THE ACCOUNTING PROFESSION AND INDEPENDENCE – THE SCRUTINY INTENSIFIES

The credibility of and trust in the accounting profession lies in its preparedness to take a strong stance on self-regulation in the public interest.

BY WARREN MCGREGOR AND GREG POUND

An updated version of an address given at the annual Australian Accounting Hall of Fame induction ceremony at the University of Melbourne on 24 July 2013.

In his address at the annual Australian Accounting Hall of Fame Awards Ceremony in 2012, Rupert Myer focused on the contribution members of the accounting profession make to Australian society, including the creative arts. One of the statements he made struck a chord with us. He said:

> It is worth contemplating...whether we would have navigated the momentous changes that have occurred as successfully as we have without men and women with expert accounting skills and possessed of high integrity, operating within a framework of rigorous accounting standards and the oversight of their accounting profession.

As members of the accounting profession, it is refreshing and indeed encouraging to hear such a glowing tribute from a highly respected person who is not, on his own admission, a part of the accounting profession. But more than that, his words shine a light on an intangible element that we believe truly underpins our profession and engenders the respect that accounting professionals have in the broader community.

The framework – which we may even call a conceptual framework – for developing the highly respected accounting professionals celebrated by Rupert Myer consists of many parts. Myer referred to some of them – expertise, technical standards, monitoring and compliance. But in our view the essential element, much like the 'asset' element in the accounting conceptual framework, is what he referred to as 'high integrity' and the profession refers to as 'professional independence'. It is both fundamental and pervasive. It is expected of our members and of the institutions that govern our behaviour, in particular those that establish our professional and technical standards. If our independence is brought into question we run the risk of losing that hard earned respect and, moreover, our pre-eminent role in business and the general community.

We raise it in this short paper because we believe the point has been reached where serious questions are again being asked about professional independence and we fear the consequences for the accounting profession if bold remedial action is not taken.

Independence

In the specific context of financial-report auditing, independence has for many decades been identified as the 'cornerstone of the profession'. This concept now extends to the broader range of assurance services provided by members of the profession, as the value of these services to users lies in the belief that the assurance practitioner is unbiased, objective and has no interest in the information other than it being prepared and presented in accordance with the required reporting framework.

It is equally well established that independence comprises two elements: perceived and real independence. The profession and individual practitioners must be, and be seen to be, independent. Real independence is of little value if users do not believe that the assurance practitioner is independent.

While not a new issue, it remains one that is critical to the profession, and not only at the level of individual practitioners but to the profession as a whole. When a user seeks to rely on the opinion of an assurance practitioner or firm unknown to them, it is the user's perception of the profession that will determine whether they will derive value from that opinion. The well-documented instances of corporate failures in recent times have called into question the independence of the profession, and continue to place considerable pressure on both real and perceived independence.

The resultant regulatory initiatives, both legislative and self-regulatory, in many countries are in our view appropriate. The question remains however whether they have been sufficiently comprehensive as a means of securing a robust model to ensure real and perceived independence on an ongoing basis.

In an interview in December 2013 with the Belgian Instituut van de Bedrijfsrevisoren (published in their magazine *Tax, Audit and Accountancy*) Sir David Tweedie, world renowned authority on financial reporting and auditing, stated that: 'The real problem is perception,' and that: '… the auditor's independence needs to be increased.' While he indicates that he is not saying that the auditor is not independent now, he noted that:

> It is just that a fact is easier to change than a perception. Once the perception is there, it is very difficult to remove it and we have to do something drastic, such as with regard to the content of the audit report and to the long term ten years fixed appointments until tendering without mentioning prices. All of that could help.

In our view, one of the more significant failures of the profession to safeguard its most fundamental underlying principle is its Code of Ethics in relation to independence. The Code of Professional Ethics issued by the International Federation of Accountants and adopted in many countries as their National Code is in our view not sufficiently robust to deal with ensuring effective regulation of independence into the future. It is our view that in relation to such a fundamental principle the requirements governing it should be clear and prescriptive. While there are elements of prescription in the Code, the model also incorporates a degree of subjectivity.

The Code, being a model that requires practitioners to identify threats to independence, and then apply safeguards to eliminate the threats or reduce them to an 'acceptable level' (based on a reasonable and informed third party test), is in our view open to differing interpretations, inconsistent application, abuse and disputes as to whether it has been appropriately applied. We find it difficult to understand how any risk to independence can be deemed to be at an 'acceptable level'. In our view, by definition, once there is a risk to independence, there is a perceived independence issue. The best solution is to eliminate the risk in the first place.

A prime example of this in the context of financial-report auditing is the controversial and ongoing debate as to whether an auditor/firm should be able to provide the auditee entity with non-audit services. While the Code does prohibit some non-audit services being provided, it still acknowledges that an auditor can provide other services under the threats and safeguards approach. We do not believe that this is appropriate, or that an auditor or audit firm can serve both interests. At the very least there is a clear perception issue of conflict of interest. In Australia the legislative response to this has, *inter alia*, been to require disclosure of the nature and amount of these other services provided to the auditee entity. It is difficult to understand how this overcomes the problem. Such disclosure confirms to users that the auditor/audit firm has another financial interest in the auditee entity and a relationship with its governing body or senior management. Arguably this does nothing to deal with the real independence issue and exacerbates the perception issue.

