however adopt a prescriptive approach to governance, audit responsibility and disclosure. Rather than execute a comparative overview, the purpose of this paper is to assess the relative strengths of the audit independence reforms. One reason this comparison is of interest is that it assists researchers in empirical studies to determine the effectiveness of the reforms. The primary criticism of regulatory impost is the cost; in this context, specifically the effect on audit fees and the market for audit services. There is growing interest in designing studies to measure the costs to audit clients of implementing the reforms, and the cross jurisdictional comparison allows for parity.

Accordingly, the paper defines audit independence and sets the background for the CLERP 9 reforms. Next, in section 3, the paper examines three indirect reforms as examples to compare the regulatory approaches between Australia and the US. In particular, the major criticism of prescriptive rules relates to the costs imposed on market participants. In this section, we also examine some of the empirical literature relating to the cost of audits (audit fees) and speculate upon the CLERP 9 effects. Finally, in section 4, we make some conclusions from our comparison.

The difference between ‘direct’ independence reforms and ‘indirect’ independence reforms are described in Figure 1. The direct reforms, which are not compared in detail in this paper, refers to the prescriptive rules relating to conflict of interest situations and conflicts. Other reforms relating to auditors, are referred to as indirect reforms, and we have selected three rules for comparison:

1. auditor rotation
2. auditor recruitment to the client firm pos audit engagement
3. the extent of the audit firm’s ability to earn non-audit fees.

Figure 1



The indirect reforms are analysed in section 3. before we turn to that analysis, we first discuss the importance and definition of audit independence.

2.0 Auditor independence and the CLERP 9 agenda

2.1 Independence

Independence is generally understood to refer to a mental state of objectivity and lack of bias. Independence ‘requires a freedom from bias, personal interest, prior commitment to an interest, or susceptibility to undue influence or pressure.’⁸ Independence is crucial in the auditing profession. ‘If the audit opinion is to provide the desired degree of assurance, the auditor must be able to form and express an opinion without bias.’⁹ Without it, the auditor’s opinion is not credible and adds little value.¹⁰ It is argued that if an auditor is

⁸ Australian Statement of Auditing Practice AUP 32 Audit Independence para 8.

⁹ M.Bazerman, Morgan K and Loewenstein G, ‘The Impossibility of Auditor Independence’ (1997) *Sloan Management Review* 91.

¹⁰ L.DeAngelo, ‘Auditor Independence, low balling and disclosure regulation’ (1981) 3(2) *Journal of Accounting and Economics* 113.

not independent, the financial statements will be less credible. This would result in an increase of the risk and cost of capital of the firm.¹¹

Audit independence has two facets- actual and perceived independence.¹² Actual independence requires the auditor to exercise scepticism and act with integrity, objectivity. It means that the opinion formed does not compromise professional judgment. To ensure independence is more apparent, APES Code of Ethics for Professional Accountants identifies guidelines for maintaining independence in appearances. In general, it means avoiding facts and circumstances that are so significant where a reasonable person would conclude that the auditor's integrity and objectivity have been compromised.¹³

2.2 Institutional arrangements

It is difficult to capture all the CLERP 9 reforms and attribute them as 'audit independence' reforms, as the legislation operates as a package that has indirect impacts as well. The CLERP 9 'independence' reforms tend to focus on the direct requirements, such as s307C(1) that requires the auditor to make a written declaration that there have been no contraventions of the independence requirements in the Act or the applicable code of conduct (now known as APES110 – see below). The independence requirements of the Act as referred to in s307C(1) relate to Part 2M.4 Div 3 Auditor Independence.

The classification of 'independence' in Div 3 commences with s324CA and relies on equating independence with conflict of interests. Division 3 creates two subsets of conflicts:

¹¹ D.Carmichael, 'In search of concepts of auditor independence' (1999) 69 *The CPA Journal* 40. <http://www.nysscpa.org/cpajournal/1999/0599/features/599p38.html> accessed 18 January 2007.

¹² APES110 Code of Ethics for Professional Accountants AUST290.8 (formerly Professional Statement F1 paragraph 14.)

¹³ Ibid.

- General conflicts – conflict of interest situations
- Specific conflicts – proscribed economic, familial, financial or employment relationships between audit client and audit firm

So for example, in the case of an individual auditor, a contravention of section 324CA (1) in the *Corporations Act* arises if:

- (a) the individual auditor engages in an audit activity in relation to an audited body at a particular time; and
- (b) a **conflict of interest situation** exists in relation to the audited body at that time; and ...
- (c) the individual auditor is aware that the conflict of interest situation existed at that time; and
- (d) the individual auditor did not as soon as possible after becoming aware, take all reasonable steps to ensure that the conflict of interest situation ceases to exist.’

