KPMG comments on the proposed amendments to the Companies Act, 1973 and the Draft Auditing Profession Bill, 2004

11 February 2005
This report contains 22 pages

Contents

1 Introduction

KPMG welcomes the proposed amendments to the Companies Act 61 of 1973 as well as the Draft Auditing Profession Bill, 2004. The process of reviewing the auditing profession has been initiated globally and we welcome the Ministerial and regulatory initiatives within South Africa, as an important step in keeping the local auditing profession in line with global trends.

We value these proposed amendments as an important first step in driving the quality of financial reporting in South Africa. However, it is important that legislation and regulation look beyond the role of the auditor to the role of corporate directors and other role players (such as investment analysts, merchants bankers etc) in the end-to-end value chain of financial reporting.

KPMG believes that to attract and retain foreign investment in our economy, SA has to be in-line with global trends and regulations. Approximately 80% of multinationals are audited by one of the big four global auditing firms. South Africa should not have more stringent regulations than those of the markets in which our local companies operate internationally. Such a situation will make it increasingly difficult for local companies to attract foreign investment and will hamper the South African initiatives of harmonization.

In general, KPMG South Africa supports the proposed amendments in both the Companies Act, 61 of 1973 and the Draft Auditing Profession Bill, 2004 as suggested, but we take this opportunity to provide additional input on certain proposed amendments.

We have structured this comment letter into the following sections:

- Section 2 – Comments on the proposed amendments to the Companies Act, 1973
- Section 3 – Comments on issues not addressed by the proposed amendments to the Companies Act, 1973
- Section 4 – Comments on the Draft Auditing Profession Bill, 2004
- Section 5 – Comments on issues not addressed by the Draft Auditing Profession Bill, 2004

2 Comments on the proposed amendments to the Companies Act, 1973

2.1 General comment

We appreciate that the summary on the proposed amendments to the Companies Act was released to facilitate and enhance public consultations on the Auditing Profession Bill, and although most of the principles in the proposed amendments are clear, we wish to emphasise that the actual wording of these amendments to the Companies Act will have to be subjected to further public scrutiny before enactment.

These proposed amendments to the Companies Act should not be viewed in isolation, as there are various other initiatives currently affecting the Companies Act, including the corporate law reform project and the Financial Reporting Bill changes that may affect the fourth schedule of the Companies Act.

2.2 Public interest companies

- **We believe that the scope of the proposed amendments should be restricted to listed entities, and only those financial institutions, unit trusts, asset managers, retirement funds, pension funds and medical schemes of significant size.**

The definition of a public interest company is ambiguous and a result in a much wider scope than we believe is necessary. The definition is also potentially at odds with the other developments in the company law field.

Some of the points of clarification include:

- Listed entities – it is not clear if the definition applies to entities listed on the JSE Securities Exchange or any other exchange in the world.
- The inclusion of financial institutions regardless of size or if the financial institution has any public shareholders.
- The effect of the definition in a group situation may also be problematical as the group structure could include various dormant companies, unlisted entities and privately owned entities.

Some further potential problems are set out below.

As highlighted in our original submission to the Ministerial Panel, we believe it is important that any restrictions and requirements be applied only to listed and other public interest companies of reasonable size and not to all entities. In particular, the cost of over regulation of smaller and privately held entities will have a negative impact on the economy. In addition, we have a severe shortage of skilled professionals in South Africa (both auditors and suitably qualified management and directors of entities), and we should not adopt an over regulated approach that further drives out or fails to attract and retain skilled professionals in our economy.

As indicated in our original submissions, we believe that the proposed amendments should be restricted to listed entities, and only those financial institutions, unit trusts, asset managers, retirement funds, pension funds and medical schemes of significant size.

The inclusion of private entities and unlisted public entities is contrary to global trends, as the objective of the proposed restrictions and amendments are aimed at protecting public investor interest. The proposed amendment for the establishment of an independent audit committee for a privately owned entity is ordinarily not required as the company's owners are often closely involved with the affairs of the business.

Practically the inclusion of many privately held entities could create very distinct problems in South Africa, especially in the case of foreign subsidiaries If a foreign subsidiary meets the definition of public interest company, which is required to have an audit committee and its members should be "independent". This situation would be very unusual for subsidiaries of foreign entities. Directors of the oversees parent company would probably represent the shareholder on the audit committee of the subsidary. It may be difficult for them to meet the independence test.

