

BUSINESS ETHICS, CORPORATE GOVERNANCE AND AUDIT INDEPENDENCE: A TRILOGY.

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ABSTRACT

Action is being taken against professional accounting firms, the most significant being that against Andersens for their role in the Enron collapse. This paper examines the issues of business ethics and audit independence in the light of recent changes to corporate governance requirements in Australia and overseas and makes comment on the teaching of business ethics in tertiary institutions. The implications of the Sarbanes-Oxley Act, passed in August 2002 and the Australian recommendation of Corporate Law Economic Reform Program, CLERP 9, are also considered.

BACKGROUND

Corporate collapses around the globe and the consequential erosion of public confidence in the capital markets have sparked significant pressure on management, auditors, directors, the accounting profession and governments' oversight role to review the issue of business ethics and independence. Action against professional accounting firms, the most significant being that against Andersens for their role in the Enron collapse, along with corporate governance models and issues of directors' personal liability for financial statements are being examined to promote business ethics. The profession has been moving worldwide from a rules based system of oversight towards a self-regulatory system. This trend may well be halted with the United States passing the Sarbanes-Oxley Act in August 2002, which eliminates self-regulation for both US accounting firms and other accounting firms worldwide in relation to their clients with US reporting responsibilities. Australia's Corporate Law Economic Reform Program, (CLERP 9) 2002 recommendations strengthen corporate governance rules. Corporate governance, audit independence and ethical behaviour, are difficult to measure and lead to a preference of regulators for rules based systems to apply to all parties concerned. CLERP 9 proposes reforms in the area of oversight of the audit profession, auditor independence and liability, and continuous disclosure [7].

Ethics derives from the Greek word 'ethos' or character. Ethical behaviour reflects on the character of both the individual and the profession they represent. Ethics focuses on what is right or wrong and on a study of choices, standards and behaviours. Some philosophical theories governing ethical behaviour include deontology, teleology, and utilitarianism which correspond to elements of the Joint Code of Professional Practice [16 CPC], to which all professional accountants must adhere. An example of this is "the concept of professionals serving the public interest, the rights and duties of auditors and shareholders" [10 p. 51].

Corporate governance issues loom large in many of the ethical/independence issues facing Boards of Directors. Kate Spargo, company director, commented at a Melbourne forum on corporate governance on the need for director diversity, director education, professional directorships, rigour and independence and the need to take courage in making a stand, sometimes against the flow of the majority of the board, as vital for non-executive directors [22]. Shann Turnbull, an author and commentator on corporate governance, advocated the use of multiple boards [19] within the one company as a system of checks and balances within corporations [24]. The Australian Federal Treasury has announced the provisions of CLERP 9, which incorporate some of the Ramsay Report recommendations for both directors and auditors. These include: mandatory period of 2 years following resignation from an audit firm before a former partner can act as director of a client firm, mandatory disclosure in the annual report of fees for non-audit services, adoption of Professional Statement F1 on Professional Independence which requires the identification of potential threats to independence and the

application of safeguards to those potential threats, mandatory requirement for the top 500 listed companies to have audit committees, and mandatory rotation of audit partners every 5 years. The Australian Securities and Exchange Commission (ASIC) and the Australian Stock Exchange (ASX) are engaged in public debate over which of them should be responsible for prescribing corporate governance. CLERP 9's recent recommendations have elicited criticism from a panel of corporate governance specialists in Melbourne. Stapledon, McCrann and Bosch were in agreement that corporate governance should be encouraged rather than mandated [5; 18; 23]. CLERP 9 proposes mandating. The Australian Stock Exchange in its Listing Rules mandates, among other things, that there be establishment and maintenance of appropriate ethical standards [4ASX Listing Rule, 4.10.3]. The Corporations Act 2002 has provisions for good corporate governance which emanated from the lessons learned in the corporate crashes of the 1980's [2 ss 180-184]. A further onus is being placed on directors through the Commonwealth Criminal Code 1995 [1].

While the accounting and auditing profession is well regulated by their professional body, many company directors are not members of the profession and therefore not bound by its rulings. The role of the public accountant is to add credibility to financial statements prepared for users of accounting information. Ethical dilemmas exist when accountants' professional independence is threatened by outside pressures on them to behave in a certain manner. This pressure could come from management and is heightened if the auditor is reliant on management for more than auditing income alone. The problem is global and has been the subject of an inquiry in Australia headed by Professor Ian Ramsay, Director of the Centre for Corporate Law and Securities Regulation at the University of Melbourne [20], by the International Federation of Accountants (IFAC) [14], the European Union [8] and most recently by the Australian Federal Treasury in CLERP 9 and the US by way of auditor independence and anti-corruption legislation [3]. The Australian auditing standards identify five threats to independence, the greatest of which is 'other services' provided by the auditor [15 AUP 32]. These are replicated in the IFAC Code of Ethics in which has been designed a conceptual framework for ethical behaviour based on the identification of five threats to independence and the identification of three potential safeguards to independence. The threats are identified as: self-interest; self-review; advocacy; familiarity; and intimidation [13]. The strategies for safeguarding independence derive: from the profession; within the assurance client; and within the firm's own systems and procedures [14]. The Ramsay Report in Australia made recommendations restricting retired auditors taking up directorships with former clients, and limiting the exposure of accounting firms to a maximum of 15% of audit fees from the one client. This is even more restrictive than the IFAC recommendation, and appears to be in direct response to the corporate crashes in Australia of HIH and Harris Scarfe, where the retired audit partners sitting on Boards of both HIH and Harris Scarfe presented problems in both independence and ethical behaviour. Non-audit services represent, in many cases, far more in value than the audit fees. The fundamental question is how independence can be maintained in the audit, when the accounting firm is so heavily dependent on the client for income from other services. Stephen Harrison, ICAA Chief Executive, claims that research both in Australia and overseas found no evidence that auditors shouldn't provide both services [11]. Harrison concedes however that we need safeguards to prohibit some services where irreconcilable conflicts of interest occur, and further, the updating of the profession's ethical standards is important in this regard. Arthur Levitt, the chairman of the Securities and Exchange Commission (SEC) in the United States ordered a split between auditing and consulting as it was perceived that audit firms had violated the rules of independence by being engaged in many different types of professional activity with their clients, including financial interest [21]. Accounting firms have responded to these conflicts and directives; in the case of the United States, by separating their consulting arms from auditing, such as in the case of Arthur Andersen creating Andersen Consulting and eventually Accenture, Ernst & Young creating Cap Gemini, PricewaterhouseCoopers in Australia selling their financial planning arm to AMP, now named Arrive, PwC Consulting currently being sold to IBM, yet to be named, KPMG Consulting, on their home page advise that "KPMG Consulting Inc is an independent consulting company, no longer affiliated with KPMG LLP the audit and tax firm [17]."

