11 February 2005

Director: Local Government Implementation
Office 1809
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Dear Sir

AUDITING PROFESSION BILL

In response to the request for written submissions to be made on the draft Auditing Profession Bill, our submission is given below for your consideration.

We believe our capital market system should be globally competitive and as such we support changes aimed at ensuring that the regulatory environment, including standards and ethics, are world class.

We therefore welcome the publication of the draft bill as well as consequential changes to the Companies Act for public comment. In particular we support the following:

- The implementation of standards that are comparable with international standards;
- Providing for effective oversight of the auditing profession;
- Requiring public interest companies to appoint audit committees; and
- Requiring rotation of audit partners as opposed to rotation of audit firms.

While there are many aspects in the draft bill that we fully support, there are nevertheless various issues that we believe should be reconsidered. These issues and related recommendations are detailed below. Section 5(3) of the draft bill will require the regulator to *'ensure the existence of clear and appropriate requirements to be complied with by any person wishing to register as an auditor.'* We believe the same should apply to the bill, but as noted below, we do not believe that some of the provisions in the bill are clear or appropriate.

1. Composition of Independent Regulatory Board for Auditors (IRBA)

The bill, in section 3, states that the Minister is to appoint the members of the IRBA and that not more than two-fifths of the IRBA are to be registered auditors. The Board of the present Public Accountants' and Auditors' Board (PAAB) is also appointed by the Minister, with no specified maximum proportion of registered auditors.

While we accept that in the current environment regarding governance issues that it needs to be seen that registered auditors are not regulating themselves, we have the following concerns:

- The bill proposes a maximum number of registered auditors on the IRBA, but no minimum number. In theory the IRBA could then have no registered auditors as members, which we not believe is acceptable. The auditing profession is increasingly adopting international standards and practices and we therefore believe the IRBA should include those who are knowledgeable about these standards and practices; these are likely to be registered auditors. In addition, we believe the IRBA needs to be careful in introducing requirements that are not in line with international requirements. We recommend that the IRBA should include a minimum number of registered auditors so that they can comment on the practicality, effect and advisability of introducing any requirements that differ from international practices.

- At the PAAB's fiftieth anniversary dinner the government representative who gave the keynote speech stated that he believed that the government needed to be more active in regulating the auditing profession. The need for this comment has been questioned as the government had the right, through their appointment of members to the PAAB, to be involved in regulating the profession. It appears that there have questions regarding the participation of some of the appointed members to the PAAB. Accordingly, there is a concern that the proposed IRBA might not be effective if the various members do not take their appointment seriously. We therefore believe that there should be a regular assessment of the contribution made by the various members of the IRBA and that this should be taken into account in determining whether a person should remain as a member.

2. International recognition of IRBA

In terms of the draft bill, the IRBA will be financed by levies payable by registered auditors. While this is consistent with how the PAAB is financed, it is likely to become more of an issue in the future, as we are increasingly following international standards and practices as noted above. This includes the view by some overseas regulators that for a local regulator to be seen to be independent of the auditing profession it should not be financed by the auditing profession.

Where this becomes an issue is in audits of multinational companies that might be listed on more than one stock exchange. Therefore more than one regulator might cover the audit of these groups. These regulators might only accept that the audit of certain foreign operations are being governed acceptably if they are satisfied with the standing of the local audit regulator, which includes their independence from the local auditing profession. In the absence of such recognition of other regulators some audit firms might be subject to oversight by more than one regulator, which is not desirable.

We believe therefore that the IRBA should be seeking international recognition as an independent regulator, meaning that registered auditors should not be responsible for financing it. It appears that recognition by various foreign regulators, who could have different requirements, might be dependent on the extent to which the IRBA is financed by auditors, with the extreme being that auditors should be not provide any funding.

3. Independence

Two-year independence requirement

We believe the proposal that a registered auditor may not audit the financial statements of an entity if the auditor or the auditor's firm has had a financial interest in that entity in the previous two years is not practical.

For example, this requirement would cover the following situations:

- Entities the auditor is requested to audit by the shareholders;
- Being requested to audit local subsidiaries of entities as a result of a change of auditors by the overseas holding company;
- Entities acquired by existing audit clients, and
- Entities in which an auditor held an interest prior to becoming a partner in an audit firm.

In the above situations an auditor is unlikely to know whether there is going to be change in auditor and accordingly to expect an auditor to not have any financial interest in all potential future audit clients is impractical. Practically it might mean that auditors cannot have any

financial interests in any entity because of the possibility that they might be required to audit that entity in the future.