It will also be very difficult and costly for small companies (if the definition public interest company applies) to find three independent non-executive directors to serve on the audit committee.

The proposed definition of a public interest company is by reference to a private company. We understand that other changes to the Companies Act might consider removing the term 'private company'. We emphasise that these proposed changes should be considered with the proposed changes in the coproprate law reform project currently underway.

2.3 Audit committees

2.3.1 Obligation to appoint an audit committee

- **We support legislating the role of the audit committee.**
- **We suggest that the proposed definition of "independent director" in the proposed amendments be refined.**
- **We believe the powers and responsibilities of the audit committee vis-à-vis the board of directors are unclear.**

As indicated in our previous submissions, **we support legislating the role of the audit committee** and we agree that a properly constituted audit committee should be responsible for appointing the external auditor, for establishing the scope of work and agreeing audit fees with auditors.

The mandate and charter of the audit committee will have to be clearly defined and in addition, audit committee members should be subject to the same sanctions as directors where they act recklessly or fraudulently.

We suggest that the proposed definition of "independent director" in the proposed amendments be refined. As it stands at present, a director is regarded independent if the director "does not receive any direct or indirect remuneration or other benefit". We submit that it will be impossible to find a person willing to serve as independent non-executive director on an audit committee without any form of payment for these services.

The Investment and Financial Services Association's (IFSA) definition of an independent director is well accepted. Under the IFSA definition, an independent director is a director, who is not a member of management (a non-executive director) and:

- is not a substantial shareholder of the company, or an officer of, or otherwise associated directly or indirectly with a substantial shareholder of the company;
- has not within the past three years been employed in an executive capacity by the company or another group member or been a director after ceasing to hold any such employment;
- is not a principal of a professional adviser to the organisation or another group member;
- is not a significant supplier to or customer of the organisation or another group member or an officer of, or otherwise associated directly or indirectly with, a significant supplier or customer;
- has no significant contractual relationship with the company or another group member other than as a director of the organisation; and
- is free from any interest and any business or other relationship that could, or could reasonably, be perceived to interfere materially with the director's ability to act in the best interests of the organisation.

Examples of other definitions of independence include:

- the Sarbanes-Oxley Act of 2002, which defines independence as not receiving, other than for service on the board or any board committees, any consulting, advisory, or other compensatory fee from the organisation, and as not being an affiliated person of the organisation or any related organisation; and
- the requirements of the New York Stock Exchange, which are that an independent director has no direct or indirect material relationship with the organisation; that his/her only remuneration from the organisation be as a director; and that has not been an employee of the organisation, or partner or employee of the independent external auditor, for a period of five years.

We believe the definition should be amended to clarify that the independent director should not receive remuneration "other than for service on the board or any committees" and additionally should incorporate the clarifications as per the IFSA.

We believe the powers and responsibilities of the audit committee vis-à-vis the board of directors are unclear. The audit committee should ideally operate as a sub-committee of the board of directors and no decisions can be taken by the audit committee without the consent of the board of directors.

With this in mind, it is also important to keep in mind that the board of directors delegates some of their responsibilities to a suitable empowered, appropriately structured and well-informed sub-committee (the audit committee) to take decisions on their behalf and thereby reducing some of the workload. Without abdicating responsibility, the board of directors should not be in situations where they feel the need to override the audit committee decisions.

2.3.2 Functions and funding

- **We support the proposed functions of the audit committee.**
- **One of the main functions of the audit committee is not only to implement a policy for determining the nature and extent of non-audit services the auditor is permitted to perform, but to also formally approve these non-audit services as they arise.**
- **The audit committee may be in the best position to evaluate and set remuneration levels for additional assurance services provided by the independent auditor.**
- **The audit committee should review the financial statements and recommend them for approval by the board of directors.**
- **The audit committee should focus their review on the appropriate application of accounting policies and principles in terms of the appropriate financial reporting framework.**
- **We suggest that the proposed amendments include a requirement that the audit committee should consist of at least one financially literate member.**

We support the proposed functions of the audit committee, however emphasise that these functions should include the international trends emerging. Below we have set out our specific comments on each of the proposed functions of the audit committee, where applicable.

To nominate an auditor for appointment who, in the opinion of the audit committee, is independent of the company.