Section 324CD(1) defines a conflict of interest situation as circumstances that exist at the time which impair or might impair, the ability of the auditor, or a professional member of the audit team, to exercise objective and impartial judgment in relation to the conduct of an audit. These terms are very similar to the general statement and pronouncements of the independence as outlined above.

Any contravention dealing with the general requirements for auditor independence could result in criminal offences for individual auditors (s324CA), an audit company and its directors (s324CB) and members of an audit firm (s324CC).

In the second subset of conflicts, the legislature has taken the view that regardless of circumstances, any relationships identified are deemed to conflict of interest situations. Therefore liability will arise if an individual auditor (s324CE), members of the audit firm (s324CF) or the audit company and its directors (s324CG) are aware that a specific relationship has occurred according to Section 324CH. For example, an obvious category of lack of independence occurs where the audit client is an officer of the audited body.

Therefore the position would enable the officer to influence the audited body in connection with its financial reports or the audit.

In the US, audit independence issues have been dealt with by the Securities and Exchange Commission (SEC) rules in 2000. Basically the rules set forth restrictions on financial (Rule 210.2-01(c)(1)) employment (Rule 210.2-01(c)(2)) and business relationships (Rule 210.2-01(c)(3)) between an auditor and an audit client. The SarbOx Act did not include additional provisions in relation to audit independence issues as the rules introduced in 2000 were deemed adequate.¹⁴

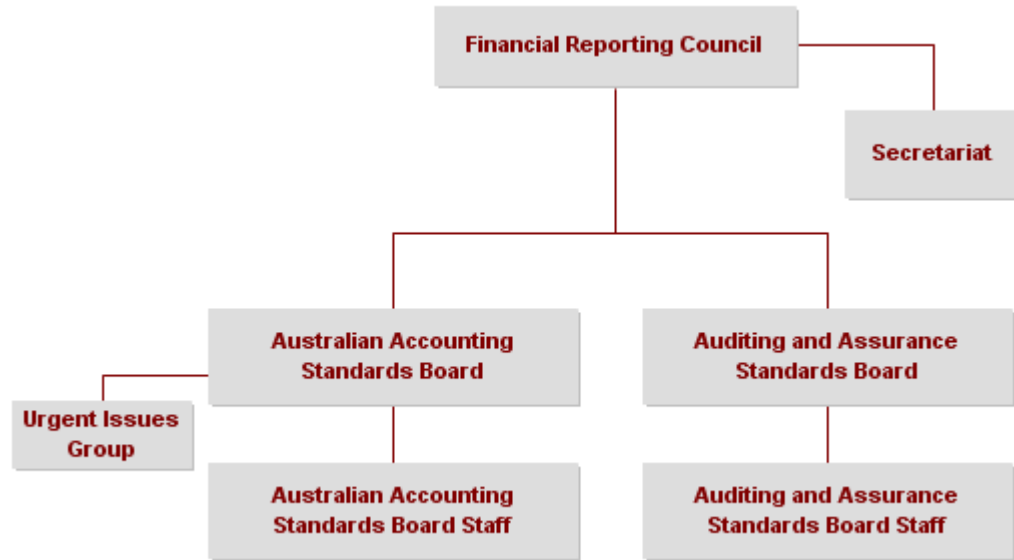
This is the structure of the direct independence reforms. However, CLERP 9 introduced other ‘tangential’ reforms as part of the package, and we turn to these indirect effects below.

CLERP 9 has given auditing standards ‘the force of law’: s 307A. At an even more abstract level, another part of CLERP 9 has been to establish the Financial Reporting Council (FRC) in Australia, that now has oversight over standards (accounting, ethical and auditing) setting in Australia.¹⁵ Sitting beneath the FRC are two separately constituted bodies, the Auditing and Assurance Standards Board (AUASB), and the Australian Accounting Standards Board, as illustrated in Figure 2 below.

¹⁴ Securities and Exchange Commission, Final Rule: Revision of the Commission’s Auditor Independence Requirements <http://www.sec.gov/rules/final/33-7919.htm> accessed 10 November 2006.

¹⁵ www.frc.gov.au accessed 17 January 2007. The FRC is responsible for providing broad oversight of the process for setting accounting and auditing standards as well as monitoring the effectiveness of auditor independence requirements in Australia and giving the Minister reports and advice on these matters.

Figure 2: FRC and institutional structure



Source www.frc.gov.au

Furthermore, during 2006, the accounting and auditing profession voluntarily commenced two initiatives designed to strengthen auditor independence measures. First, the Accounting Professional and Ethical Standards Board¹⁶ was established jointly by the accounting and auditing professional bodies, The Institute of Chartered Accountants Australia (ICAA) and CPA Australia (CPAA) as an independent body. The Board released the former Code of Professional Conduct in the form of a new standard, APES110 Code of Ethics for Professional Accountants. This operates as a mandatory code of ethics and professional standards by which their members are required to abide and similarly, has the force of law.

