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Reportable irregularities and audit quality: Insights from South Africa

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ABSTRACT

In the aftermath of numerous corporate scandals and, more recently, the global financial crisis, the issue of audit quality is particularly relevant. Increasingly, numerous jurisdictions are relying on more exogenous forms of control over the audit profession in the interest of improving the quality of audit engagements and the reliability of audit reports. The purpose of this research is to examine the case for a form of mandatory whistle-blowing by South African auditors. Using an interpretive approach, this paper explores the association between a complementary reporting duty and notions of audit quality, recommending that a requirement for auditors to bring certain transgressions to the attention of an appropriate regulator can be a consideration for policy makers. At the same time, the research adds to the existing corporate governance literature by providing one of the first interpretive accounts of audit quality and reporting in a non Anglo-Saxon setting.

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1. Introduction¹

In South Africa, over and above the duty to express an opinion on a client's financial statements, the external auditor is expected to bring 'reportable irregularities' (RI's) to the attention of an independent regulator: the Independent Regulatory Board for Auditors (IRBA). This additional reporting requirement, which may be loosely regarded as a form of whistle-blowing, has its genesis in the 1950s when the South African Government took the position that auditors owed a duty to society to do more than just provide a generic opinion on financial statements. In the aftermath of a series of local corporate failures and international governance scandals (Konar et al., 2003; Manuel, 2002; Nel, 2001), the reporting duty was broadened and firmly entrenched in South African auditing practice under section 45 of the [Auditing Profession Act No 26 \(2005\)](#) (the APA).²

Although France, Malaysia, the United Kingdom and U.S.A. have similar reporting requirements, these exist often only in terms of the relevant auditing standards or apply in limited circumstances (Maroun & Gowar, 2012; Nel, 2001; Schultz, Johnson, Morris, & Dyrnes, 1993). In contrast, South Africa is one of the few jurisdictions where the auditor is faced with

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¹ Non-standard abbreviations include: Auditing Profession Act No. 26 of 2005 (APA); Independent Regulatory Board for Auditors (IRBA); International Auditing and Assurance Standards Board (IAASB); International Federation of Accountants (IFAC); International Standards on Auditing (ISA); material irregularities (MI's); [Public Accountants' and Auditors' Act No. 80 of 1951](#) (PAAA); Public Accountants' and Auditors' Board (PAAB); reportable irregularities (RI's); and South African Institute of Chartered Accountants (SAICA).

² This paper uses the terms 'section 45 of the APA' and 'RI provisions' interchangeably.

a generic duty to blow the whistle on stipulated client transgressions (Nel, 2001). This has been justified on the grounds that the standard audit report lacks sufficient depth, it being possible for the auditor to issue a clean report despite the occurrence of 'acts' or 'omissions' which may be contrary to the interests of various stakeholders (IRBA, 2006; Nel, 2001). The European Commission (2010a), International Auditing and Assurance Standards Board (IAASB) (2012) and Solomon (2009) make similar arguments, pointing out that, currently, audit reports ought to provide additional insights into audit findings in the name of enhanced governance.

To date, however, there has been little research on the impact of whistle-blowing on the audit profession. Some researchers have examined whistle-blowing in an internal audit setting (Kaplan & Schultz, 2007) or as part of the internal operations of external audit firms (Brennan & Kelly, 2007). The implications of reporting a client's wrongdoings for audit practice, quality and the standing of the external audit profession have not been examined in detail (Maroun & Atkins, 2014). Consequently, the objective of this research is to explore the perceived relevance of the South African reportable irregularity (RI) provisions for audit reporting and the quality of audit engagements. Using a correspondence analysis and detailed interviews, the research finds that the RI provisions, despite not leading to a significant change in audit practice, have made a positive contribution to the perceived usefulness of the external audit process. In particular, having a duty to bring transgressions to the attention of the IRBA – backed by sanctions for non-performance – stresses the relevance of auditor reporting as part of the corporate governance machinery.

While being relevant, in practical terms, for the local audit profession, the research contributes to the broad need for case-specific investigations of audit practice to complement the majority of audit quality research which tends to rely on inferential testing of quality surrogates (Humphrey, 2008; Power, 2003). Furthermore, this paper is one of the first studies on audit quality in an African setting, simultaneously shedding light on the relationship between external regulation, whistle-blowing, and external audit. In turn, the research speaks to the need for broader sectorial and jurisdictional analysis (Brennan & Solomon, 2008; Humphrey, Kausar, Loft, & Woods, 2011). Finally, due to the recent interest in expanding existing auditor reporting duties by numerous regulatory bodies (European Commission, 2010a; IAASB, 2012), understanding how a complementary reporting requirement in South African is associated with audit quality will prove interesting for regulators and practitioners in various jurisdictions.

This paper is organised as follows: Section 2 provides details on the duty to bring RI's to the attention of the IRBA. Section 3 discusses the prior literature on audit quality, introduces the quality control provisions based on International Standards on Auditing (ISA) and defines each of statements used for carrying out a correspondence analysis. Section 4 explains the method in more detail. Section 5 presents and discusses the findings and Section 6 concludes.

2. Reportable irregularities in South Africa

In terms of ISA, an auditor is required to express an opinion on the fair presentation of a client's financial statements (IAASB, 2009a; IRBA, 2011). In addition to this, South African auditors are obliged, in terms of section 45 of the APA (the RI provisions), to bring RI's to the attention of the IRBA. This is despite the duty of confidentiality and irrespective of whether or not the audit report is qualified; the RI has been rectified; or the matter has been communicated to those charged with governance (IRBA, 2006).

2.1. The reporting duty

Section 1 of the APA (2005) defines an 'RI' as 'any unlawful act or omission committed by any person responsible for the management of an entity,³ which:

- (a) 'has caused or is likely to cause material financial loss to the entity or any partner, member, shareholder, creditor or investor of the entity in respect of his, her or its dealings with that entity; or
- (b) is fraudulent or amounts to theft; or
- (c) represents a material breach of any fiduciary duty owed by such person to the entity or any partner, member, shareholder, creditor or investor of the entity under any law applying to the entity or the conduct of management thereof.

In terms of section 45(1)(a) of the APA '[a]n individual registered auditor . . . of an entity that is satisfied or has reason to believe that a reportable irregularity has taken or is taking place in respect of the entity must, without delay, send a written report to the [IRBA]'. The report must set out particulars of the RI, as well as other information considered appropriate by the auditor (section 45(1)(b) of the APA). Thereafter, within three days, the auditor must notify the client of the report issued and provide the client's management with a copy of the report (section 45(2)(a)&(b) of the APA). Management should be afforded a reasonable opportunity to discuss the report with, and provide representations to, the auditor (section 45(3)(a)&(b) of the APA). Following this, the auditor is required, within thirty days of issuing the first report, to submit a second report to the

³ The APA uses the term 'management board' which would include the board of directors or other body or individual(s) responsible for the management of the business of an entity (IRBA, 2006; s1 of the APA). This paper uses 'management' and 'management board' interchangeably.

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