Referring to the definition of "independent auditor" in the proposed amendments, the following requires additional clarity:

- 'connected'

- "Where a registered auditor has previously been appointed as auditor of the company, [the] audit committee must consider whether the auditor's independence may have been prejudiced as a result of such an appointment." It is not clear if this sentence implies that an annual evaluation of the auditor's independence must be performed by the audit committee. Although this concept is in line with international trends and is a current requirement of the Companies Act, the auditor's independence should not be impaired by the mere fact that he/she was appointed in the previous year. Internationally, the external auditor provides an annual written declaration to the audit committee that he/she is still independent in fact and appearance. Moreover, the concern around an auditor's prolonged appointment is adequately addressed through the rotation requirements.

"Independence" is a term clearly defined in the International Federations of Accountants' (IFAC) Code of Ethics and may be used to provide a conceptual approach to be used in South Africa.

IFAC defines "independence" as:

a) *Independence of mind* – The state of minds that permits the provision of an opinion without being affected by influences that comprise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

b) *Independence in appearance* – The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.

The following five principles of independence incorporated in the IFAC code are:

- **Self-interest threat** (a firm or member of the audit team should not have a financial interest in, or other self-interest conflict with, an audit client)

- **Self-review threat** (an auditor should not audit his or her own work / the audit team should not include a person who was previously a director or officer of the client)

- **Advocacy threat** (a firm or member of the audit team should not promote or be seen to promote a client's position or to represent a client)

- **Familiarity threat** (a firm or member of the audit team may not have a close relationship with an audit client, its directors, officers or employees that causes too sympathetic an attitude to the client's interests)

To determine the fees to be paid to the auditor and the auditor's terms of engagement.

Although the proposed amendments indicate that the audit committee should determine the fees to be paid to the auditor and the auditor's terms of engagement, it is unclear if this requirement applies to audit services only, or the wider range of assurance engagements performed by the external auditor.

In light of the current developments in engagement standards issued by IFAC, the auditor is permitted to perform a wider range of assurance services for a client and **the audit committee may be in the best position to evaluate and set remuneration levels for additional assurance services**.

To determine the nature and extent of any non-audit services which the auditor may provide for the company.

This requirement is sound in terms of international trends, however **one of the main functions of the audit committee is not only to implement a policy for determining the nature and extent of non-audit services the auditor is permitted to perform, but to also formally approve these non-audit services as they arise**. The amendments to the Companies Act should include a restriction on the audit committee that this pre-approval may not be delegated to management and should be provided before the commencement of any non-audit service.

The audit committee may be permitted to delegate the pre-approval responsibility to certain members of the audit committee or in line with an agreed pre-approval policy, however all decisions should be tabled at the following audit committee meeting for ratification.

To insert a statement in the financial statements as to whether or not the audit committee is satisfied that the financial statements and any audit of them are in compliance with the provisions of any applicable law and that the auditor is independent of the company.

We agree that this function is a valuable contribution from the audit committee and that in fact in terms of international trends; **the audit committee should review the financial statements and set them forth for approval by the board of directors.**

The term 'applicable law' is a grey area under the auditing standards and even the extent of the auditor's responsibility to evaluate a client's compliance with laws and regulations is currently a hotly debated issue. For an audit committee this would be an even greater risk exposure to certify that the financial statements are prepared in terms of any applicable law as this requirement would imply that every audit committee must have at least one legal expert as member.

Of greater importance would be to evaluate that the financial statements comply firstly with the financial reporting framework adopted by the company and **the audit committee should focus their review on the appropriate application of accounting policies and principles in terms**

of the appropriate framework. This framework should further comply with the provisions of the Companies Act and specific laws applicable to the company's preparation of the financial statements e.g. the Banks Act.

The proposed amendments do not incorporate any requirement for the audit committee to include financially literate members. Internationally, as well as in South Africa, there are various requirements regarding financial literacy or expertise of audit committee members.

King II on corporate governance requires the majority of members of the audit committee to be financially literate.

The Combined Code in the United Kingdom incorporates the requirement that the board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience. It also states that it is desirable that the committee member whom the board considers to have recent and relevant financial experience should have a professional qualification from one of the professional accountancy bodies.