We believe it is more practical to require an auditor to dispose of any financial interest the auditor has in an entity before being able to accept the appointment as auditor of that entity.

Definition of financial interest

We also believe that the definition of financial interest should be clarified. For example, while it is presumed that a financial interest would include shares in an entity and deposits and loans made to the entity, it is not clear whether it also covers loans from the entity and credit accounts. By way of example, if the definition is regarded as including credit accounts then it is unlikely that any auditor could accept the appointment of the sole fixed line telephone provider because of the difficulty of operating a business without fixed line phones.

The definition of independence also makes no reference to materiality so it would also relate to immaterial amounts.

Recommendation

Accordingly we recommend that the definition of financial interest be reconsidered to provide more clarity as what is being envisaged or being excluded by the proposed bill.

In addition, we question whether independence issues should be included in legislation, seeing that the PAAB's Code of Professional Conduct already covers these. Accordingly we believe that the Board for Auditor Ethics should consider independence issues. This will make it easier for changes to be made to independence requirements, when considered necessary, and also allow for interpretations to be issued, if required, on how independence requirements should be applied. For example, the proposed changes to the Companies Act refer to book-keeping, accounting and internal audit services, when the meaning of these terms might not be interpreted in a consistent manner by registered auditors. Some might believe that book-keeping services includes assistance with year-end adjusting entries, whereas others might believe that book-keeping refers to a regular provision of services and thus excludes once-off services in insignificant areas where an entity does not have sufficient expertise.

Section 20(3) of the bill deals with auditors performing accounting functions. Internationally this is becoming a less acceptable practice, especially for public interest companies, which is a major part of the public interest that the bill is dealing with. We believe that the Code of Professional Conduct should specify the limited number of circumstances when an auditor can provide such services and that this section should make reference to this service only being allowed if provided for in terms of the code. This compares to the present wording in the bill, which starts from the presumption that auditors can provide this service to all clients, with the restrictions on the provision of this service not being placed in this bill, but in the proposed changes to the Companies Act.

The Board for Auditor Ethics could also provide more guidance as to the meaning of financial interest and the extent to which it applies to immaterial interests.

If this recommendation is not accepted then we believe that the following aspects of independence as provided for in the draft bill should be reconsidered:

- The period that an auditor cannot have a financial interest in an entity before accepting the position of auditor in a company;
- The definition of financial interest;

- Only requiring the legislation to apply to material financial interests;
- Providing for a specified period (for example, one year) between an auditor resigning from a firm of auditors and accepting a management position with one of his/her previous audit clients; and
- Broadening the requirement in the proposed changes in the Companies Act from a nominated auditor not being able to provide certain services to state that the nominated auditor as well as any partner or employee should not provide the specified services.

4. Reportable irregularities

Comparison with present requirements

Section 22 of the draft bill is designed to replace the existing section in the Public Accountants' and Auditors' Act dealing with material irregularities. It is debatable how effective this requirement of the Act has been in resulting in companies and directors being prosecuted.

We question whether the new proposed requirement will be any more effective. In fact, the effect of the proposed section is that it will result in an increase in reporting, both to the IRBA and to appropriate regulators. We are concerned that the bill will require an auditor to report unsubstantiated contentions to external parties.

Materiality

The proposals are more onerous than the current requirements that only relate to material irregularities, as, in the requirement to report fraudulent acts, theft or dishonesty, there is no reference to materiality.

Even when the bill makes reference to 'material' items it will be difficult to apply in practice. For example, section 22(1)(a) and (c) refers to an issue being material to *'any partner, member, shareholder or creditor of the entity'* and thus requiring materiality to be viewed from the perspective of these parties. Without knowing who these parties are and their particular circumstances it is not possible to determine whether an issue is likely to be regarded by them as being material or not. One shareholder might regard the value of 100 shares as being material, whereas to another shareholder it might be the value of 1 000 000 shares. Accordingly we not believe that the requirements of the bill are capable of being interpreted in a consistent manner, except if all irregularities are reported.

Therefore we believe that reportable irregularities should only apply to material issues and that materiality should be considered in light of what is regarded as being material to the entity concerned.

Other interpretation issues

It is also not clear what dishonesty or breach of fiduciary duty comprises. Dishonesty includes issues that would be considered by some to be ethical issues and therefore subjective. For example, an entity might be applying for an increase in selling prices and gives reasons for increases, which might all be valid reasons, but is it dishonest, and therefore a reportable irregularity, not to mention some factors that could have resulted in a smaller increase being requested? In addition, is it a breach of fiduciary duty when the directors declare a dividend but have to borrow to fund the dividend, in a situation where the holding company told the directors to declare the dividend?

