The South African Institute of Chartered Accountants

9 February 2005

Director: Local Government Implementation
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Dear Sir/Madam

COMMENT LETTER ON THE ISSUES ARISING FROM THE DRAFT AUDITING PROFESSION BILL

The South African Institute of Chartered Accountants (SAICA) would like to congratulate the drafting committee on the work it has performed to incorporate comments received on the Accountancy Profession Bill and the Ministerial Review Panel Report, as well as for the improvements it has made to the draft Auditing Profession Bill's readability and ease of understanding.

The revision of the regulatory framework of the auditing profession is a positive step for South Africa to become a global player in the capital markets of the world.

In principle SAICA supports the draft Bill and encourages efforts to steer it through the necessary legislative processes to have it enacted as soon as possible. This draft Bill achieves an important objective of flexibility to deal with an ever changing business environment. We have a number of comments which we have set out in the attached submission. Many of these comments are intended to highlight uncertainties. There are some concerns which we believe need to be addressed in order to avoid practical implementation difficulties.

For ease of reference, our specific comments refer only to sections in the draft Bill where we have noted concerns and provided suggestions. We have used the same headings, sub-headings and sequential numbering as has been used in the draft Bill.

We have also incorporated comments relating to the proposed amendments to the Companies Act to further enhance the integrity and independence of the South African auditing profession. We support the provisions contained therein in relation to the establishment and maintenance of the independence of auditors, which remains one of the overriding principles of public protection. In particular, we strongly support the inclusion of additional corporate governance requirements, such as audit committees for public interest companies.

There is an interdependency between the draft Auditing Profession Bill and Corporate Law, therefore it is important to ensure that amendments that follow from the Corporate Law reform process are synchronised with the provisions of the draft Auditing Profession Bill.

If you have any queries regarding the comments made or require any further information, please do not hesitate to contact me.

Yours sincerely

Ignatius Sehoole
EXECUTIVE PRESIDENT

1 GENERAL COMMENTS

1.1 Public Protection

SAICA favours that the focus of the draft Bill is on auditors instead of the broader accountancy profession and that public protection is strongly emphasised throughout the draft Bill. The independence requirement built into the structures of the Independent Regulatory Board for Auditors (IRBA) as well as the Ministerial oversight are welcomed, as these will further enhance public protection.

SAICA does not oppose some form of regulation of accountants. This may well be necessary in future. However, at this stage it is unclear how this could be done effectively, whereas the need to modernise the regulatory structures for auditors is paramount and an urgent public interest issue. It is also important that South Africa is putting in place this important building block in its governance and oversight structures, which will contribute to making South Africa a more attractive place to invest.

1.2 Funding

The issue of funding remains a concern in light of the inherent conflict created by registered auditors being the sole funders of their own regulator. This places a burden on the IRBA to balance the need to register auditors to fund operations, while at the same time being responsible to discipline registered auditors, which could result in their cancellation and removal.

Furthermore the scope and capability of the regulator will be constrained by the ability of registered auditors to pay the likely steep registration fees. This will impair the capability of the regulator to achieve its objectives and it is likely that the outside world will downgrade its rating as an effective regulator. The funding model proposed in the draft Bill will not, for example, meet the requirements of the Securities Exchange Commission (SEC) in the United States for collaboration with that body. SAICA calls upon the Minister to reconsider the funding. Whilst there is no doubt that registered auditors benefit from the work of the IRBA, so do corporate entities that are audited as well as the general public. We urge the Minister to consider introducing some sharing of costs between auditors, corporate entities and government.

1.3 Education

We welcome the introduction of the accreditation model for education. We believe it will be a fairer system which will separate the roles of provider and regulator. In addition, it should improve transparency with regard to the programmes of professional bodies meeting the accreditation criteria. However, in our view the process is not entirely clear. We have elaborated on this in the specific comments below.

1.4 Reportable irregularities

This matter was previously dealt with in section 20(5) of the Public Accountants' and Auditors' Act (PAA Act). With the initial publication of section 20(5), various uncertainties arose in so far as its application was concerned. Nevertheless, over time the auditing and legal professions, through practical application and experience have come to terms with the interpretation of the section. We are concerned that a complete rewrite of this section may result in similar or new uncertainties being created.

