Consultation Response

DRAFT AUDIT PROFESSION BILL

Comments from the Association of Chartered Certified Accountants (ACCA)

February 2005

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Executive Summary

1. The Association of Chartered Certified Accountants (ACCA) welcomes the opportunity to comment on the draft Auditing Profession Bill and on the draft amendments to the Companies Bill which have been issued for comment contemporaneously.

2. ACCA supports strongly the aim of the draft Auditing Profession Bill, which is to establish an independent and transparent regulatory structure for the auditing profession in South Africa. Comparable arrangements are being set up in many countries around the world and are now being seen as necessary in order to restore business and public trust in the integrity of the profession.

3. The objectives, duties and powers to be allotted to the IRBA are extensive and take over many responsibilities which hitherto have been the preserve of the professional bodies. This will require substantial input in terms of personnel and financial resources. Without compromising on the overriding aim of independent regulation the Government should consider whether all the matters to be delegated need to be allotted to IRBA or whether some matters can be left to the professional bodies.

4. We welcome the commitment in the Bill to ensuring that the IRBA and the two standard-setting boards reflect the wider interest in the integrity of the audit process and support the inclusion of requirements which should ensure that the new bodies take into account the concerns of business and the public.

5. The Bill needs to be more specific on a number of key issues. These include the range of audit services to which the Bill's provisions will

apply, the advertisement of registered auditor status and the penalties that will apply for infringements of the law governing that status.

6. We have a number of detailed comments on the clauses in the draft Bill. These are set out on the following pages.

Specific comments

Preamble

7. The first recital of the preamble to the Bill states that 'the primary responsibility of the [audit] profession is to protect and promote the public interest through services rendered.' With respect, we consider that this statement is a factually inexact summary of the role of the audit profession.

8. The primary responsibility of the auditor is to the body which appoints him, which in the case of a company is its membership. Auditors are appointed by the members and have a statutory and contractual responsibility to those members to carry out their work to the best of their professional competence. It is the members of an audited entity who are the primary potential losers in any case of incompetent audit work and it is they who will usually have the right of legal recourse in respect of any loss they incur as the result of such incompetent work.

9. The fact that the law requires company accounts to be audited by a qualified, independent expert – and by virtue of the current Bill one who is subject to effective and transparent regulation - is a recognition that it is desirable for the law to intervene to ensure that investors' interests are protected from possible mismanagement via the audit process. In our view the concern to protect investors' interests in this way is not the same thing as a concern to protect the wider 'public interest'.

10. We consider that it is important to be clear about the nature of the auditor's primary responsibility at the outset in order to avoid misunderstandings occurring when considering detailed technical questions about the responsibilities of auditors. We accept that third party interests, including what may be termed the 'public interest', may additionally be affected by the quality of audit work and agree that these interests should be taken into account in establishing the new regulatory framework. But we consider that, though important, the impact of audit work on such parties is technically a secondary function of the audit process.

11. It would be more accurate, in our view, if any statement of responsibility in the preamble were to provide that 'the responsibility of the profession is to ensure that regulated audit work is carried out to the highest technical and ethical standards in the interests of stakeholders in the audit process'.

Chapter II - The Independent Regulatory Board for Auditors (IRBA)

Clause 4 – Objectives of IRBA

12. One of the key functions of the proposed IRBA will be to accredit new professional bodies and verify the status of those which are to attain accredited status via 'grand father' provisions, as well as to monitor the continuing compliance with the accreditation criteria. This discretionary function should be referred to specifically under the objectives and duties set out in clauses 4 and 5.

Clause 5 – Powers and Duties of IRBA

13. We have two comments regarding the proposed range of powers and duties for ISBA as set out in clause 5.

14. paragraph 5(1)(h)(i) provides that IRBA has the power to participate in the activities of auditing standard-setting bodies, both at home and abroad. It would be more appropriate in our view if such involvement were expressly attributed to the SBA, a body which, unlike the IRBA, will be comprised mainly of auditing experts.

15. Paragraph 5(1)(h)(o) gives the IRBA power to publish journals and publications containing information and guidelines relating to the audit profession. There is nothing untoward with IRBA issuing relevant material direct to auditors but suggest that the new framework should avoid duplication of resources. If IRBA is in future to issue material directly to auditors itself, it should restrict itself to material which is not likely to be issued to their members separately by the accredited professional bodies.