We are concerned with the lack of clarity in how this section should be applied, particularly as in terms of section 32 of the bill an auditor could be sentenced to a term of imprisonment of up to ten years for making a false report. Seeing that auditors are unlikely also to be lawyers or trained in all matters of law, it is necessary for the meaning of section 22 to be clear because of the potential serious consequences of not complying with this section.

Likelihood of rectification

Section 22(2)(a) of the bill requires an auditor to state whether it is likely that the irregularity will be rectified within 30 days. We question the practicality of this requirement seeing that the auditor may not know whether it will be rectified if the irregularity has not been discussed with the management board. It is onerous to expect an auditor to able to predict how such a board will respond to receiving a copy of a report on reportable irregularities. Furthermore, there is a practical difficulty in interpreting whether an irregularity can be corrected from a legal perspective. For example, if someone commits an offence and is tried by a court, then the court, in deciding whether the person is guilty or not, will not take into account any actions a person might have taken to mitigate the effect of the offence, but could take this into account in determining the extent of any punishment. Accordingly if stolen property is returned, in one sense the irregularity has been rectified, but on the other hand the fact that a theft occurred cannot be changed.

Disclosing the name of an auditor

Section 22(4) of the bill states that the IRBA is not to disclose the name of an auditor reporting a reportable irregularity when informing an appropriate regulator of such an irregularity, without the auditor's consent. We question the need for this requirement seeing that the information provided to the regulator is likely to only have been obtained from the auditor and the name of the auditor can be obtained from the Registrar of Companies. This means the regulator is able to know who in all likelihood provided the information and accordingly there doesn't seem to be any need for this requirement.

Recommendation

We believe the following should be reconsidered in respect of reportable irregularities:

- How to make the effect of reporting more effective as regards companies and directors being prosecuted;
- Whether reportable irregularities should be reported before the management board has had an opportunity to respond to the auditor's report;
- Which type of offences should be regarded as reportable irregularities, including requiring offences only to relate to issues that are material to the entity concerned;
- Providing clarity as to what constitutes reportable irregularities so that it will be applied consistently by auditors;
- Whether auditors should be reporting on the likelihood of future events without having discussed this with the management of the entity, and
- Whether there is a need for the auditor's name to be withheld when the IRBA reports issues to an appropriate regulator.

5. Practice issues

5.1 Multi-disciplinary practices

We are disappointed that the bill does not make provision for multi-disciplinary practices. As business has become more complex, some audit firms have employed 'partner-equivalent' persons to enable them to audit such entities. This includes persons with expertise in areas

such as tax, information technology and actuarial science. These persons can be an integral part of an audit team even if they are not registered auditors.

We believe that serious consideration should be given to providing for multi-disciplinary practices in future legislation, subject to a specified majority of the partners being registered auditors. This is necessary to ensure that firms have top people with experience to deal with areas auditors need to consider. In addition, there is a need for multi-disciplinary practices as a result of the challenge to attract and retain these people if they are not partners.

5.2 Registration as individuals

In addition, the bill provides for individuals to register as auditors. In certain cases, while one partner in an audit firm has responsibility to sign the audit report on a set of financial statements, that partner may not make the final decision about that audit opinion. Audit firms have risk management processes that could require, in particular circumstances, for the audit opinion to be approved by another partner or a committee of partners. If there was later a question regarding the appropriateness of the audit opinion, then it appears that the partner who signed the audit opinion would be investigated even though that partner did not make the final decision regarding the audit opinion.

In terms of *ISQC 1 – Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information and Other Assurance and Related Services Engagements*, which becomes effective in South Africa with effect from 1 July 2005, audit firms will be expected to have various risk management processes in place. These processes will not rely on one person, but will rely on a range of checks and balances during the course of an audit, dependent on a number of persons, some who will be partners while others would not be registered auditors, as well as including some who are not involved on the audit directly.

For these reasons we believe that consideration should be given to providing more emphasis on the registration and regulating of firms than individuals.

6. Rotation of audit partners

We support the proposed change to the Companies Act, where the nominated auditor of a public interest company can only serve as auditor of that company for a limited time.

However, we believe that the period suggested, namely four years, should be longer. It should be based on what is regarded as appropriate internationally, which indicates that a period of five to seven years is considered acceptable. This is particularly relevant in a South African situation for the following reasons:

- For some specialised types of audits (e.g. banks, insurance companies, pension funds etc) it can be difficult for a partnership to attract another partner with the same types of skills and it can take time to develop employees to be able to be promoted to partners in situations where there are no other partners with appropriate expertise.
- It takes time for partners to be fully acquainted with new audits, particularly large and complex audits. This means firms have to bear additional costs as a result of the rotation of auditors. It doesn’t appear sensible to require an auditor to rotate off an audit fairly soon after the auditor has become fully acquainted with the company being audited.