We therefore recommend that, instead of rewriting section 20(5) of the PAA Act, consideration should be given to retaining the existing section with enhancements to address known concerns. One of these concerns is the ability of the auditor to speed up the reporting if he or she is aware that fraudulent activity is being undertaken. Another concern is the fact that regulators and law enforcement agencies do not act in a timely manner to deal with the reported irregularities and the auditors' regulator is not always able to deal with reported items in a speedily manner. Whilst it is not an issue to be dealt with in the Act, it blunts its effectiveness.

SAICA has also obtained a legal opinion on the proposed provisions relating to reportable irregularities, which is included as an addendum to this submission. The intention of this is to get an understanding from a legal perspective whether or not the proposal would be practical and workable.

1.5 Disciplinary matters

We welcome the enhancements introduced into the disciplinary process. However, we have identified some serious practical difficulties which we believe need to be addressed. These are set out in the specific comments below.

1.6 Auditor's liability

We support the inclusion of section 51(2), that will allow for the appointment of damages concept to be used in regard to claims arising out of contracts concluded with auditors. This is a significant step in ensuring the long-term sustainability of the auditing profession. However, we believe consideration should be given to limiting or capping auditor liability.

1.7 Rotation of auditors

We support the requirement for rotation of audit partners for public interest companies. In our view this requirement will strengthen the independence of auditors. However, we believe a four year rotation period is too short, particularly in a country where there is such a shortage of skills. Our recommendation is that a five year rotation period be implemented, since this is more closely aligned to international practice.

Furthermore, the amendments to the Companies Act should adequately provide for an effective date, and the phasing in of this requirement in order to overcome practical difficulties.

1.8 Consequential amendments to other legislation

With the enactment of this Bill other legislation, for example, the Schools Act and Sectional Titles Act, need to be amended to take into account the fact that audits can only be conducted by registered auditors. For example, the Schools Act requires an audit to be performed, but allows in certain circumstances for the audit to be performed by a non-auditor. This section should either be changed to require that the work be done by an auditor, or if considered appropriate, to amend the scope so that an audit is not required.

2 SPECIFIC COMMENTS

2.1 <u>Chapter I – Definitions and establishment of Boards</u>

Consideration should be given to the inclusion of a definition of 'auditor'. This would be beneficial as this term is used throughout the draft Bill. Furthermore, such a definition will restrict the use of the term auditor to auditors registered with the IRBA.

We are aware that a specific definition in the act might cause unintended ramification on the broader use of the term 'auditor'.

IFAC definition: The auditor is the person with final responsibility for the audit. This terms is also used to refer to an audit firm.

A similiar definition is proposed: *"auditor is a person or firm registered as such with the Independent Regulatory Board for Auditors".*

2.2 <u>Chapter II – Independent Regulatory Board for Auditors, Accreditation and registration</u>

2.2.1 IRBA: composition and succession to property etc.

We support the proposal that the IRBA is not composed of a majority of registered auditors, however we recommend that the registered auditors be nominated by professional bodies accredited by the IRBA. These nominations should be subject to approval by the Minister.

2.2.2 Independent Regulatory Board for Auditors: powers and duties

Section 5(1)(d) allows for the determination of levies and fees. As mentioned under our general comments, we are concerned with the inherent conflict caused if the operation of the IRBA is solely funded by subscriptions from registered auditors. The conundrum of the IRBA depending on registered auditors for funding against the duty of the IRBA to remove errant registered auditors from the register needs to be considered, especially where a shortfall in the IRBA's budget is anticipated. To overcome this, consideration should be given to other sources of funding.

Since the key objective of the IRBA is to protect the public interest, it makes sense that government should share in the funding. We are also concerned, as mentioned in the general comment, that the proposed model will not meet the requirements of the SEC for recognition. This could result in auditors of foreign listed companies and subsidiaries being subject to costly external regulation. It is also likely that the European Union will follow the United States example of only recognising regulatory bodies that are perceived to be fully independent.

2.2.2 Requirements for accreditation

Full accreditation model
In terms of the transitional arrangements noted in section 6(2) *"…at the commencement of its functions by the IRBA, any body which at that time is accredited to the PAAB shall be considered to be a professional body accredited by the IRBA*".