16. We also suggest that, with cross-reference to clause 24, the IRBA should be given the express power to set up arrangements to monitor the professional work of registered auditors.

Clause 6 – Requirements for Accreditation

17. Clause 6(2) says that, at the commencement of the IRBA's functions, any body which is currently accredited to the PAAB shall be considered to be accredited by the IRBA (although any such body must, within a year, satisfy the IRBA that it meets the new accreditation requirements. This clause is technically incorrect since, at present, no body is accredited to the PAAB. The PAAB only admits individuals who meet its criteria and not professional bodies at this stage. It needs therefore to be revised. Page: 8

18. We believe that registration at a particular level of the NQF, is not on its own, an appropriate criterion against which to judge the suitability of an education and training programme. The key is that such education and training should be relevant to auditors. We recommended that accreditation criteria which relate to the competences of auditors are established for education and training.

Clause 7 – Accreditation of Professional Bodies

19. Clause 7(2) should be amended to clarify that IRBA must accredit any body which complies with the requirements set out in clause 6 (rather than its own requirements).

20. Clause 7(3) states that, once accredited, a professional body must satisfy IRBA that it continues to comply with the formal requirements for accreditation *at least once a year*. This timescale seems to us unreasonable and is likely to result in an unnecessary bureaucratic burden both for the IRBA and for the individual accredited bodies. It will also create a climate of uncertainty for accredited bodies and their registered auditor members. We suggest it would be more realistic if the standard renewal of accreditation were to be carried out every three or five years, with a reserve power for the IRBA to carry out an interim renewal procedure in respect of any individual body if it had reason to believe that a body was no longer compliant with the rules. This would in our view be sufficient to ensure effective compliance.

21. The requirement in clause 7(5) for IRBA to cancel a body's accreditation should be made expressly subject to the provision in clause 7(6) (discretion of IRBA to allow conditional accreditation). This would be given effect by inserting as a preface the wording in section 7(5), "Subject to the provisions of section 7(6), the IRBA must cancel the accreditation…"

22. We note that there is no provision in the accreditation criteria for a body to have rules and practices which require their registered auditor members to comply with pronouncements issued by the SBA and SBE. We suggest that such a provision be added.

Clause 8 – Effect of Termination of Accreditation on Auditors

23. Clause 8 provides that individual auditors who are members of a body whose accreditation has been terminated have six months to become members of another accredited body, failing which they will lose their status as registered auditors. This process must be careful not to penalise the individual auditor for the failings of his or her professional body in meeting the compliance requirements of the new legislation. The process will not work if it proves impossible for an auditor from a terminated body to secure membership of another, still accredited body. It is therefore essential that the Government ensures that auditors are treated fairly within the new framework. If it is not possible to ensure that in all cases accredited professional bodies accept an auditor from a terminated body as a full member, an alternative approach could involve scaling down the current provisions which insist on acquiring membership status of another accredited body. Instead, a person who is not accepted for full membership could secure continuing registered auditor status by virtue of his agreement to abide by the rules and regulations of the accredited body and be subject to the regulatory control of that body. Such a person would of course also be subject to the regulatory control of the IRBA.

Clause 9 – Registration of Individuals as Auditors

24. Clause 9(4) says that the IRBA may decline to register a person who has entered into a compromise with creditors or who has been

provisionally sequestrated. We would hope that the IRBA will adopt a pragmatic approach on this matter and avoid penalising individuals for past events where those events have no bearing on their ability to conduct audit work to the required standards in the future.

Clause 11 – Practice by a Registered Auditor

25. There needs to be a tighter definition of what services are to be restricted by law to the registered auditor. This should not restrict the provision of accountancy services other than audit. The definition needs also to be coherent with the definition of 'practice' contained in clause 1. We suggest the following as a possibility for clause 11(1):

26. 'No person except a registered auditor may engage in practice as an auditor'.

27. The definition of 'practice' in clause 1 could be re-worded to read

28. ''Practice' for the purposes of this Act includes accepting appointment as an auditor and holding oneself out as being capable of accepting appointment as auditor'.