Of all regulations on financially literacy, the Sarbanes-Oxley Act (SOx) in the United States and the Securities and Exchange Commission require each issuer to disclose whether or not, and if not, the reasons therefore, the audit committee of that issuer is comprised of at least one member who is a financial expert, as such term is defined by the Commission. In defining the term `financial expert' the Commission considers whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, controller, or principal accounting officer of an issuer, or from a position involving the performance of similar functions:

- an understanding of generally accepted accounting principles and financial statements;
- experience in:
    - the preparation or auditing of financial statements of generally comparable issuers; and
    - the application of such principles in connection with the accounting for estimates, accruals, and reserves;
- experience with internal accounting controls; and
- an understanding of audit committee functions.

The requirements above range from financial literacy to financial expertise. SOx clearly defines financial expertise as an in-depth knowledge of accounting and auditing standards, as well as a thorough knowledge of the company and the industry in which it operates. Contrary to expectation, financial literacy in audit committees is not clearly defined and could be explained as a working knowledge of accounting and auditing standards.

We suggest that the proposed amendments include a requirement that the audit committee should consist of at least one financially literate member.

2.3.3 Appointment of the external auditor

- **We believe that the audit committee is the appropriate body to recommend to the shareholders the appointment of the external auditor and we subscribe to the international trend where the audit committee appoints the external auditor, determines the scope of the external audit, and negotiates the appropriate level of remuneration.**

The proposed amendments refer to a requirement that "a public interest company" may appoint an auditor other that the one nominated by the audit committee. It is unclear if this requirement refers to the board of directors or the shareholders of the company. The trend internationally is that the audit committee nominates the external auditor after evaluating the auditor's independence and capability, and the shareholders formally appoint the external auditor at the Annual General Meeting.

If this requirement enables the board of directors to veto the nomination of the audit committee, the consequence will be (even if unintended) no different from the current situation where the board of directors can be strongly influenced by management in appointing the external auditor.

2.4 Filling of casual vacancies

- **We do not agree that the "directors" propose to the audit committee a registered auditor to become the new auditor in the instance of a casual vacancy**.

This is contrary to the principle that the audit committee must evaluate prospective external auditors and nominate an appropriate candidate to be appointed by the shareholders. These comments should also be read in conjunction with our comments on the roles and responsibilities in section 2.3.1.

The proposed amendments do not include the definition of the term 'casual vacancy'.

2.5 Appointment of firm as auditor

- **We agree in principle with the proposed amendment that, in addition to the name of the firm, the name of the individual registered auditor is needed to appoint a firm as auditor.**

In a group situation, practically, additional guidance will be required to clarify to which level of the group this requirement will apply. In the example of a multi-national group, the local registered auditor, who will sign the local statutory opinion, often is not the actual individual taking responsibility for the entire group. This work is ordinarily performed on a referred basis and the local audit firm is not appointed by the local statutory company.

We recommend that the "appointed" auditor be the name of the individual responsible for signing the audit opinion.

2.6 Rotation of auditors

- **We agree that mandatory partner rotation should address the perceived relationship build-up between senior client staff and the audit firm.**
- **We believe that the time limit of four years as proposed in these amendments should rather be in line with international trends.**
- **We recommend that the individual appointed as the auditor to sign off the final audit opinion rotate after a period of seven years with a two year cooling off period.**

The proposed amendments for partner rotation refer to the term "nominated" auditor. This term is not defined in terms of the summary and we believe that the correct term in this section should refer to the individual "appointed" as the auditor to sign the final audit opinion. Practically the auditor will be referred to as "nominated" until this nomination is confirmed by the shareholders, after which the auditor should be referred to as "appointed".

We agree that mandatory partner rotation should address the perceived relationship build-up between senior client staff and the audit firm. However, **we do not believe that the time limit of four years as proposed in these amendments is appropriate**. This requirement will not only contradict the current requirements internationally but also the Banks Act in South Africa. This will result in our local subsidiaries operating to differing requirements from their holding companies.

We suggest that the recommendation be in line with global trends contained in the requirements of the International Federation of Accountants' (IFAC) Code of Conduct and the Sarbanes-Oxley Act of 2002.

As is evident from these international trends, a suitably empowered audit committee is the right forum to provide the necessary safeguards regarding the independence of auditors and decide on the rotation of audit firms and audit partners.

We suggest that SA adopt an approach in line with international trends, but given the slight divergence in these trends, **we recommend that the individual appointed as the auditor to sign the final audit opinion rotate after a period of seven years with a two year cooling off period** in line with the IFAC requirements.