Currently SAICA is the only professional body 'accredited' by the Public Accountants' and Auditors' Board (PAAB) for purposes of writing the professional practice examination (part 2 of the qualifying examination). As the PAAB currently sets the professional practice examination (part 2 of the qualifying examination), the existing model does not reflect the accreditation model suggested in the draft Bill. If the new IRBA is to be an independent body set up to protect the public interest, a full accreditation model should be applied.

It is vital to establish separate roles of regulator and provider in all respects (including education) so that the proper balance is achieved between public interest standards and requirements, as well as the profession's need to remain competitive and in line with international trends. Participating professional bodies are better placed to set examinations so as to take account of the ever changing environment. However, regulator oversight is vital to protect the public interest. The transitional provisions need to recognise the existing process, but ultimately the objective should be for the full accreditation model to be introduced within a reasonable timeframe.

Setting of examination
In terms of the powers and duties of the IRBA in section 5(1)(b), the IRBA has the power to *"…ensure the standards of professional qualifications, competence, ethics and service of registered auditors, <u>including the setting and administration of exams</u>*."

In principle the regulator should be setting accreditation criteria to evaluate the standards of professional bodies who apply for accreditation. It is important that the IRBA is granted sufficient discretion in setting these criteria. However, this should be a transparent process.
In our view the regulator should only set examinations if no professional body meets the accreditation standard. This would require the current wording to be clarified or amended.

Continuing Professional Education versus Continuing Professional Development

Section 6(4)(c) refers to "*continuing professional education*". In terms of the education standards issued by the International Federation of Accountants (IFAC), the terminology now used is 'continuing professional development'. The term 'development' is broader than 'education' and includes informal learning. The draft Bill should be amended to reflect this new terminology.

2.2.3 Registration of firms which are partnerships or companies

The draft Bill excludes the possibility of establishing multi-disciplinary practices. In order to effectively audit a large entity today, skills beyond those of a traditional auditor, for example legal, actuarial, forensic and information technology skills are required. To accommodate these skills, we believe that multi-disciplinary practices should be allowed, with the necessary safeguards.

An example of a safeguard in allowing of multi-disciplinary practices would be to require that at least 75% ownership of such a practice is held by registered auditors and that the multi-disciplinary practice itself, as a firm, should be subject to the disciplinary powers of the IRBA. Multi-disciplinary practices are permitted in certain other countries, and in our view, this provision should be in line with that of our international counterparts.

2.3 Chapter III - Functions and Composition of Subsidiary Boards

2.3.1 Standard-Setting Board for Auditor Ethics: composition

Section 14 proposes that the Standard-setting Board for Auditor Ethics should consist of the following members appointed by the IRBA:

a. "Five registered auditors;
b. Three persons representing users of audit services;
c. One person representing an exchange which is the holder of a stock exchange licence issued under the Stock Exchange Control Act, 1985 (No. 1 of 1985); and
d. One advocate or attorney with at least ten years' experience in the practice of law."

We believe that, in order to ensure the independence of this body and to bring South Africa in line with international trends, less than 50% of the Board should be registered auditors.

We question why the draft Bill is so prescriptive insofar as the membership of this Board is concerned. The fact that representatives from certain industries and regulators are specifically prescribed constrains the flexibility of this Board to operate in a changing environment.

We recommend that the composition be left to the consideration of the IRBA, with reference to members having suitable qualifications and experience. The sole provision should be that not more that 4 registered auditors are appointed. In order to operate effectively we recommend that a maximum membership of 10 should be stipulated.

2.3.2 Standard-Setting Board for Auditing: composition

Section 17 proposes that the Standard-setting Board for Auditing should consist of the following members appointed by the IRBA:

a. "Five registered auditors;
b. One person with experience of business;
c. The incumbent of the office of the Auditor-General, or a person nominated by that incumbent;
d. The incumbent of the office of Executive Officer of the Financial Services Board, or a person nominated by that incumbent;
e. One person with experience in the teaching of auditing at a University recognised or established under the Higher Education Act, 1997 (Act no. 101 of 1997); and
f. The incumbent of the office of the Registrar of Banks, or a person nominated by that incumbent."