It should also be borne in mind that this proposal would become a problem to audit firms who consist of only one registered auditor.

Regarding the proposal relating to rotation of auditors, provision needs to be made as how it will be implemented. For example, it could require auditors on many audits to change

immediately and then again in four years time. Therefore we believe consideration should be given to a phased introduction of this requirement, so that it does not disrupt audit firms unnecessarily. This should be included in the transitional provisions in the proposed act.

In addition, the transitional requirements should also make provision, in the case of joint audits, that the various appointed auditors will not be required to change in the same year.

7. Determination of liability

Liability of auditors

Public indemnity insurance is a major area of cost to audit firms. In some cases it can be difficult or very expensive to obtain insurance cover for certain levels of potential exposure. One of the reasons for this is that when a company fails aggrieved parties might look to the auditor of the company to reimburse them for their losses.

This is an issue to auditors internationally. We believe that this issue needs to be considered because it can be a deterrent to attracting and retaining suitably qualified and experienced auditors. Such persons can consider the risks associated with auditing as being totally unique from other employment options available to them. We therefore firstly suggest the legislation should consider providing for limited liability partnerships, which are catered for in the United Kingdom and the United States of America. Such a partnership protects partners personally, but not their firm, from possible sequestration if the firm or one of the other partners is being sued. At present a partner could be sequestrated even if they had no involvement in an audit that lead to action being taken against the partner's firm. There is a need to attract suitably qualified people into the profession without them being too unduly exposed to possible financial risks and limited liability partnerships is one suggestion to deal with this issue.

While auditors accept that they should be held responsible for their actions, the law as it stands at present provides for joint and several liability. Accordingly an auditor could be required to pay for the full loss even though they are only to blame to a very small extent. As investors know that auditors carry professional indemnity insurance, they are more likely to sue an auditor, who might be able to recover their losses, than the parties who are the main reason for the losses suffered. Auditors can also suffer by having to spend an inordinate amount of time defending their actions.

This position is regarded as being unfair on the auditor in many situations. Accordingly auditors have believed for many years that liability should be determined in such a way that the auditor is only responsible for the proportion of the loss or damage that can be ascribed to the auditor based on the relative degree of fault. We therefore secondly suggest that the legislation should make specific provision for the determination of the auditor's liability.

The draft bill, in section 51 does refer to the Apportionment of Damages Act. This seems a strange area to place this reference, namely in a section dealing with repeal of laws, when in fact it is proposing, in effect, a definition of damage. In addition, the reference to this Act only refers to a contract concluded with an auditor. This means that the provision does not extend to other parties who might rely on an audit report or to a shareholder who has no contract with an auditor, which leaves the auditor to the mercy of common law principles of apportionment of liability. We believe that the Apportionment of Damages Act should apply to all parties who might want to sue an auditor.

Liability of directors and other parties

We believe that the proposed changes to the Companies Act should also make it an offence for directors, employees and others connected to companies to mislead or deceive auditors or to not provide material disclosures. This proposal was contained in the recommendations of the Ministerial Panel for the Review of the Draft Accountancy Profession Bill.

We do not believe it appropriate for changes to be made to the regulation of auditors, if the necessary changes applicable to other role players in audits are not dealt with.

8. Certified public accountant

Section 11(1) of the draft bill uses the title ‘certified public accountant’ in relation to an auditor in practice. As accountants and auditors are different professions, and increasingly auditors are not allowed to carry out accounting work on their audit clients, it is odd that an auditor in practice should have the word ‘accountant’ in the description of his/her profession.

Accordingly we believe that the word ‘accountant’ should be replaced by the word ‘auditor’ or that the description should be changed to ‘registered auditor’, which is similar to the present description.

9. Companies subject to audit

One area we expected to be covered by the proposed changes to the Companies Act is which companies should be subject to an audit. Internationally in many countries not all companies are subject to audit. We believe this is an issue that should be considered.

10. Registration of auditors

Transitional provisions

Section 52(3) of the bill provides for persons who will be registered as an auditor immediately prior to the proposed Act becoming effective to be deemed to be registered as an auditor in terms of the proposed Act. Section 10(2)(c) of the bill states that the IRBA may cancel the registration of a registered auditor who ceases to be a member of an accredited professional body.