2.7 Non-audit services

- **We agree with the proposed amendment which allows for the audit committee to limit the services which an auditor of a public interest company may perform.**
- **The prohibition on providing internal audit services to an audit client is out of line with international trends.**
- **We recommend that legislation should establish a robust principle-based process applied by the audit committee that can deal with independence issues as they arise in order to keep in line with global trends.**

Please refer to section 3.6 for our comments on the term "nominated" auditor.

As indicated in our previous submission, we support the global trends (both in the US and the EU) that prohibit the provision of services which would require the auditor subjecting the non-audit service to his/her own external audit procedures.

Whilst there is a case for again reviewing the nature of each service an auditor may provide and whether it is perceived as a conflict to his duties as an auditor, a "blanket" prohibition of non-audit services to audit clients is ill founded and would actually harm audit quality by limiting the ability to recruit the range of skills required to complete a complex audit engagement.

In the first draft of the Sarbanes-Oxley Act an extensive list of non-audit services was deemed "unlawful".

On deliberating more fully, this initial legislation has been significantly adapted in that **the prohibition on non-audit services to audit clients is only applicable if it is concluded that the service will be subject to his/her own audit procedures during the audit of the annual financial statements**.

These services include:

- accounting and bookkeeping services;
- financial information systems design and implementation;
- appraisal or valuation services, fairness opinion or contribution-in-kind reports;
- actuarial services; and
- internal auditing outsourcing services.

The auditor is, however, still **prohibited** from performing the following functions:

- Management functions i.e. acting as a director, officer, or employee of an audit client, or performing any decision-making supervisory or ongoing monitoring function for the audit client.
- Human resources – seeking out prospective candidates for managerial, executive or director positions.
- Broker or dealer, investment adviser or investment banking services.
- Legal services – providing an audit client any service that, under circumstances in which the service is provided, could be provided by only someone licensed, admitted or otherwise qualified to practice law in the jurisdiction in which the service is provided.
- Expert services to an audit client, or a legal representative of an audit client, for the purpose of advocating that audit client's interests in litigation or in a regulatory or administrative proceeding or investigation.

The auditor is permitted to provide tax compliance; tax planning and tax advice to audit clients. **All other services are permitted subject to the approval by the audit committee.**

KPMG do not agree with the proposed prohibition on providing internal audit services to an audit client and could complicate global appointments where the firm is appointed as both internal and external auditor. In a modern audit process, external and internal audit work together in providing an adequate level of assurance on the external audit. In cases where an audit client does not have an internal audit function, the external auditor could be responsible for performing the audit procedures, which would normally be carried out by internal audit. We do not believe that providing internal outsourcing services to an audit client will necessarily impair the external auditor's independence. The only reason it is reflected above is one might, for example under the Sarbanes-Oxley Act, be required to report on the proper functioning of the internal audit department. Where pieces of internal audit work are performed on behalf of an internal audit function and under management supervision of the client's internal audit function, this potential conflict is clearly not an issue. While we therefore do not believe that providing internal outsourcing services to an audit client will necessarily impair the external auditor's independence.

As indicated previously and in line with the SOx regulations, we do believe that situations where the auditor is placed in the position of 'marking his own homework' are not acceptable and will create undue influence.

To manage this situation, and all other instances of the auditor providing non-audit services, as is envisaged by the King II report on corporate governance, **we recommend that legislation should establish a robust principles-based process applied by the audit committee that can deal with independence issues as they arise in order to keep in line with global trends.**

2.8 Attendance of certain meetings by auditors

- **We agree in principle with the requirements for the auditor to meet with the board of directors for both the public interest company and limited purpose company**

We do believe that these proposed amendments should however take account of the current corporate law reform project, which is considering proposing that limited purpose companies should not in fact be subject to an external audit. We suggest that any changes to the Companies Act here consider the changes to the types of companies and requirements for an audit being considered under the corporate law reform.

Once again we draw attention to the use of the term "nominated" auditor with reference to the offenses when the auditor does not attend the required meetings. It would be more appropriate to replace this term with "appointed" auditor.

3 Comments on issues not addressed by the proposed amendments to the Companies Act, 1973

3.1 Director liability

- **We believe that the directors of a company are first and foremost accountable to their stakeholders and the major exposure to liability should rest with the directors / executives responsible for making the decisions and for preparing the financial statements that mislead stakeholders.**
- **We also believe that the board of directors should carry Directors and Officers Insurance.**

The terms of reference issued to the Ministerial Panel referred to an appropriate set of liabilities and disciplinary procedures for executive management of companies who fail to properly disclose the true financial health of an entity to the auditors.