We again recommend that the composition be left to the consideration of the IRBA, with reference to members having suitable qualifications and experience. A single requirement should be that not more than 5 registered auditors be appointed. Due to the technical nature of the activities of this Board, it is felt that a 50% registered auditor representation would be appropriate. Once again, to provide for the effective operation of this Board, a maximum membership of 10 should be stipulated.

2.4 Chapter IV - Powers and Duties of Registered Auditors and Reviews by Independent Regulatory Board for Auditors

2.4.1 Auditor having financial interest in entity excluded from audit

Section 21(2) defines financial interest as "*a financial interest of any description whatsoever (and whether direct or indirect), other than –*

a. A right to fees or charges earned by the auditor (or the firm of which the auditor is a member) in respect of services; or
b. In the case of an entity which is or includes a pension fund organisation or which provides a collective investment scheme, any interest in the fund or scheme which gives the auditor no greater right to participate in the making of decisions as to the management of the entity than any other member of the fund or scheme."

It appears that the objective of this section is to enhance auditor independence. However, this matter is already dealt with in the Code of Professional Conduct of the PAAB, which will become the code of the IRBA. We therefore question the reason for the specific reference in the draft Bill to financial interest. We submit that this section of the draft Bill is redundant, and should be removed.

However, if the section on financial interest is retained the definition should be reconsidered as it is very broad. Given the problem of a limited number of audit firms being in a position to audit listed companies, this exclusion could result in no firm meeting this requirement (and consequently being unable to perform the audit). Furthermore it will prevent many individuals from making small investments in publicly traded shares. The broad wording of financial interest also includes the mere holding of a bank account or insurance policy, which surely is not intended.

2.4.2 Auditor's duty to report on irregularities

Immediate report to the IRBA
Section 22(1) contains definitions which would be more appropriately placed in Chapter 1.

The requirement that the registered auditor report directly to the IRBA without first reporting to the management board is problematic. It will lead to very many such reports being filed, many of them of an inconsequential nature. Under section 20(5) of the current PAA Act, many material irregularity letters are sent to undertakings throughout the country annually, but most of them are resolved between the auditor and the company concerned, with the consequence that only a limited number of reports have to be made to the existing PAAB. However, this benefit will be lost as all the reports will go directly to the IRBA, in the first instance. It is questioned whether the IRBA will be able to cope with this administrative burden.

Nature of reporting to the IRBA
A further difficulty arises from the uncertain nature of the report to the IRBA. It is in effect a preliminary report by the registered auditor. The irregularity can be rectified after the report has been given. It seems to be an unnecessary process to require the steps to be taken only for the course of action to be stopped at a later stage because the registered auditor has concluded that there has not been a reportable irregularity.

Another difficulty lies in the requirement that the registered auditor must state whether it is likely that the irregularity will be rectified within 30 days. This is a very onerous responsibility as the registered auditor is expected to express such an opinion without discussing the matter with the members of the management board. It is unclear what is meant by the requirement that the irregularity has to be 'rectified' - for example, is the repayment of money stolen from the entity a means of rectifying the matter?

Furthermore what is the consequence of the registered auditors reporting that the irregularity has been rectified? If the irregularity is serious, but has been put right, is that the end of the matter as far as the IRBA is concerned? If the report has gone through to the regulator, and the IRBA informs the regulator that the matter has been put right, what does the regulator do?

A further difficulty relates to the circumstances in which the registered auditor must send a copy of his report to the IRBA to the members of the management board of the entity concerned. In terms of subsection 22(2)(b), the registered auditor must send a copy to the management board unless he considers it 'inappropriate' in the circumstances of the case. No guidance is given in relation to the responsibilities of the registered auditor in this regard.

The definition of a reportable irregularity

This definition seeks to give some meaning to the term 'reportable irregularity*'.* The equivalent term in Section 20(5) of the PAA Act is *"material irregularity*". There is no attempt to define material irregularity in the PAA Act and this has been a source of difficulty over the years. Nevertheless, as set out in our general comment, the legal and auditing professions has come to terms with the concept, which is now reasonably well understood. All the same, we believe that it would clarify matters if there were to be a definition to guide auditors and the public as to what the legislature intends should be reported on.