Second, the major audit firms¹⁷ voluntarily established The Audit Quality Review Board (AQRB) in February 2006 by. It is a not-for-profit company that independently reviews member firms' compliance with applicable professional standards and legal obligations when conducting audits of listed clients.¹⁸

¹⁶ www.apesb.org.au accessed 17 January 2007.

¹⁷ The initial participating firms are PricewaterhouseCoopers, Ernst & Young, KPMG, and Deloittes.

¹⁸ www.aqrb.org.au accessed 17 January 2007..

Rather than proceeding through a ‘shopping list’ of CLERP 9 measures, we can discern some level of expected importance or priority by cross referencing CLERP 9 with these parallel initiatives. Auditors are clearly subject to countervailing pressures and are exposed to potential threats to independence during and even before accepting an audit engagement.¹⁹ Therefore governments have introduced regulations to curb these countervailing pressures.

A useful tool provided in APES110 is the ‘threat matrix’, to assist auditors in recognizing and building safeguards to threats.²⁰

APES 110.100.10 provides:

Compliance with the fundamental principles may potentially be threatened by a broad range of circumstances. Many threats fall into the following categories:

- (a) Self-interest threats, which may occur as a result of the financial or other interests of a Member or of an Immediate or Close Family member;
- (b) Self-review threats, which may occur when a previous judgment needs to be reevaluated by the Member responsible for that judgment;
- (c) Advocacy threats, which may occur when a Member promotes a position or opinion to the point that subsequent objectivity may be compromised;
- (d) Familiarity threats, which may occur when, because of a close relationship, a Member becomes too sympathetic to the interests of others; and
- (e) Intimidation threats, which may occur when a Member may be deterred from acting objectively by threats, actual or perceived.

Rather than tackling head on conflict situations (which we may allocate to the ‘self interest’ threat above), other CLERP 9 reforms are useful in addressing these other threats to auditor independence, based on experiences commonly perceived by practice. Using the threat matrix, CLERP 9 promotes safeguards to the familiarity threat and the self review threat by the following measures:

¹⁹ K.Houghton and Jubb C, ‘An Australian Response to recent developments in the market for audit services’ (2002) 12(2) *Australian Accounting Review* 24.

²⁰ The derivation of the threat matrix is discussed in Ramsay, op cit n 1, chapter 4.

- Auditor rotation – familiarity threat
- Auditor recruitment post engagement – familiarity threat
- Non audit fees – self review threat

Accordingly, these three CLERP 9 measures are the subject of investigation and comparison in this paper.

3.0 Specific independence threats

3.1 Auditor rotation – a response to familiarity threat

Auditors who remain with clients for significant periods may develop inappropriate relationship which may compromise independence. The Ramsay Report recommended a model of appointment of auditors that has a fixed term, referred to auditor rotation. The Ramsay Report reviewed the past work of the Audit Review Working Party²¹ and favoured the proposal to rotate the lead auditor in the team, as opposed to the audit form as a whole. This perceived breach of independence is much more apparent to the lead engagement²² and review auditors.²³ This is because they have the ability to decide the work performed by other members of the engagement team and are responsible for the type of audit opinion issued.

Regulatory response

In response to this long anticipated change, section 324DA *Corporations Act* states that individuals who play a significant role in the audit²⁴ of a listed company for five successive years are ineligible to do so again. There is a waiting period of a further 2 years. Section 324DA is also a strict liability section, which means contravention is a criminal offence.

²¹ MINCO, op cit n 7, recommendation 7.7.

²² Under Section 324AF, a ‘lead auditor’ is the registered company auditor who is primary responsible to the audit firm or audit company that is conducting the audit.

²³ Under Section 324AF, a ‘review auditor’ is the registered company auditor (if any) who is primary responsible to the individual auditor, the audit firm, or audit company for reviewing the conduct of the audit.

²⁴ The term ‘play a significant role’ in the audit is defined in s 9 and essentially means the lead auditor and the review auditor.

Similarly, in the US, s 203 SarbOx Act requires rotation by the lead auditor and reviewing auditor after 5 years. However, there is no explicit 'down time' specified in the s 203 prohibition.

Alternatives

The CLERP 9 report suggests that there was "broad support" among stakeholders for this recommendation.²⁵ Given that it had been suggested since the 1997 working party, then the market has been expecting it.