This original concern has not been addressed by the proposed amendments to the Companies Act, and as stated in our original submissions **we believe that the directors of a company are first and foremost accountable to their stakeholders and the major exposure to liability should rest with the directors / executives responsible for making the decisions and for preparing the financial statements that mislead stakeholders.**

Management have an overall responsibility to the stakeholders for reporting the health of the company through the financial statements and not merely to the auditors. The auditor's responsibility is to express an opinion on the financial statements.

In accepting the position as a director of a company, such director automatically assumes onerous duties, responsibilities and personal liabilities under both common law and statutory law. Directors cannot avoid their responsibilities nor completely delegate them. They must answer to their company's stakeholders, such as shareowners, employees, lenders, trade creditors and customers. Directors are under increasing pressure to become more accountable, transparent and responsive to stakeholder and community interests.

3.1.1 Global trends

Trends in the US

After the failure of Enron, calls in the US for director accountability were addressed in the Sarbanes-Oxley Act. Section 302 states that the CEO and CFO of each company shall prepare a statement to accompany the audit reports to certify the "appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer." A knowing and intentional violation of this section gives rise to liability.

Trends in the UK

Currently in the UK, there is no separate legislation dealing with the liability of management for the accuracy and appropriateness of the financial statements. Under common law in the UK, directors are held civilly and criminally accountable for fraud.

3.1.2 Our point of view

It should be an offence for executives not to disclose the true financial health of an entity to the auditors, but more importantly to the stakeholders of the company. The extent of liability should be dealt with as a legal matter and legal council should make recommendations.

We also believe that the board of directors should carry Directors and Officers Insurance. Auditors should not be regarded as the insurer for any loss from any cause by anyone. The liability of the directors should be no less than that of the auditor and any system of accountability instituted in South Africa should be in line with global trends and regulation. It is unreasonable to place liability at the feet of the auditors first and foremost, as they spend less time at the company than directors do and in many instances the audit fee is less than the salary of one director.

It is also desirable for all directors, or at least the CEO and CFO, to be required to be a member of a professional body in order to qualify as directors, from which they would be disqualified if they are found guilty of an offence (including misrepresenting the financial position of their company). Such professional or similar bodies would need to have a code of ethics and disciplinary procedures that would allow complaints to be lodged, investigations and disciplinary hearings to be held, and a person to be struck off where necessary thereby barring them from continuing as directors.

3.2 Legal backing for financial reporting standards

- **KPMG supports the need for legal backing for financial reporting standards**.

The proposed amendments have not addressed the issue of legal backing for the financial reporting standards. At present, the certain financial reporting requirements are still contained within the Companies Act, 1973 and it is unclear what effect the amendments will have on these requirements or if these amendments will be enacted through the Financial Reporting Bill.

3.3 Internal control over financial reporting

- **KPMG suggests that public interest companies be required to implement a recognised framework of internal control (COSO) and the external auditor to report on the financial reporting controls.**

The proposed amendments make no reference to the global trend of entities being required to adopt a recognised system of internal control over financial reporting and the auditor's responsibility to review and report on this system.

Regulation and auditing standards in the US and certain EU member states require the management of the entity to implement internal controls over financial reporting and the auditor to obtain an understanding of assess and report on these internal controls.

The final rules adopted on section 404 of the Sarbanes-Oxley Act of 1002, directs each annual report to contain:

- A statement of management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting;
- A statement identifying the framework used by management to evaluate the effectiveness of this internal control;
- Management's assessment, as of the end of the most recent financial year, of the effectiveness of the company's internal control structure and procedures for financial reporting; and
- A statement that its external auditor has issued an audit report on management's assessment.

To enable the external auditor to express an opinion on internal controls, the external auditor will expect management to identify, document and evaluate significant financial reporting controls, based on suitable control criteria. The final rules adopted on section 404, requires management to adopt a framework, which is a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment.

The most commonly used internal control framework is that of The Committee of Sponsoring Organizations (COSO) of the Treadway Commission, whose report provides suitable criteria against which management may evaluate and report on the effectiveness of the company's internal control over financial reporting.