We do not believe that the definition of reportable irregularity in the draft Bill clarifies the position. The definition perpetuates the notion that the irregularity must take place in the conduct of the management or control of an entity. We agree with that approach. Sub-paragraph (a) describes the irregularity as being any unlawful act or omission which "*has caused or is likely to cause financial loss which is material to the entity or to any partner, member, shareholder or creditor of the entity."* In this respect it should be noted that the materiality refers to the financial loss, and not to the seriousness of the unlawful act or omission. This is a change from the existing position, where the concept of materiality qualifies both the irregularity and the financial loss – in other words, quantitative and qualitative factors have to be taken into account when considering the materiality of the irregularity. The seriousness of the unlawful act cannot be disregarded, even if the financial consequences are limited.

Furthermore, sub-paragraph (a) refers to financial loss which is material to any partner, member, shareholder or creditor of the entity. The auditor's assessment of materiality is normally determined in relation to the entity. It would be extremely difficult for the auditor to assess materiality in relation to the other parties mentioned, as required by the draft Bill.

The second aspect of this definition, which is contained in sub-paragraph (b), is that the unlawful act or omission must be fraudulent or amount to theft or otherwise be dishonest. It is noteworthy that the issues of financial loss or materiality do not arise here, with the consequence that, on a strict interpretation of the definition, any unlawful conduct which amounts to fraud or theft or is 'otherwise dishonest', however trivial the conduct or its consequences, will be reportable. We do not believe that this was what the legislature intended. Moreover, the phrase "*otherwise dishonest*" is capable of wide interpretation and could give rise to uncertainty.

Furthermore, unlawful conduct is a reportable irregularity if it represents a material breach of a fiduciary duty owed by the person concerned to the entity or third parties connected with the entity. This is contained in sub-paragraph (c) of the definition. Here the legislature has imported the concept of the breach having to be material, but it is not coupled with any financial loss.

While the attempt to define a reportable irregularity is to be welcomed, the definition in the draft Bill will cause confusion and uncertainty, and an attempt must be made to align the concepts of 'materiality', both in relation to the conduct and the consequences and 'financial loss'.

Upon reflection and taking into account the reasons set out in the general comment above, we believe that it may be better to retain the existing wording of Section 20(5) of the PAA Act with modifications as mentioned under our general comments section to speed up the process where necessary.

2.4.3 Practice reviews

Section 24(5) addresses the disclosure of information in certain instances and consequently, requires the retention of such records. The retention of records provision places an administrative burden on safe custody which can be costly. Our recommendation is that a limitation of six months be prescribed for the retention of this information, after which time the information may be destroyed. The proposed six month period is also in line with the principles of the Promotion of Administrative Justice Act.

2.5 Chapter V - Disciplinary Matters

In general the section that addresses disciplinary matters is not very clearly drafted and the intention of the legislator does not come through clearly.

It would appear that a distinction is being sought between public interest matters and general disciplinary matters. This specific focus on public interest matters is to be welcomed. However, the distinction and the different processes to be followed is unclear from the current provisions of the draft Bill. We believe that it is vital for the credibility of the auditing profession that public interest cases should be concluded as quickly as possible. The process should ensure that this is possible.

Many of the sections appear to be lacking detail when compared with the detail contained in the current PAA Act and its regulations, and seem to require a reference (presumably) to regulations in order to understand their operation. The regulations have not yet been published.

In addition, there is no punishment enabling section of the draft Bill as is currently to be found in section 13(h) of the PAA Act.

2.5.1 Appointment of tribunal and committees to carry out disciplinary functions

The appointment of an independent person as president of the tribunal is welcomed, but should also be extended to the other committees in the process. A question mark will remain over the independence of committees consisting solely of registered auditors unless an independent chairperson is appointed. We therefore also recommend that the composition of the committees is extended beyond registered auditors in order to enhance the credibility of the disciplinary functions.

Process
The process itself is not clear and the functions, powers and duties of the distinct parts are not clearly defined. For example, it would appear that the sole function of the investigation committee is to establish whether or not a *prima facie* case exists and refer the matter to the tribunal president. No provision is made for such committee to dispose of the matter at that stage. Furthermore, no distinction is drawn between serious and

frivolous complaints and it would appear that all instances of alleged improper conduct need to be referred onwards.