The Ramsay Report and CLERP 9 have balked at rotating the audit firms, even though this measure would increase the public perception of auditor independence. Those who support the rotation of audit firms also believe that audit quality would increase. This is because audit firms know that their work will be reviewed by another audit firm in the near future. Therefore, they would carry out their audit procedures better more diligently. The arguments in favour of audit firm rotation are canvassed in more detail in Raiborn et al²⁶ as below.

- Decreases the development of 'coziness' between audit firm and client
- Decreases the potential for auditors to succumb to management pressure
- Increases public perception of auditor independence
- Increases the potential for auditors to be more vocal in disagreeing with management
- Potentially increases the supply of audit firms in niche sectors
- Increases the level of competition among audit forms for clients
- Increase audit quality by providing a 'fresh look'.

²⁵ *Corporate Disclosure: Strengthening the financial reporting framework* (2002) Commonwealth of Australia, 83.

²⁶ C.Raiborn, C Schorg, M Massoud, 'Should Auditor Rotation be Mandatory?' (2006) 17(4) *The Journal of Corporate Accounting & Finance* 37 at 40.

The Securities and Exchange Commission has addressed the criticism of the five year period, as it can be seen as potentially arbitrary. Rather than restricting lead and reviewing auditors, is it appropriate to also extend a different rotation period to other personnel in the audit team? Given that the current restriction on lead and review auditors is five years, some have suggested that other auditors be given a longer restriction. Such restriction would allow audit firms to establish appropriate transition plans from one lead or concurring auditor to the next. The longer rotation period for the other auditors would allow them to spend time on the engagement team to learn about the business and the industry before taking on the ultimate responsibility for the engagement.²⁷

Although clearly the lead and the review auditor perform critical functions that affect the conduct and effectiveness of the engagement, however, in many larger engagements, the engagement team will include more than just the lead and review auditor. Therefore those other auditors on the engagement team who play a significant role in the conduct of the audit and maintaining ongoing relationships with the audit client should be restricted as well.²⁸

Others have argued that mandatory auditor rotation incur additional costs and would result in a loss of knowledge as well. It is argued that the costs involved are far greater than the perceived improvement in audit independence.²⁹

When auditors are rotated they will be new to the client and to the business environment the client is operating in. This inadequate knowledge can lead to severe consequences as

²⁷ Securities and Exchange Commission, Final Rule: Revision of the Commission's Auditor Independence Requirements, 27/3/2003 <http://www.sec.gov/rules/final/33-8183.htm> accessed 17 January 2007.

²⁸ Securities and Exchange Commission, *ibid.*

²⁹ M.Sinnott, 'Are There Good Reasons For Auditor Rotation?' *Financial Executive*, 1 October 2004, 29.

it has been reported that audit failures are three times more likely to occur if the auditing firm is conducting its first or second audit of the company.³⁰

Others have concerns when the rotation requirements are applied to smaller audit firms. This is because most small audit firms usually do not have many lead and review auditors. Therefore these firms would be unable to provide audit services to their public clients for the long term. Many have argued that this would result in those clients incurring greater costs such as from having to identify a new accounting firm, from the need to familiarize accountants with the client firm's industry and business practices and from the resulting reduction in competition among firms.³¹

Conclusion

Although there has been some controversy attached to the lead auditor versus audit firm rotation debate, the Australian response is similar to SarbOx. If there is an argument of relative 'stringency', we have noted that a lead auditor becomes eligible for re-appointment after a two year 'down time'.

3.2 Auditor recruitment post engagement – familiarity threat

Key audit personnel that have been directly involved with the audit of a client get to know the corporate officials on a fairly personal basis. This relationship would develop over the course of several years. As a result, when the client does have to fill a key financial position, the auditor would certainly be a key candidate as they are familiar with the corporation's financial activities and they would have the relevant experience and

³⁰ G.Nashwa, 'Auditor Rotation and the Quality of Audits' (2004) 74(12) *The CPA Journal* 22.

³¹ Gavin Clancy, 'CLERP 9 reforms may limit talent pool for company directors' (2003) http://www.deloitte.com/dtt/press_release/0,1014,sid%253D5625%2526cid%253D26536,00.html accessed 17 January 2007.

expertise for the job.³² Therefore such an employment raises issues with respect to independence. From the outset, doubts arise regarding the remaining auditors ability to be independent when dealing with the ex-colleague, given that the ex-colleague was generally of a higher position in the audit team than the remaining auditors.³³ Also questions have to be raised on the insider knowledge that the former auditor will have on the practices of the audit firm.³⁴ Such insider knowledge can have undesirable consequences, as evidenced in the HealthSouth Corporation collapse (discussed below).³⁵ Given that there is support for the notion that audit independence is undermined as a result of ex-auditors employed by clients, changes have been made in both legislation to reflect the need to provide some sort of restriction on former auditors and their client.

