

Regulation of auditing in Australia

Dear Committee,

We would like to outline some issues in the process of regulating auditing in Australia. Our principal focus is on item 7: “the role and effectiveness of audit in detecting and reporting fraud and misconduct” from the term of reference. However, some other items will be discussed such as 1, 2, 3, 5, 6 and 8.

We have experience working for international accounting firms; thus, our opinion is based on our experience as well.

This submission discusses four topics: audit is perceived to be effective, reliance on audit experts, the technology of materiality and the use of audit to serve public interest. To finalise, we suggest some solutions.

With best regards,

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Audit is perceived to be effective

The effectiveness in the public sector is a movement that was influenced by the introduction of the new public management (NPM). This means a ‘privatisation’ of the public sector from a belief that public sector was a waste of money. Power (1997, p. 10) argues that the introduction of NPM helped the monitoring practices meeting public ideals. This NPM helped to make things ‘auditable’ creating the opportunity for Value for Money (VFM) audits, for example, that supported the practice of government by shaping their programmes in more efficient, economical and effective (Power, 1997, pp. 10-11). The major problem is NPM assumes a neoliberal perspective originated from the private sector, but it limited to the broader needs of societies. Audit, in this, is a practice of a neoliberal assumption (power, 1997, p. 43).

The effectiveness of audit is questionable especially while considering the role of audit to detect fraud or corruption. The issues involve the scope of the audit, the narrowed financial view, and the tracking mechanisms in society.

First, the scope of audit is limited and narrowed to the relevant evidences and sampling considered by the auditors. However, “evidence is always relative to the rules of acceptance of particular communities” (Power, 1997, p. 69). This means that the selection of evidences is cultural, judgemental and partial. In addition, the sampling technique is an alternative to the costly detailed examination of the entire range of transactions; it is an inferential test that aims to generate a basis for conclusions based on a small number of transactions (Power, 1997, pp. 70-71). In this, the use of sampling is driven by self-interest of auditors to have an incremental benefit (Power, 1997, p. 72). Further, sampling is controversial because it carries assumptions of the population that is not always true. In short, the scope of auditing is based on subjective evidences as a catachrestical sample – a ‘leg’ of the chair representing the whole chair. In sum, the catachrestical sampling in audit is narrow, limited and might not represent the entire number of transactions. In addition, audit has been used to detect fraud. To detect fraud, audit might not be appropriate due to fraud being left out of the sampling technique or under undocumented evidences.

Secondly, audit mainly focuses on financial transaction or information related to financial reporting. This scope does not cover all transactions and information. This focus is limited to the formal transactions recorded in the business systems. In many corruption cases, many transactions were not recorded in the systems or, when recorded, they were kept under the radar. Thus, the effectiveness of

audit to detect and report fraud is doubtful within creative fraud schemes, collusion cases and manipulation of information happening outside of the financial systems.

Thirdly, the effectiveness of audit is based on a society that does not exist when corruption/fraud arises. The whole concept of effectiveness assumes that individuals in societies will be tracked using mechanisms similar to financial audit that includes systems, documents and protocols. However, corruption does exist in many types of societies. Corruption is about behaviours rather than an opportunistic gap (Roberts, 2015). Closing the gaps will not stop people to engage in forms of corruption.

In summary, the effectiveness of audit (from private and public sectors) is challenging especially regarding detecting corruption because it is based on the samples, financial transactions and the assumptions of tracking mechanisms such as systems. Fraud/corruption commonly originates from informal and unsystematic practices that audit is incapable to detect.

Reliance on audit experts

The reliance on auditors as the experts on audit is complicated due to five reasons.

First, the operational tasks of the auditors are obscure including the use of technical terms in their audit reports such as risk, reliability, appropriateness, etc. In other words, auditors use technical terms to explain its role without expressing their judgments clearly. Power (1997, p. 27) argues that “financial auditors have deliberately obfuscated the issue what audits really do”. The similar essence in financial audit applies to other forms of audits. To exemplify, audit risk is assessed by each auditor considering relevance and appropriateness of the pieces of evidence provided. In the final audit report, these elements are used to fundament the auditor’s opinion. This opinion is based on professional experience and judgments. Leaving technical terms exposed creates instability in the profession and that is unwanted as the reliance of audit experts is political. Power (1997, pp. 39-40) asserts the opacity that audit is situated because the heart of audit is not certification or insurance, but opinions based on professional judgements. More precisely, auditors are experts not because no one would do the job, but because they keep their task under an obscure cover. This cover protects their profession and creates legitimacy that is essentially exercised to patch over auditee’s expectations (Power, 1997). Auditors have their own agenda including maintaining legitimacy within its obscure tasks that conflicts with the interest of the auditee.

Secondly, corruption/fraud does not have a recipe. Corruption/fraud is a human creation that does not have a specific manual or guideline or standard or regulation to detect. It entails that any attempt to understand a case of corruption of today will inevitably fade by tomorrow’s new case. Humans are complex living beings capable of impossible unimaginable things. Thus, corruption/fraud in this scenario is impossible to frame, encapsulate or accurately define. Knowing this, any attempt to guarantee that someone will detect fraud/corruption is hopeless.