This in itself leads to another problem, in that the tribunal president is then tasked with deciding where the matter should be referred. Given the volume of cases (119 new cases reported to the PAAB in 2004 alone) this could create a bottleneck and unacceptable delays. Furthermore, the impartiality of the tribunal president may be called into question where he/she has made the decision to refer the matter to a tribunal and then presides over that same matter.

Powers
The subpoena powers of the disciplinary process need to be enhanced, and the investigatory committees need the power of subpoena, rather than having to wait for a matter to be referred to a hearing before such power becomes available, as section 30 of the PAA Act currently proposes.

Punishment
The punishments have not been prescribed, and presumably these will be published in the form of regulations.

The form of publication (as envisaged by section 31(3), should be left to the discretion of the disciplinary committee and not be restricted to publication in a newspaper only.

2.6 Chapter VI – Offences

It is not clear why the issue of contingency fees has been singled out as an offence (section 34(2)(c)), as such matters are adequately covered in the Code of Professional Conduct.

3 COMMENTS ON THE PROPOSED AMENDMENTS TO THE COMPANIES ACT

3.1 Definition of Public interest companies

In terms of the definition proposed a company will default into the category of a public interest company if it does not meet the definition of a limited purpose company. We are concerned that this definition could result in smaller and medium sized companies that are closely held, being classified as public interest companies. This would place an unnecessary burden on such companies in so far so administration and costs are concerned, in order to comply with the proposed amendments to the Companies Act. We therefore recommend that the definition be reconsidered to cater for certain companies to be specifically included in this category instead of defaulting into the category.

3.2 Rotation of auditors

We support the principle of rotation of audit partners as a mechanism for improving auditor independence. However we recommend that the suggested four year rotation period be reconsidered, in light of the fact that it normally takes auditors between two and three years to fully understand all the complexities and nuances of a complex client. The SAICA & IFAC Code of Professional Conduct currently requires rotation of audit partners after a period of seven years, which might be seen to be too long a period. Consideration should be given to applying the term limitation as prescribed in the Regulations to the Banks Act, which stipulates a period of five years.

In order for this rotation provision to operate effectively there would need to be an effective date provision allowing for prospective, rather than a retrospective, application of the section.

3.3 Non-audit services

We fully support the proposal that certain non-audit services should not be open to the current auditor of a public interest company. One of these services is accounting work, however this is a very broad term and the intention of this needs to be clarified.

ADDENDUM

REPORT FOR SAICA

SECTION 22 OF THE
DRAFT AUDITING PROFESSION BILL, 2004

We have been asked to comment on the provisions of Section 22 of the draft Auditing Profession Bill, 2004. This Section deals with the auditors' duty to report on irregularities and will replace the procedure presently governed by Section 20(5) of the Public Accountants' & Auditors' Act. We do not set out to catalogue the differences between the two Sections and this memorandum will deal only with those provisions in the new Section which we consider require comment.

Section 22(1) - Definition of "*Management Board*"

It would be desirable to have consistency in the concept of management and control. This definition refers to the Board or individual:

"*having control and direction of the business."*

The definition of "*reportable irregularity*" refers to the acts of a person in the conduct:-

"*of the management or control of an entity."*

in the lead into the definition and to the "*conduct or management*" of the entity in sub-paragraph (c) dealing with fiduciary duties.

Concepts of "*management*" and "*control*" are relatively familiar stipulations which have interpretational support in the case law. The notion of what is constituted by "*direction of the business of an entity*" is less certain.

Section 22(1) – Definition of "*Reportable Irregularity*"

The introductory sub-paragraph of this definition clearly indicates its application *to acts or omissions in the conduct of the management or control of the entity. This is a welcome clarification of the confusion arising out of the use in the old Section of activities "*in the conduct of the affairs" *of the business. The interpretation that Section 20(5) did not apply to isolated acts by employees or unauthorised acts by employees not involved in management or control is now confirmed by the express wording of this Section.*

Sub-Section (b) imposes an obligatory reporting obligation in respect of <u>any</u> unlawful act or omission by any person in the control or management of the company which is fraudulent or amounts to theft or is otherwise dishonest. It will be immediately apparent that there is no requirement of financial loss, nor is there any qualification that the act should be material. Interpreted literally, this will require an obligatory report to be made without delay upon the discovery of any such act or omission. The debate as to the appropriateness of management conduct in regard to such matters as:-

- expense accounts
- travel allowances
- questionable tax strategies
- statistical returns
- software licensing
- questionable commissions or incentives

and a myriad of other incidental management activities will all become everyday realities in the lives of every auditor. The unqualified reference to an act or omission which is "*otherwise dishonest*" will leave the auditor dealing with moral and ethical judgement calls in relation to business practices which may be regarded as questionable or not falling within acceptable business norms.