SarbOx Act Response

Section 206 of the SarbOx states:

‘It shall be unlawful for a registered public accounting firm to perform for an issuer any audit services required by this title if a chief executive officer, controller, chief financial officer, or any person serving in an equal position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of the issuer during the 1-year period preceding the date of the initiation of the audit.’

Thus, the Act requires a cooling-off period of one year before a member of the audit engagement team can begin working for the registrant in certain key positions

³² R.Kaplan, ‘The Mother of All Conflicts: Auditors and Their Clients’ (2004) *The Journal of Corporation Law* 370.

³³ M.Beasley, Carcello J and Hermanson D, ‘Should you offer a job to your external auditor?’ (2000) 11(4) *Journal of Corporate Accounting & Finance* 37.

³⁴ Ibid.

³⁵ Carrick Mollenkamp HealthSouth Accounting Woes Grow to as Much as \$4.6 Billion, *Wall Street Journal*, 21 January 2004, B2.

CLERP 9 Changes

Under the Act, a person is prohibited from becoming an officer of an audited body for two years³⁶ if the person either ceases to be a member of an audit firm or director of an audit company and was a professional member of the audit team³⁷ engaged in an audit of the audited body (Section 324CI) or ceases to be a professional employee³⁸ of the auditor if the person was a lead auditor or review auditor for an audit of the audited body (Section 324 CJ).

Criticism

In comparison, while the SarbOx Act requires a cooling off period of one year before a member of the audit engagement team can begin working for the audit client in certain key positions, CLERP 9 has implemented a mandatory two-year cooling-off period.

While some have argued that the one year period in the US is insufficient, others have argued that the two year prohibition is too harsh. CLERP 9 imposes more strict requirements in relation to auditor rotation, claiming that a restriction of less than two years is insufficient.³⁹

Some have argued that the cooling off period in the US of one year is insufficient as an audit partner, who could have easily audited the firm for more than ten years in different positions, once gets rotated off the job once for a year duration can then be allowed to

³⁶ It was four years under the original recommendation by the HIH Royal Commissioner. Due to the overwhelming opposition to this proposal, the Act has implemented a mandatory two-year cooling-off period.

³⁷ Section 324CE defines 'professional members of the audit team' as any registered company auditor who participates in the conduct of the audit, any other person who in the course of doing so exercise professional judgment regarding the application of or compliance with accounting or auditing standards and legal requirements, and any other person who is in a position to directly influence the audit outcome.

³⁸ Section 9 defines a 'professional employee' of an auditor is someone who participates in the conduct of audits and in the course of doing so exercises professional judgment regarding the application or compliance with accounting or auditing standards or legal requirements.

³⁹ J. McConvill, *An Introduction to CLERP 9* (2004) at 59.

join the corporation.⁴⁰ In the scandal of HealthSouth Corporation,⁴¹ profits were overstated by \$4.6 billion over several years. The company auditor Ernst & Young was unable to detect the errors as not only the company spread the misstatements across several accounts, company officials also ensured that these illegal transactions did not exceed the dollar threshold that Ernst & young used to check year-to-year variations. It was revealed that the chief financial officer used to work in Ernst & Young in the 1980s. In this context, the current restriction of one year would have had no impact as it would not have prevented the same chief financial officer from getting appointed even today. The implemented CLERP 9 reforms may pose some real difficulty for smaller listed companies as many of these smaller listed companies welcome the input of members from their former audit teams because of the expertise and knowledge they bring with them.

3.3 Non- Audit fees—a threat to audit independence?

Section 2 provides the definitions in SarbOx Act. It states that non-audit services means any professional services provided to an issuer by a registered public accounting firm, other than those provided to an issuer in connection with an audit or a review of the financial statements of an issuer. In comparison, there is no definition in the *Corporations Act* in Australia. However, non-audit services are generally regarded to cover all services not coming within the scope of the audit contract that an audit firm provides to an audit client.⁴²

⁴⁰ Kaplan, op cit n 32.

⁴¹ Carrick Mollenkamp, op cit n 35.

⁴² Ramsay n 1.