29. We understand that the intention of the legislation is to regulate the provision of audit services of all kinds, i.e. to corporate bodies and non-corporate bodies and non-profit-making bodies alike. If this is not the intention, then the definition of 'practice' must identify the range of audit services which are to be restricted to registered auditors. Given that there will be a financial cost for the new system of regulation, a cost which will inevitably be passed on ultimately to auditors' clients, the Government should consider whether individuals and firms which provide audit services to some categories of entity, such as charities or charities which fall below a specified size threshold, should be exempt from the regulatory framework.

30. There needs to be a suitable statutory penalty, probably set out in chapter VI, for infringement of the rule that only registered auditors may provide restricted services.

Clause 12 – Registration of Firms

31. In the interests of clarity it would be helpful if current clauses 10 and 11 could come after clause 12 so as to make clear that those provisions apply to firms as well as individuals.

Chapter III – Subsidiary Boards

Clause 17 Composition of the SBA

32. Given that the first duty of the SBA is to develop technical auditing pronouncements, we consider that the provisional composition of the SBA contains an inadequate representation of practising auditors. We appreciate the desirability of involving persons such as those listed in clause 17(1) and agree that the concerns of a wider group of stakeholders should be brought to bear. We suggest however that, if the SBA is to perform its given function as an expert body, it should comprise at least a bare majority of registered auditors.

Chapter IV – Powers and Duties of Registered Auditors

Clause 20 – General Obligations of Registered Auditors

33. Clause 20(2)(a) requires the auditor to satisfy himself that he has carried out the audit 'free from any restrictions whatever'. This is a very wide-ranging criterion and could conceivably encompass peripheral issues such as staff absences etc. We suggest it would be more reasonable and focused for the Bill to require that the auditor

satisfy himself that he has been able to carry out the audit 'free from any obstructions relevant to the proper performance of his duties'.

Clause 21 Auditor having Financial Interest

34. Clause 21 forbids a registered auditor from conducting the audit of an entity's financial statements, either on an individual basis or as a member of a firm, if he has had a 'financial interest' in that entity at any time during the previous two years. This leaves open the possibility that a firm may take on the audit of an entity in which one of its partners has had a financial interest as long as that partner is not the appointed engagement partner. This is an issue which the SBE will doubtless wish to consider making further pronouncement on.

35. There will also need to be rules to address whether the restriction on providing audit services, where the auditor has or has had a financial interest in the entity, should be extended to connected persons of the auditor or audit firm. Again, it is for consideration whether such rules need to be set out in law or in ethical standards.

Clause 22 – Auditor's Duty to Report Irregularities

36. The workability of the requirement to report irregularities revolves around the definition of reportable irregularity. The current definition in clause 22(1) is extremely wide, and covers any unlawful act committed in the conduct of the management or control of an entity. The definition should be linked to a criterion of proportionality, based on an understanding of the sort of information, and the amount of information, which the regulatory body may need in order to be able to fulfil its own functions. We suggest that a more proportionate approach would be to specify, in the definition, that reportable irregularities are unlawful acts or omissions *which are relevant to* the conduct of the management or control of an entity'.

This more focused definition would, we consider, be sufficient to produce relevant information for the regulator while reducing the risk of meaningless or innocuous reporting.

37. Under clause 22(3), the auditor has to inform IRBA forthwith of any possible reporting irregularity but may follow this up within 30 days with another notice to say that he is now satisfied that no reporting irregularity has taken or is taking place. Despite this, IRBA is required to notify the regulatory body of the entity concerned once the initial report has been received. Given that the Bill recognises that an initial suspicion on the part of the auditor may be overridden by subsequent evidence, it seems inconsistent that the IRBA is required to report the initial suspicion immediately to the regulatory body. It would be more appropriate to delay the implementation of IRBA's own reporting duty until the expiry of the auditor's 30 day reflection period. The provision in clause 22(6) for IRBA to make a second report to the regulatory body if the auditor subsequently considers there is not irregularity would simply cause more bureaucracy.

38. Clause 22(4) says that IRBA must disclose any report of a reportable irregularity to the regulatory body of the entity concerned, but need not disclose the source of the report without the auditor's consent. We query how useful this latter provision will be since it will be apparent that the IRBA's information has come from the entity's auditor.