In terms of the current Act, a person is not required either on application or later to be a member of an organized body of accountants and auditors, except that, in the case of a non-resident auditor, the person is required to be a member of such a body.

This means that some registered auditors might not be members of any accredited professional body when the proposed Act becomes law and could have their registration cancelled. Accordingly we suggest that the bill makes provision to require such auditors to become members of an accredited professional body within a reasonable period of time.

Accredited bodies and examinations

Section 6 of the bill provides for the accreditation of professional bodies, while section 5(1)(b) provides for the IRBA to set examinations. We question why the IRBA needs to set examinations if it accredits members of professional bodies. This suggests that being a member of an accredited body with *‘necessary competence to practise as an auditor’* (section 9(2)(d)) is not regarded as sufficient for registration as an auditor; a person is also required to pass the IRBA’s exams. This implies that the professional bodies are only partially accredited in that attainment of their requirements is not sufficient for registration as an auditor.

If the intention is that professional bodies be fully accredited then there does not seem to be a need for the IRBA to set its own exams.

This being the case, a definition of 'professional competence' as required for the accreditation of professional bodies should be considered for inclusion in the bill. For example, it is not clear whether this just covers the passing of exams or whether it also requires an assessment of whether the professional body determines whether prospective auditors have had sufficient appropriate practical experience as an auditor, including having worked for a registered auditor for a specified period. This should also enable the IRBA to assess whether the professional bodies' exams are of a suitable standard, obviating the need for the IRBA to set its own exams.

11. Attendance of auditor at annual general meeting

The proposed changes to the Companies Act will require auditors to attend annual general meetings and to *'respond to the best of his or her ability to any question which is put to him or her and is relevant to the audit of the financial statements.'*

While this appears to be a commendable requirement, it should be borne in mind that this requirement might not have the effect envisaged, as auditors, in terms of their Code of Professional Conduct, have a responsibility to respect the confidentially of information acquired during the course of an audit and may not disclose that information without authority, unless there is a legal or professional duty to do so.

This means that auditors are unlikely to be able to disclose information that goes beyond that provided by the directors or to provide much more information regarding the audit than is already included in the audit report. Accordingly we believe that the wording in the bill should be amended to clarify the auditor's responsibility in relation to confidentiality of information.

12. Public interest companies

We believe that the definition of a limited purpose company in the proposed changes to the Companies Act should be amended, as it is difficult to understand. For example, it can be read as meaning that a limited purpose company is a private company that is not a subsidiary of a public interest company. This would mean that each subsidiary of a public interest company, even if dormant, would be regarded as a public interest company. We do not believe it is practical to require each such company to appoint an audit committee nor to require the auditor to attend a directors' meeting and annual general meeting of that company. The definition, in addition, requires such subsidiary to be authorised to operate as a limited purpose company. The reason for this is not clear; it appears to state that if such company is authorised to operate as a limited purpose company it is still regarded as a public interest company. We question whether this was the intention of the legislation, seeing that this additional wording does not appear to have any effect.

If the intention is that subsidiaries, associates or joint ventures of public interest companies could elect to become limited purpose company, then we recommend that the wording in the definition be clarified.

In addition, we suggest that the legislation make it clear when unanimous consent is required. For example, must the consent be required before the start of a financial year or can it given at a later date, and if so, how much later?

13. Audit committees

While we support the requirement for public interest companies to appoint an audit committee, we are concerned with the requirement that the committee is to consist of at least three independent non-executive directors. Our concern relates to it being difficult to find a sufficient number of directors in South Africa to fulfill these positions. It is possible that all independent non-executive directors of a company will also be required to be members of the audit committee, when ideally the chairman of the company, who should be an independent non-executive director, should not be a member of the audit committee. This means that public interest companies would be expected to have at least four independent non-executive directors.

In addition, if the person is not allowed to receive any direct or indirect remuneration from the company, then there might be less incentive to become an independent non-executive director of a company in that the person is more likely to want to be regarded as a non-executive director than an independent non-executive director, because of extra income that could be earned, particularly in the case of professional non-executive directors.

Accordingly, we suggest that, at present, three should be regarded as the desirable number, as opposed to the required number, of independent non-executive directors.

Conclusion

If you would like to discuss any of the above comments with us or require clarity on any of the issues raised, please do not hesitate to contact Garth Coppin at Ernst & Young, PO Box 2322, Johannesburg, 2000 or alternatively on telephone 011 –772 3033, fax 011 –772 4033 or e-mail garth.coppin@ey.za.com

Yours faithfully

Ernst & Young