Price competition since the mid 1970s has resulted in a reduction in profit margins in external audit. This caused the provision of audit services to become less appealing.⁴³ This in turn has given rise to a rapid expansion of the provision of non-audit services. However, the provision of non-audit services is a threat to the perceived independence of auditors. While some argue that the provision of both non-audit and audit services by the external auditor raises huge doubts regarding the independence of auditors⁴⁴ others do not think likewise.⁴⁵

Empirical Evidence

The extent of the threat to independence posed by the provision of non-audit services has long been a fascinating question. In Australia, Craswell designed a study, using empirical techniques on audit fees, to conclude that provision of non-audit services may not pose a threat to auditor independence.⁴⁶ The provision of both non-audit services and audit services can provide certain efficiencies as the client is a known entity.⁴⁷ Also, the provision of non-audit services by the audit firm may increase the amount of information given to the auditor and hence would issue an audit report of higher quality.⁴⁸ Clients may also purchase non-audit services from the audit firm so as to lower costs or to improve the reporting of financial statements.⁴⁹ Also, the specialization of either non-

⁴³ C.Hayes, 'The Ramsay Report and the Regulation of Auditor Independence in Australia', (2002) 12(2) *Australian Accounting Review*, 5.

⁴⁴ The HIH Royal Commission, 'The failure of HIH Insurance' (2003) Commonwealth of Australia, Canberra; see also Houghton and Jubb, n 19; Kaplan, op cit n 32 .

⁴⁵ H.Ashbaugh, LaFond R, and Mayhew B, 'Do Non-audit Services Compromise Auditor Independence? Further Evidence' (2003) 78(3) *The Accounting Review* 625; see also W. Kinney, Palmrose Z, and Scholz S, 'Auditor Independence, Non-audit services, and restatements: Was the U.S. Government right?' (2003) 42(3) *Journal of Accounting Research* 573.

⁴⁶ A.Craswell, 'Does the Provision of Non-Audit Services Impair Auditor Independence?' (1999) 29(3) *International Journal of Auditing*, using a logit model to test Australian data for 1984, 1987 and 1994.

⁴⁷ Houghton and Jubb, op cit n 19.

⁴⁸ D.Simunic, 'Auditing, Consulting and Auditor Independence' (1984) 22(2) *Journal of Accounting Research* 700.

⁴⁹ Kinney, Palmrose, and Scholz, op cit n 45.

audit or audit services in large firms could make it uneconomical for them to retain crucial expertise,⁵⁰ or not.⁵¹

Critics argue that large fees, especially those that relate to non-audit services, may make auditors more dependent on the client.⁵² This is because the more financial remuneration an auditor receives, the more influence that client potentially could exert over the auditor. Indeed, fees from non-audit services can be far more material than those from audit services. This is demonstrated in recent studies as they reveal that firms have paid far more to their audit firms for non-audit services than previously estimated. For example, in 2001, Sprint Corporation spent \$2.3 million on audit fees and \$64 million on non-audit services.⁵³ Audit independence could be impaired as the audit firm may not be willing to criticize work performed in its consultancy department so that non-audit services can be continued.⁵⁴ Auditors who receive non-audit fees are less likely to qualify their opinion than auditors who don't receive such fees.⁵⁵ It is perceived that firms that appoint two separate audit firms to perform audit and non-audit services are more independent than firms who appoint the same audit firm to perform both services.⁵⁶

⁵⁰ Houghton and Jubb, op cit n 19.

⁵¹ L.Ribstein, Corman R, and Corman M, 'Market vs Regulatory Response to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002' (2002) Working Paper, University of Illinois College of Law.

⁵² C.Becker C, DeFond M, Jiambalv, J, and Subramanyam K, 'The Effect of Audit Quality on Earnings Management' (1998) 15(1) *Contemporary Accounting Research* 23.

⁵³ Judith Burns, 'Proxy Reports Show Firms Pay Hefty Non-Audit Fees', *Dow Jones Newswire*, 12 April 2001, 06:48.

⁵⁴ S.Chai and Jubb C, 'Audit and Non-Audit Service Provision: Earnings Management and Audit Opinion Implications' (2000) Research Paper University of Melbourne.

⁵⁵ G. Wines, 'Auditor Independence, Audit Qualifications and the Provision of Non-Audit Services: A Note' (1994) *Accounting and Finance* 75-76.

⁵⁶ S.Swanger, and Chewing E, 'The Effect of Internal Audit Outsourcing on Financial Analysts' Perceptions of External Auditor Independence' (2001) 20(2) *Auditing: A Journal of Practice and Theory* 121.

Despite previous studies that offer no obvious answer whether the provision of non-audit services do affect audit independence, regulators seem to believe that it will.

Previous empirical literature suggests that size of audit fees is a function of various factors including client-specific factors (such as size, risk and complexity) and auditor specific factors, notable auditor quality (measured by big 4 or non big 4).⁵⁷ With the new laws relating to auditor independence and disclosure of non-audit fees, it is interesting to speculate whether these changes will have an effect on audit fees – and the relative magnitude of non-audit fees.