39. Under clause 22(7), the IRBA may disclose any information provided to it under this section to all or any of the specified list of persons, including members and creditors of the entity concerned. This seems to us to be a wide and unspecific power, especially since the matter reported on by the auditor need not be proven to be a breach of any law. It would be more appropriate if the wider disclosure of the kind considered here was delayed until a proper investigation had been

carried out and a conclusion reached as to whether the matter in fact constituted a breach or not. After all, the purpose of the auditor reporting such matters should be to give the appropriate regulatory authorities information on the basis of which they can carry out investigations and, where necessary, take effective remedial action – it should not be for their information to be simply made public.

Clause 23 - Limitation of Auditor's Liability

40. We have no problems with the provisions of clause 23 on auditors' liability as they stand. We consider however that the clause could usefully go further and establish a statutory principle that the auditor's liability to the client should be determined on a fully proportionate basis. This would provide that, where an opinion, report or statement from the auditor is found to be defective, the auditor may be held liable to the extent of his own responsibility for that negligent opinion, report or statement, but he should not be responsible in respect of the negligence of other parties who may have had their own responsibilities for the information on the basis of which he made his report, opinion or statement. Such a formula would be especially appropriate in respect of the audit opinion on a set of company accounts, the primary responsibility for which lies with the company's officers. The rule of law whereby an auditor can be held wholly liable for loss caused to shareholders as the result of a negligent audit report, even though the client company's directors may have been largely to blame for misleading the auditor, is now increasingly seen as being defective. Statutory rules introducing the principle of proportionate liability have already been introduced in the US and most recently Australia, and a version of it is likely also to be introduced in the near future in the UK. We consider that this would be an appropriate occasion to consider its introduction in South Africa.

Clause 24 – Practice Reviews

41. Clause 24(1) provides that the IRBA *may* review the practice of a registered auditor. We consider that the IRBA should implement a standard programme by which the work of all registered auditors is reviewed at standard intervals, as is currently provided by the PAAB. Such programmes have been implemented in the US under Sarbanes-Oxley and will shortly become a standard legal requirement for the regulation of statutory auditors in the EU. Since the IRBA is to be charged with implementing internationally comparable standards of auditing in South Africa, we believe that practice reviews should become a priority issue for it. Ideally an objective to this end should be included in the Bill.

42. We recommend that any adverse review findings should result in consideration by the IRBA of whether a firm is fit to continue as a registered auditor. There should, accordingly, be provision in clause 10 for the IRBA to cancel or suspend the registration of a registered auditor or firm whose performance has been judged to be seriously defective. Monitoring reviews, in due course, need to be performed by a dedicated team employed solely to perform this function, as is the case in the UK or through a peer review system as is the case in the US. ACCA will be pleased to share with the new regulatory body information from its substantial experience of European Practice Review systems.

Chapter V – Disciplinary Matters

43. It is important that the Bill makes clear that no person who has taken part in the consideration of a case at the investigation committee stage should be permitted to sit in judgment on the same case when it is considered by Disciplinary Tribunal or Disciplinary Committee.

44. Clause 30(7) states that, if the disciplinary body finds an allegation proven, it may impose any prescribed punishment against the auditor. The range of punishments need to be listed in the Bill. These should include fines, suspensions from authorisation to practice and, for the most serious cases, cancellation of registration.

45. By virtue of clause 31(2), the disciplinary body may impose an order for costs 'unnecessarily incurred' against the subject of a complaint even where that person has been found not guilty. This seems very unfair. If the allegations are found to be groundless, then the costs incurred in bringing the proceedings will have been incurred by decision of the IRBA, not the subject of the complaint. Preventing IRBA recovering costs where the defendant is found to be not guilty would help ensure that in every case IRBA considers the strength of allegations very carefully before bringing formal proceedings.

46. There needs also to be provision for a right of appeal, in the event that a registered auditor is dissatisfied with the outcome of the disciplinary process.

Clause 34 - Offences

47. We strongly support the provision in clause 34(2)(b) to the effect that registered auditors should not sign any report et al unless the work concerned was performed by them or under their personal supervision. This provision is essential in order to ensure that audit work is not carried out by an unqualified person and then 'rubber stamped' by a qualified person. In contrast, we object to the exemption clause in 32(3), which purports to say that the above provision does not apply where work is performed by one registered auditor on behalf of another. We believe that such a measure defeats the object of 34(2)(b) – appointed auditors should always assume full

responsibility for the work that they are engaged to carry out. We strongly urge the deletion of clause 32((3)(a).