Thirdly, auditors do not have corruption as their principal focus. More precisely, fraud is a concept without a settled meaning. However, the auditor has a duty to detect fraud, however, it is positioned by “the concept of a ‘reasonable expectation’ of detection” (Power, 1997, p. 23). In other words, the lack of a clear guidance produces space for a business case to create new opportunities to serve their clients, however, it does mean enhancing external visibility without tackling the problem of fraud (Power, 1997, p. 24). There are some examples that auditors found fraud/corruption, but mostly large scale ones. Financial auditing have the capacity to detect large mis-statement in financial statements (Power, 1997, p. 24). However, it is a matter of judgement to assert the ‘reasonable expectation’. Their checking driven task is not able to conduct a thorough review because of the inability to detect an uncontrollable/undefined thing: fraud/corruption. Addition to that, the audit procedure is based on samples and professional judgements that are unable to conduct a systematic review on corruption as it is hard (costly too) to be part of a very precise technical audit procedures.

Further, auditors might be part of corruption schemes. As human beings, anyone can be part of corruption. There is a classic example in the business literature. The American company Enron with the help of their auditors from one of the largest audit firms (Arthur Andersen) manipulated information

and engaged in criminal activities. Additionally, the risk of an auditor being corrupt is similar to a manager. Both are high profile experts surrounded by many mechanisms of power. These mechanisms might support fraudulent transactions. Simply because experts hold trust in their activities which implies social protection. “Trust in auditing may be risky” (Power, 1997, p. 138). In this protection, fraud might occur. And, few people might suspect an auditor’s involvement.

Fifth, auditor’s independence is an issue. Auditors provide service to clients who pay auditors expecting to have a good result – as many audit services reassure the quality of the management. The question is: can really auditors provide an honest opinion of their audit process? That is why there are few cases of qualified audit reports¹. In addition, auditors expect to have a strong client’s relationship to keep a good portfolio of clients. The close relationship between auditors and clients creates many questions about the independence of auditors’ judgements. It is questionable because its closeness and its financial interests do not sustain a transparent opinion. In other words, auditors are susceptible of bribery and personal inclinations. Thus, it is very important to emphasise that the independence of auditors is aspirational to sustain its opaque expertise.

In conclusion, the reliance on audit experts is political. “Experts and practitioners play a key role in exercising their power to define expertise to exclude societal stakeholders unable to frame their interests in abstract, “technical” language” (Botzem, 2012, p. 179).

The technology of materiality

“Materiality’ has been interpreted qualitatively in professional guidance as the degree of tolerable or acceptable error in financial statements but, like the term ‘reasonable expectation’, is not precisely specified beyond this” (Power, 1997, p. 23).

The technology of materiality is crucial while considering detecting fraud/corruption. This concept differs within many areas, especially in Audit, Law and Politics.

In Audit, materiality is a technocrat concept based on auditors’ judgement (Power, 1997). In practice, this judgment is based on a numerical threshold. That is in itself difficult. This threshold is some sort of a ‘magical threshold’ that conveys all relevant material information. The major problem is fraud/corruption is not something within a threshold nor does it arise from a normal transaction assumption. In a sense, a qualitative judgement would be appropriate, but because it is hidden to protect the legitimacy of the auditor. Thus, it creates a mystification of materiality in audit. To sum, materiality concept is a Pandora box that mainly fails to detect fraud.

In Law, materiality is based on the legal framework aiming to provide justice to societies. Despite the fact that many laws are tricky, the main objective of Law is to provide justice. In this, materiality is a concept that drives the impact of justice for people. In addition, fraudulent cases are very creative and unique which means that previous similar legal cases/regulation might not be appropriate anymore to access a corruption case. The presence of regulation does not necessarily stop people to commit fraud. Materiality is constantly changing when a new fraud case arises. It involves legal discussion aiming a better justice practice for the benefit of all citizens.

In Politics, materiality is a flag of political risks. When something is material, it affects political risks. It involves a matter that changes public expectations. It relates to gestures, words, voice tones, dressing, financial aid, support of policies, rejection of an attitude, etc. In a broader sense, it is closer to the complexity of human lives and it somehow connects to the fraud/corruption activities. It is important to mention that a small case of fraud could affect the political risk of a company or a country. Thus, materiality in politics is closer to the complexity of human lives and it does impact political risks regardless of its degree.

In summary, the concept of materiality implies a range of meanings in audit, law and politics. It rarely means the same. One thing in common is the impact of fraud/corruption within the lenses of materiality

¹ A qualified audit report is based on the opinion of an auditor and it states that the material audited (normally financial reports for financial audits) is not conformed to the auditing/accounting standards.

is unpredictable. In Audit, materiality is entity-focus and based on auditors' judgements. In Law, it is redefined and rediscussed in society when a new case arises. In Politics, it can be a disaster from a minimal aspect of it. Hence, materiality concept is broadened in Politics following by Law, then it is narrowed in Audit. The principal point is that materiality affects people's lives. It affects how people interact with each other and it does change the perceptions in law, politics and audit.