In an effort to provide some indication of the trend in Australia, Table 1 below shows data collected on the fees audit firms received for audit and non-audit services over a six year period – 2000 – 2001.⁵⁸ This six year period was selected to accommodate pre-CLERP 9 and moving through the announced changes and the actual changes. Whilst not providing empirical evidence to support a conclusion, the descriptive information provides the following insights:

- The audit fees for the sample firms have been increasing over the six year period
- Non-audit fees have been declining since 2001.
- For total fees, the mean total fees have been increasing, suggesting that the amount paid for audit fees has increased dramatically in relative terms.

⁵⁷ A.Craswell, Francis J and Taylor, S, ‘Auditor brand name reputations and industry specialisations’ (1995) 20 *Journal of Accounting and Economics* 297.

⁵⁸ The data was collected from a randomly selected sample of 50 listed firms from a range of industries (no banks), that had not received a qualified opinion over the six year period.

These aggregate statistics provide some interesting points for researchers to investigate possible causes of fee increase over the last six years. As lawyers, it is compelling to believe that there may be some CLERP 9 effects in those increases.

Table 1

| | Audit Fees 2000 | Audit Fees 2001 | Audit Fees 2002 | Audit Fees 2003 | Audit Fees 2004 | Audit Fees 2005 |
|-----------------------------|----------------------------|----------------------------|----------------------------|----------------------------|----------------------------|----------------------------|
| Mean | 300462 | 394731 | 472022 | 472495 | 599160 | 670070 |
| Median | 113500 | 139075 | 146325 | 157875 | 204760 | 236600 |
| Maximum | 3898000 | 5478000 | 8045000 | 6285000 | 6460000 | 8460000 |
| Minimum | 13500 | 16000 | 21720 | 16287 | 25500 | 22180 |
| % of total fees | 0.5 | 0.48 | 0.56 | 0.62 | 0.7 | 0.73 |
| | Non Audit Fees 2000 | Non Audit Fees 2001 | Non Audit Fees 2002 | Non Audit Fees 2003 | Non Audit Fees 2004 | Non Audit Fees 2005 |
| Mean | 304778 | 421506 | 365606 | 285020 | 261526 | 248333 |
| Median | 42232 | 64134 | 55914 | 102692 | 107274 | 88729 |
| Maximum | 4249000 | 8468000 | 5750000 | 3778000 | 1909700 | 1600464 |
| Minimum | 0 | 0 | 0 | 0 | 0 | 0 |
| % in relation to total fees | 0.5 | 0.52 | 0.44 | 0.38 | 0.3 | 0.27 |
| | Total Fees 2000 | Total Fees 2001 | Total Fees 2002 | Total Fees 2003 | Total Fees 2004 | Total Fees 2005 |
| Mean | 605239 | 816237 | 837627 | 757515 | 860686 | 918403 |
| Median | 174499 | 180016 | 188415 | 268475 | 326817 | 349894 |
| Maximum | 8147000 | 13946000 | 13795000 | 7096000 | 6846000 | 8659000 |
| Minimum | 13501 | 19500 | 22001 | 19027 | 27256 | 22180 |

Response by the SarbOx Act

The response of the SarbOx Act to the problem posed by non-audit services is two-fold.

While specific non-audit services are banned (Section 201(g)), others are permitted only if they are pre-approved by their own audit committee (Section 201(h)).

The SarbOx Act Section 201(g) prohibits an auditing firm from providing eight categories of non-audit services to existing audit clients.

It states:

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;
- (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.

In addition, the Public Company Accounting Oversight Board (PCAOB) is allowed to include any services to be added to the list. The PCAOB may also exempt any particular accounting firm on a case by case basis from this statutory prohibition. All in all, accounting firms are still allowed to provide any non-audit services to all firms that are not their existing audit clients, but are prohibited to provide the eight categories of non-audit services to their existing audit clients.

The Securities and Exchange Commission (SEC) Rules also require disclosure of fees billed for non-audit services.

CLERP 9 Response

Unlike the SarbOx Act, CLERP 9 does not ban specific non-audit services. It requires relevant non-audit services has to be identified and the director has to declare that it has

not compromised audit independence. These are incorporated in section 300 (11B) which states:

- ‘The report for a listed company must also include the following in relation to each auditor.
- (a) details of the amounts paid or payable to the auditor for non-audit services provided during the year by the auditor;
 - (b) a statement whether the directors are satisfied that the provision of non-audit services during the year by the auditor is compatible with the general standard of independence for auditors imposed by this Act;
 - (c) a statement of the directors’ reasons for being satisfied that the provision of those non-audit services during the year by the auditor did not compromise the auditor independence requirements of this Act.’

Section 307C also requires the auditor or the lead auditor to provide a written declaration that they have complied with the independence requirements of the *Corporations Act*.