COSO defines internal control as a process that is designed to provide reasonable assurance on the effectiveness and efficiency of operations, compliance with applicable laws and regulations and the reliability of financial reporting. COSO further defines internal control as consisting of five components: control environment, information and communication, control activities, risk assessment and control environment. The Section 404 review is limited to the financial reporting controls within the five components.

The newly issued International Standard of Auditing 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement", requires the auditor to obtain an understanding of the internal control relevant to the audit. Internal control, as discussed in the ISA, also consists of the five internal control components as defined in COSO.

KPMG suggests that public interest companies be required to implement a recognised framework of internal control (COSO) and the external auditor to report on the financial reporting controls.

3.4 Resignation of the auditor

- **We suggest that these amendments require the auditor to disclose the reasons for resignation to the JSE Securities Exchange and possibly also the Independent Regulatory Board for Auditors.**

There are numerous reasons for an auditor to resign from a client, including in the most extreme cases unethical behaviour or even unpaid auditing fees. Currently, in terms of South African legislation, the auditor should, upon resignation, complete and sign a CM 31 form stating that there is no reason for the auditor to believe that a 'material irregularity' as defined has taken place at the company.

Although this regulation is aimed at protecting public investors from 'unlawful' companies, in many instance these material irregularities may not be reported to the appropriate regulators. The occurrence of a material irregularity is also in rare instances only and due to the narrow definition would not reflect, for instance, unethical behaviour in general.

Internationally, in terms of the Sarbanes-Oxley Act in the United States, the auditor is required to fully disclose the reasons for resignation to the Securities and Exchange Commission.

4 Comments on the Draft Auditing Profession Bill, 2004

4.1 Composition of the IRBA (Section 3(1))

- **KPMG South Africa supports the formation of an independent oversight body for the auditing profession in line with global trends, but recommend a minimum representation of registered auditors on that body.**

The members of this independent oversight body will have to have an integral understanding of the scope, purpose and limitation of an audit of an entity. The existence of such a body could enhance the credibility of the South African profession and encourage investors in our economy.

The Bill currently does not require a minimum number of IRBA members to be registered auditors. The consequence of this could be that the IRBA has no representation from the auditing profession. An oversight body should also understand the auditing profession in South Africa and at all times adopt international best practices and comply with international frameworks and standards and we therefore believe that it is imperative that the Bill stipulate the minimum representation level for registered auditors.

4.2 Auditors having financial interest in entity excluded from audit (Section 21)

- **We support the proposed amendments to the Companies Act, a registered auditor may not conduct the audit of any entity if he/she has had a financial interest in the entity, but require definition of the term "financial interest".**
- **We support using the IFAC definition of financial interest in the Draft Bill.**
- **We recommend that this requirement be amended to require the auditor to dispose of financial interest before or on appointment as auditor.**

The definition of financial interest in the Bill is unclear (reference to the word "whatsoever") and does not exclude the normal day-to-day transactions between auditors and banks, or indeed the fees they are paid for their services as auditors.

"Financial interest" is defined in the IFAC Code of Ethics as:

An interest in an equity or other security, debenture, loan (not made under normal lending procedure, terms and requirements) or other debt instrument of an entity, including rights and obligations to acquire such an interest and derivatives directly related to such interest.

This definition will allow for the practical situation where the registered auditor requires banking facilities in his /her personal capacity that will not impair his/her independence. **We support using the IFAC definition of financial interest in the Draft Bill.**

The requirement that a registered auditor may not conduct the audit of an entity if, at any time during a two year period, the auditor had a financial interest in the entity, will result in companies not being able to appoint any new auditors who might in the prior two years have had a financial interest. This unintended consequence will have the opposite effect of the proposed auditor rotation requirements.

We recommend that this requirement be amended to require the auditor to dispose of financial interest before or on appointment as auditor.

4.3 Reportable irregularity (Section 22)

- **We believe that the current definition of "material irregularity" contained in section 20(5) of the Pubic Accountants' and Auditors' Act is robust enough to deal with the concept of reportable irregularities and should be retained in the Draft Bill.**

The proposed definition of reportable irregularity in the Draft Bill includes "any unlawful act or omission". As indicated in section 2.3.2 the issue of laws and regulations is contentious both internationally and in South Africa. The extent of the auditor's responsibility in terms of "any" law is one of legal interpretation as the auditor may not be in the best position, nor indeed required, to evaluate the client's compliance with **all** laws.