The use of audit to serve public interest

The use of audit to serve public interest is becoming a common mechanism. Audit became a tool to restore the trust within the principal-agent-accountability issue (Power, 1997). First of all, the principal in the political sphere is hard to point out assuming many changes in the leadership, political processes and many disagreements within political parties. In this, the principal is not something simple to define. Secondly, the agent commonly known as the managers are chosen by the principal using its democratic process. This agent is the channel between the principal and the public. In audit, the auditors work together with the managers and they are chosen by the principal. In other words, the auditors are part of the agent group with a defined function to provide an audit service to the principal. In this, agents have their own agenda and it might differ from the principal and/or the public. Thirdly, the public is not a homogeneous group. Basically, the principal in the public sector would serve the public interest. However, the public is not always present in the democratic process or even consulted. If so, the public is not captured by one single or particular perspective. Public is a complex amalgamation of people. Thus, the principal would have a challenging time to define who to account for. Then, accountability becomes a mystery.

The accountability is a puzzle because the principal, agents and public are difficult to define. Thus, applying accountability, being accountable for the actions practised by the principal, is a difficult task due to the vague definition of the public, principal and the managerial tie. From the principal, when you do not know who to account for, it becomes a guessing game. This game includes expectations, assumptions and beliefs that are not necessarily a representation of the public interest.

The public interest is diverse (Carter & Warren, 2018). It includes the interests of the principal, managers, auditors and many other groups. It is endless and impossible to set an ultimate meaning because it is constructed by many actors with different, contrasting and competing ideas. The public interest is a goal. A goal without a final signification. A goal defined and redefined every day by political actors. In this sense, public interest is never a complete end. It is an aspirational goal without a singular intention.

Without a settled definition of public interest, audit to serve the public interest is impossible. However, the public interest is the main goal of the principal. The principal needs to be supported by their public by their electorate by their citizens. Nowadays, many groups are sceptical by their elected leaders. These leaders (principal) need to gain their trust back. It is where audit situates. Audit is constructed to fill the gap between the lack of trust between the principal and the public. In doing this, audit creates two major issues.

First, the lack of a final definition of the public and its interest creates a space for the principal to use audit for a political purpose. In this, audit is to serve the political agenda of the principal that mainly needs to recover the trust back to its government. This trust is obtained if the principal addresses the needs of its electorate. Because its electorate has many needs, the principal will achieve a parcel of these needs. Of course, the principal chooses which need corresponds to their agenda. In doing this, the needs are never completely fulfilled. They are incomplete. In fact, trust is a dream from the principal but never actually a goal due to the lack of fulfilment of the needs of the citizens. So, audit is placed to restore this trust. What audit does is to cover over this unachievable trust by making the principal appear trustworthy.

Secondly, the agents carry their own agenda. Agents are managers, directors and auditors. Each of them desires something different that may or may not represent the principal's interests. Also, the agents represent some groups in societies. In saying this, the closeness to the principal impacts on the actual execution of the principal's agenda which could be redefined, re-configured or readjusted by the

agents. Also, the plans, intentions and goals of the principal could be translated and materialised in different ways by the agents. On top of that, auditors have three groups to serve: the principal, the managers and the public. Auditors work closely to the agents, aim to serve the principal's interest and should serve the public interest. However, none of those interests is completely satisfied because the groups are heterogeneous. As auditors have their own agenda (keeping the client relationship and keeping their status in society), it is hard to believe that the public interest would ever be served.

The public interest represented in the auditing standards is narrowed to the interests of the financial users. However, the recent event from the Royal Commission in the Financial Industry in Australia revealed the broadening concept of public interest. It includes the interest of the many people that are affected by large and powerful corporations. In this sense, audit engages in a definition that narrows the public interest definition. Whatever public interest is, from the auditors' perspective, it is different from any other agent.

In summary, public interest is an unsettling concept and broadened every day by many actors. The impossibility to define public interest places audit in a political space. That does affect the relationship between the principal (government) and the public. In that sense, the principal loses their trust from their electorate. Audit is then placed to mislead public about government. Audit is far from serving the public interest. It serves a public interest changing from time to time (Black, 2002).

Proposed solutions for the government

- ✎ A multidisciplinary task force to combat corruption (forensic approach)

We would like to suggest that the task to combat corruption needs to be considered in a broader sense. In this, forensic accounting might be a great option to join a task force that includes many specialists on fraud and corruption arising from auditing, law, psychologist, management and other areas.

- ✎ Open conversations about ethics in many spheres such as schools, industries, social media, etc.

Roberts (2015) suggests that people would engage in corruption for many other reasons despite of the financial drivers commonly associated to fraud and corruption. There are many other reasons that cross the boundaries of acceptance in many societies such as the enjoyment and the transgression feelings that come from corruption/fraud (Roberts, 2015). In this sense, it is important to discuss in classroom the implication of corruption/fraud, reasons for that, and how societies can live without the need of corruption or the exhilaration.

- ✎ Engage in a transparent approach

As hard it sounds, the combat against corruption needs to be an open debate. Having a transparent approach avoids fraud/corruption.

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