Conclusion

Despite inconclusive empirical evidence that the provision of non-audit services actually breach audit independence, both the CLERP 9 and the SarbOx Act has imposed restriction in the provision of non-audit services. As SarbOx Act is prescriptive in specifically prohibits the types of non-audit services that auditors can provide to their audit clients, it would be argued that the Australian position is less stringent.

4.0 Concluding Remarks

4.1 Summary

This paper has shown that audit independence is crucial in ensuring that the audit process is credible. This is recognized by the implementation of parallel regulations in both

Australia and US. We have identified the three main areas (auditor rotation, employment relationship with former auditor, and client and non-audit services provided by the auditor) where the regulations have focused on specific breaches of independence. This is in addition to the general discussion on the direct independence reforms, that prohibit certain conflict of interest situations and relationships.

4.2 Similarities and difference of the two Acts in relation to audit independence

If we were to identify our four areas of examination – audit independence & relationships, auditor rotation, former auditor recruitment and provision of non-audit services – as a sliding scale of stringency, we could assess these on a scale of similar levels of impost, demonstrating less stringency.

As identified earlier, the two areas in which the regulation have adopted the same approach is audit independence and auditor rotation, although auditor rotation in Australia has a leniency with a built in re-eligibility clause, but balanced with this has strict liability for non-compliance. In relation to recruitment of former auditor by clients, CLERP 9 imposes stricter enforcements than the US. In relation to non-audit services, it is believed that the SOX Act imposes stricter enforcements than CLERP 9, as the latter favours a disclosure approach, not a prescriptive approach. These differences effectively boil down to two main reasons.

1 The recommendations made as a result of the corporate collapses enquiry

The US Senate Commerce Committee 2002 and HIH Royal Commission Report 2003 were established to investigate the reasons behind the corporate collapses. In the HIH Royal Commission Report, it was identified that three former partners of Andersen were appointed to the board of HIH, namely Cohen, Fodera and Gardener. Gardener was appointed as the chair of chairman of the audit committee 17 months after his retirement from Andersen. Fodera joined HIH as the chief financial officer (CFO) the day after he resigned from Andersen, where he had been the engagement partner on the HIH audit. Cohen was appointed to the board of HIH approximately five months after his retirement from Andersen, where he had played a significant role in the audit of HIH for twenty-five years.⁵⁹ Given the magnitude of the employment relationships that existed between former Andersen auditors and HIH leading up to the collapse of the insurance company, it is expected that CLERP 9 would impose tougher restrictions. The HIH Royal Commissioner argues that any duration shorter than two years ‘might not be sufficient to arrest a reasonable apprehension that former partners retain an influence over members of the audit team.’⁶⁰

2 The adverse impact it might have on firms

While the banning of certain services provided by auditors would impact both US and Australia in a similar fashion, there is a recognition that the economic impact may be greater - professional firms in this country are generally regarded to be smaller in size and volume as well. First, as identified in the US, the new legislation has resulted in

⁵⁹ HIH Royal Commission Report Chapter 21.4.3

<http://www.hihroyalcom.gov.au/finalreport/Chapter%2021> accessed 10 December 2006.

⁶⁰ James McConvill, n39..

separate incorporate entities for non-audit services. As a result of the separation, non-audit and audit fees are bound to increase as costs cannot be spread across business lines. Audit fees in particular, have already been expected to increase because of other changes made by CLERP 9 and the International Financial Reporting Standards (IFRS).⁶¹ As the audit is mandatory and costs have increased, we may expect discretionary spending on other professional services to decline. For example, firms that need to improve on their controls may not decide to do so because of the huge increase in audit fees.⁶²

Next the demand for non-audit services will decline. If the demand drops rapidly, consulting firms maybe forced to shut down. This can result in undesirable consequences. While these arguments can be put forward in the US as well, because firms are generally much smaller in Australia when compared to the US, the consequences can be felt much more in Australia.⁶³

4.3 Findings

Overall, without looking at the detail, it is difficult to sustain generalities such that SarbOx is more stringent in auditor independence than CLERP 9. Each jurisdiction was responding to similar, yet subtly different audit and corporate governance environments. Whilst empirical questions measuring the 'value' or cost of regulation are an exciting

⁶¹ Australian disclosing entities are required to comply with Australian equivalents to IFRS for financial years ending on or after 1 January 2005. They will change existing accounting standards in relation to the recognition and measurement of assets, liabilities, equity, revenue and expenses. These changes could allow investors to make informed decisions across different jurisdiction. However, this also means that there will be drastic changes to the financial reports of a company after 1 January 2005.

⁶² Ramsay, op cit n 1.

⁶³ Some of these arguments or scenarios are discussed in the Ramsay report, op cit n 1.

development, it is important that researchers understand the degree to which findings can 'translate' across jurisdictions.