48. There is no requirement in clause 32 for an auditor to sign his audit report as 'registered auditor' or to list his status as such on his business stationery. We believe that both are necessary measures.

49. One relevant matter which is not addressed in the Bill is whether the law should provide for sanctions for company directors who knowingly mislead auditors. Clause 22 provides for the auditor to report irregularities, and clause 20 requires the auditor to satisfy himself that he has not been obstructed in the audit process. But there remains, we suggest, scope for the law to intervene to sanction directors who knowingly mislead their auditors. (We accept that such a sanction would probably be more appropriate in companies legislation). Another alternative would be to follow the example of Sarbanes-Oxley and require CEOs to vouch personally for their companies' financial reports. Consideration should also be given to requiring each listed company to appoint a qualified accountant (not necessarily the CEO) as the designated person reporting to the audit committee and charged with ensuring the adequacy of disclosure.

Chapter VII – Procedural Matters

50. There appears to be no maximum duration for service on either IRBA or the subsidiary boards. We suggest that a fixed yet reasonable cap on the length of service, e.g. three three-year terms, would be in the interests of transparency.

PROPOSED AMENDMENTS TO THE COMPANIES BILL

51. We set out below our comments on the terms of the proposed related amendments to the Companies Bill, which have also been issued for public consultation.

Audit Committees

52. ACCA strongly supports the establishment by publicly traded companies of audit committees. We believe audit committees can play a major role in reinforcing the integrity of the whole reporting process.

53. The proposed amendment would require that members of audit committees must be 'independent' non-executive directors (NEDs). We agree that this is an appropriate qualification for committee members. The criteria proposed for defining independence are suitable as far as they go but they could be added to. There is no provision, for example, for imposing a length of service cap as a condition of independence, as has been adopted in the EU. The rationale for adding a service cap would be to ensure that NEDs do not become too close to the company's executive and its internal structures that they cease to be able to adopt an appropriately objective stance with respect to the financial reporting process.

54. We fully recognise the practical problems which will face publicly traded companies in finding suitable independent NEDs and accept that the law should not demand more than can be achieved in practice. But we recommend that the law and best practice guidance should keep under review the need for further elaboration of the definition of independence in this context.

55. With respect to paragraph 2.3.2 of the Government's consultation summary, we note that the committee will be required to nominate 'an auditor' for appointment. Given the distinction made between the audit firm and the appointed auditor, we suggest that the term 'auditor' in this context will need to be clarified.

Appointment of the Firm as Auditor

56. The proposed amendments would require the formal designation of one individual within an audit firm as being the 'appointed auditor' of the client company. It is standard practice for an audit firm to appoint one of its number to be the engagement or lead partner on a particular audit. But the proposed amendment would formalise this process and impose separate statutory obligations on the appointed auditor, e.g. to attend board meetings and the company's general meeting.

57. We are not convinced that there is anything to gain from the proposed formalising of the role of the appointed auditor. Under the Audit Profession Bill, firms will have to meet stringent qualifying conditions in order to become registered audit firms. It is also the case that any individual engagement partner will rely heavily for the conduct of his or her audit on the internal quality control procedures of the firm (another mater which will be regulated by the aforementioned legislation). Having a statutory status as appointed auditor may cause practical difficulties where, for any justifiable reason, the appointed auditor was unable to attend a scheduled meeting.

58. We would suggest that an alternative approach, which would avoid unwanted practical problems, would be for the law simply to require the audit firm to notify the client company of the name of the

individual registered auditor who will be the lead partner for the engagement. Related provisions of the Bill should also ensure that the duty to attend meetings should apply wherever possible but with reserve permission for another registered auditor to attend where necessary.

Rotation of Auditors

59. We support the provision to rotate audit partners within a firm rather than the firm itself. We agree that this is the correct approach. There is no evidence that mandatory rotation of firms has any beneficial effect on the quality or integrity of the audit process. We would only comment here that the proposed limit of initial appointment, of four years, is rather short in comparison with international practice. We suggest that the EU's rotation period of five years be considered as an alternative.

Approval of Non-Audit Services

60. We note that the proposed amendments would impose strict limitations on non-audit services which may be provided by the appointed auditor but would not necessarily impose comparable restrictions on the audit firm itself. The Government needs to consider whether this is what it wishes to achieve in this regard.