Self-regulation or rules-based oversight

The accounting profession in Australia has its Joint Code of Professional Practice, as well as the recent Professional Statement F1, which cover independence and ethics. The International Federation of

Accountants has issued its Code of Ethics. The European Union has issued its FEE [8; 13; 14; 16]. These all represent self-regulation. Australia has released the Ramsay Report with recommendations aimed at ensuring independence and ethical behaviour with pressure however for Australian legislators to adopt the provisions of the Ramsay Report [20]. CLERP 9 adopts many of the Ramsay Report recommendations [7]. The Australian Securities and Investments Commission (ASIC) Commissioner, Berna Collier, in an address to the ICAA reported on an ASIC survey of Australia's Top 100 companies in relation to their independence from clients [6]. The results indicated that provision of non-audit services was widespread, almost 50% of total fees of audit firms emanate from non-audit services, rotation of audit partners is inconsistent and rotation of firms is almost non-existent, while on the positive side only a few companies had former audit firm's partners on their Boards or as senior executives, and the vast majority had an audit committee in place with appropriate operating guidelines. The United States has taken extreme measures of regulation of auditor independence in response to the Enron and WorldCom crashes, and the role of Andersens in these collapses, by introducing the Sarbanes-Oxley Act of 2002. [3]. The importance of this Act for Australia derives from its applicability to all accounting firms with a reporting responsibility in the US. Some provisions of the Act include the following: it is unlawful for an auditing firm to provide any non-audit services contemporaneously with the audit, excluding taxation services, partner rotation every 5 years, statement of existence of and adoption of a code of ethics for senior financial officers, and the provision to send shockwaves around the business community, financial statements filed with the SEC must be confirmed by both the CEO and CFO which must certify that statements comply with SEC requirements and that they present fairly in all material respects in relation to operations and financial conditions. The maximum penalty for violation of this condition is a fine not in excess of \$500,000 and a jail term of up to 5 years [3]. The Prime Minister John Howard, in a speech to the Securities Institute and ICAA in Sydney commented that while it was important not to overreact, the expectation of the Australian community was for good corporate governance at all times and that the Sarbanes-Oxley Act, with revisions, well might become law in Australia [12]. CLERP 9 has displayed some similarities with Sarbanes-Oxley by proposing the mandating of some corporate governance issues.

Some Australian corporations have taken strong stances on corporate governance and auditor independence. The self-regulation by both audit firms, as mentioned, and corporates, may forestall strong legislation to mandate certain features of independence as has occurred in the United States. Woolworths, for example, has responded positively by tendering out its audit every 5 years, prohibit former auditors from being directors, and excludes executives from the audit committee's interviewing and appointment of the auditor. The ANZ Bank who has defined three categories of non-audit services, one of which cannot be provided by auditors.

A post-script: ethical issues and how to present them to students

Can Business Schools afford to ignore ethics on the understanding that most ethical values are determined in one's early years? CLERP 9 has as one of its proposals "to promote and advise on the adequacy of the teaching of professional and business ethics by the professional accounting bodies and tertiary institutions [7 p. 1]." While undergraduates might have varied exposure to the corporate world they all face ethical dilemmas in their home, workplace, university, sport, club and community. An ethical framework can be grounded in some of these experiences. The identification of an ethical issue together with, for example, the use of the American Accounting Association model of ethical decision making to deconstruct the relevant issues, is of value. [9 p. 74]. We cannot prepare students for every potential scenario; we can provide them with some tools with which to recognize, analyse and find some resolution to ethical dilemmas. With this experience, perhaps when faced with dilemmas such as those facing the directors of Enron, WorldCom, HIH or Harris Scarfe, or their auditors, they may be able to rely on a framework which assists them in arriving at a decision which not only complies with the legal requirements set by legislators but also to the higher standard of ethical behaviour and good corporate governance. If our graduates take with them models for ethical behaviour and ethical decision making, self-regulation of the auditing profession may remain the standard in Australia.

A full reference list is available from the authors on request.