This requirement may result in the auditor needing to appoint a legal consultant during the performance of each audit, which in turn will result in a significant increase in the audit fee.

The Draft Bill does further not require the auditor to report irregularities detected while performing his duties as the auditor.

The Draft Bill does not provide for overlapping reporting obligations which arise from other legislation, for example the Financial Intelligence Center Act.

4.4 Offences (Section 32 (3))

- **We recommend that these offences be brought in line with penalties imposed on directors in terms of the Companies Act.**

The Draft Bill refers in this section to the auditor being convicted under this section to a fine or to imprisonment for a period not exceeding ten years or both.

This penalty far exceeds the existing penalties of directors and officers under the Companies Act, which at present is limited to two years for any specific offence.

We recommend that these offences be brought in line with penalties imposed on directors in terms of the Companies Act.

4.5 Offences relating to practice by auditors (Section 34 (2)(i)(iii))

- **We recommend that the names of the managing directors appear on the letterheads of a firm registered as a company.**

The Draft Bill requires that if a registered auditor practices as a company, the names of the directors must appear on the letterhead of this company.

This requirement may not be practical in large auditing firms registered as companies, as the number of directors can exceed three hundred at any point in time. This requirement will also necessitate the firm to amend and re-print letterheads with the regular occurrence of even minor changes in the names of directors.

4.6 Funding of the IRBA (Section 43(1))

- **In line with international trends, to maintain the independence of the IRBA, we do not believe the body should be funded by the profession.**

Section 43(1) of the Draft Bill sets out that the funds of the IRBA consist of fees and monies received under the Draft Bill.

Should the IRBA be funded by registered auditors only, this body will not be regarded as independent oversight body, which will negate all the principles of independence contained in the Draft Bill.

Internationally, the reciprocal recognition (please refer to section 5.2) of our auditing regulator will not be granted by the Public Company Accounting Oversight Board in the United States or the European Commission should the IRBA not be considered independent. This will place South African practitioners at a distinct disadvantage and in many instances may result in a local auditors not being accredited to perform multi-national audit engagements.

5 Comments on issues not addressed by the Draft Auditing Profession Bill, 2004

5.1 Limited liability

- **We believe it is necessary for the revised legislation to formally allow for the limitation of auditor's liability.**

Currently the law does not allow for the limitation of liability on statutory audits.

A large percentage of audit revenue is consumed by legal, settlement and insurance costs associated with liability. It is also becoming increasingly difficult for auditors of major corporations to fully insure against their exposures, and auditors have become the easy target to sue even when collapses are unrelated to any audit failure **because of unlimited liability**. This results in the further drain of, and failure to attract, suitably qualified auditors.

We believe it is necessary for the revised legislation to formally allow for the limitation of auditor's liability on statutory audits whether by means of:

- Contractual agreement where liability is limited to an agreed multiple of fees; or
- Ring fencing of liability to a corporate entity as appropriate.

5.2 Reciprocal recognition

- **We believe that our regulation should be in line with international regulations to provide for reciprocal recognition of other audit regulators.**

Internationally the trend of reciprocal recognition is receiving significant attention. The Draft Bill does not provide for reciprocal recognition of other audit regulators, which will place increased pressured on South Africa practitioners.

The revised eighth directive issued by the European Commission states that auditors and/or audit firms from other countries that issue audit reports in relation to securities traded in the European Union (EU), need to be registered in the EU and be subject to Member State systems of oversight, quality assurance and investigations and sanctions. If the other country is subject to an equivalent system of oversight, these countries are exempt from registration. This exemption is applicable only if there is a reciprocal treatment of Member States and therefore South African regulations would have to clearly state that our IRBA will accredit professional bodies from Member States if they comply our equivalent system of oversight.

Access to working papers also requires reciprocal cooperation by the other country. The Commission will perform this assessment at EU level with cooperation of the Member States. The access will be granted if:

- The purpose of the exchange is justified
- The request respects professional secrecy requirements and
- The working papers are only used for the oversight on auditors.

Once again, our local regulations must clearly state that the IRBA will allow access to working papers on the conditions stated above.

We believe that our regulation should be in line with international regulations to provide for reciprocal recognition of other audit regulators internationally to ensure that South African practitioners can provide their services to a broad range of multi-national clients without additional restrictions.