In our view the overall approach to the Code, and this example, demonstrates the need to re-assess the self-regulatory approach to independence.

Despite what has occurred to date, and while the initiatives taken in some countries have been more extensive than others, evidence of the continuing growing concern about professional independence is seen in the attempt by the European Union (EU) to impose further regulations on auditors. In December 2013, member states of the EU agreed to the following new audit regulations:

– A 10-year maximum period during which a member state may allow an audit firm to continue auditing the same public-interest entity. If the engagement is put out for public bid, the member state may allow the engagement to continue for a maximum of 20 years. In cases of joint audits, where multiple audit firms share the engagement, the maximum period is 24 years.

– A prohibition on provision of certain non-audit services by audit firms to the public-interest entities they audit. Member states will have the right to allow firms to provide some tax and valuation services to their audit clients, provided they are immaterial and have no direct effect on the audited financial statements.

– A requirement that fees from permitted non-audit services to an audit client cannot exceed 70 per cent of the audit fees.

Although the new regulations will only be effective if and when they are approved by the European Parliament and the council of national governments, this development is a tangible expression by law makers that something has to change.

We believe it would be folly to dismiss the growing concerns about professional independence as an overreaction to knee jerk reactions by regulators and others in the wake of the global financial crisis and to assume that order will be resumed when the world's economies return to normal. Indeed, some leading practitioners believe the profession is on the brink of sliding into disrespect and possibly irrelevance; and that the recent actions of the EU are just the latest manifestation of a much broader and deep seated concern

So what has been happening?

We believe there are two separate forces at play and the profession is caught in somewhat of a pincer movement.

First, community expectations have been changing. As markets have interconnected and as more and better-informed players have participated in those markets, the bar has steadily risen. Market participants, and by extension the broader community, are demanding greater assurance that accounting professionals are independent. When they perceive potential conflicts of interest – for example, when accounting firms audit the same clients for long periods, when a significant percentage of audit fees are derived from too few clients, and when accounting firms provide other services to audit clients – they are less easily fobbed off by retorts that we have professional standards in place and we are actively managing the risk.

Secondly, those with a vested interest in undermining independence have become better organised and more determined in their attempts to bend the rules or indeed to have less demanding rules in the first place. For example, the International Accounting Standards Board (IASB) has witnessed coordinated actions by banks, in the presence of ineffectual regulators, to put pressure on auditors and the IASB itself to avoid or lessen write downs on their asset portfolios. A measure of their success is the fact that in Europe today many banks continue to carry assets at amounts clearly unrepresentative of their underlying value.

There have also been blatant attempts to intimidate accounting standard setters in order to achieve less-demanding accounting standards and less-transparent financial reporting outcomes. For example, when the IASB was endeavouring to introduce an accounting standard that would require the expensing of stock options, the

Financial Executives Institute in the US threatened to spend tens of millions of dollars to prevent them from doing so. President George Bush even offered the IASB accounting advice that bore a remarkable similarity to the view being expressed by hi-tech companies in Silicon Valley desperate to retain their current accounting practices. In a similar vein, President Jacques Chirac went in to bat for French banks when the IASB was endeavouring to introduce an accounting standard on financial instruments.

There have also been attempts to undermine the independence of the IASB by agitating for changes to the way the Board operates, the structure within which it operates and even the composition of the Board.

So what needs to be done?

First and foremost the accounting profession needs to admit that there is a problem. It then needs to engage in constructive debate both internally and externally.

Within the profession there is a need to reassess educational requirements, professional standards, and the systems and procedures that give effect to those standards.

Externally, the profession needs to engage in constructive debate with policy makers to better understand the reasonable expectations of market participants and the broader community. And there needs to be a preparedness to support significant change. An example of a change we believe the profession should consider is to move the International Auditing and Assurance Standards Board, the International Public Sector Accounting Standards Board (IPSASB) and the International Ethics Standards Board away from the profession – and either set them up as independent boards or relocate them within a presently existing independent standard setting structure such as the IFRS Foundation. In this particular context, it was encouraging to see the Institute of Chartered Accountants in Australia recently publish a thought leadership paper, titled 'It's time...for global, high quality public sector financial reporting', that advocated such a move for the IPSASB.

The credibility of and trust in the accounting profession lies in its preparedness to take a strong stance on self-regulation in the public interest. Failure to do so will increase the risk of further legislative intervention. Courageous decisions will be required and there will be some short-term pain. However, we are confident the leaders of the accounting profession both here in Australia and internationally can rise to the challenge. The long-term gain will be retaining the pre-eminent position of professional accountants in business and the general community.

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