One of the clearest yardsticks that has enabled the profession to deal with the practical implementation of Section 20(5) has been the requirement of materiality. Irrelevant or inconsequential irregularities have been dealt with appropriately by reports to management and an indication that the practice in question is wrong. In this manner an avalanche of bureaucratic reports has been avoided, with consequential reduction in the staffing required to process reports and, most importantly, this has enabled the Board to focus on material reports to it.

We fear that the implementation of an obligatory reporting obligation without any limitation will produce a flood of reporting of minor infractions, which will mask and dissipate efforts to identify matters requiring regulatory intervention.

The linkage of the reporting obligation to actual or foreseen material financial loss would ameliorate this position.

Sub-Section (c) deals with material breaches of any fiduciary duty. We note that the nature and extent of fiduciary duties are not crisply demarcated and the decision as to whether a duty exists and whether it has been breached will involve an understanding of the evolving law on the topic as it is developed by the courts.

Of particular relevance is the doubtful existence of any fiduciary duty upon company directors to members, shareholders and creditors of the company, each of which grouping are specifically referred to in this definition.

Given the limited civil remedies applicable to actions based upon breach of fiduciary duty, it is questionable why the process of creating a mechanism for registration of such breaches is justified. By and large most acts which amount to a breach of a recognised fiduciary duty would, in any event, fall within the ambit of sub-paragraphs (a) and (b) of the definition in any event.

The uncertain nature and extent of the concept of fiduciary duty and its breach will leave auditors struggling with the notion of what it is that they are obliged to report and what the test of materiality is, given that there is no link to financial loss. Certainly the present training of accountants does not equip them to deal with complex legal issues of this nature and they will be driven to continuously seeking legal advice in order to decide whether a reporting obligation exists. The reporting of this conduct, unrelated to financial loss, appears to place a burden on practitioners which is not generally within their sphere of expertise and not generally within the regulatory environment in which the profession is expected to provide supervisory functions.

Section 22(2) – The Reporting Mechanism

The section seeks to address the weakness of the procedure followed under section 20(5) by requiring the auditor to report to the IRBA "without delay"*. Under the old system the auditor was required to give the company thirty days in which to effectively rectify the irregularity. In urgent cases the delay involved in that notice period and in the subsequent submission of a report to the PAAB could produce unacceptable delays in the initiation of remedial steps by the regulators.*

The difficulty with the current proposal is the mechanism adopted to limit the burden which would be placed upon the regulators by the sudden influx of endless reports of irregularities. That mechanism is to impose on the auditor the obligation to express an opinion as to whether the irregularity will be "rectified within thirty days"*. There is no indication of what is meant by rectification in this context. Presumably, this must be linked to the matters canvassed in subsection 3, namely that the auditor should be satisfied that the irregularity has ceased and that* "adequate steps" *have been taken for the prevention or recovery of any loss consequent upon it.*

The likelihood is that, in all but the most trivial of cases, auditors will be reluctant to express an opinion that "rectification" *will occur within thirty days. That is particularly the case in regard to the requirement that* "adequate steps have been taken for the prevention or recovery of any loss"*.*

It would render the auditor's decision making process easier if the opinion required was that the auditor was reasonably satisfied that the relevant irregularity has ceased or that management would within thirty days take adequate steps to stop the irregular act or omission and to prevent such further activity and to commence the process of recovery of any loss consequent upon it.

If that reasonable expectation was not met within the thirty day period the subsequent reporting obligation under subsection 3 would follow.

By this process the prospect of defensive and conservative unqualified reporting by members would be reduced.

The proposal in section 22(2)(b) that the auditor should not be required to advise the client of the making of a report if the auditor "considers it inappropriate in the circumstances of the case" *will again create difficulties for the profession. As a general principle the confidential professional relationship between the auditor and the client requires the professional to advise the client of the publication of information relevant to the professional relationship to any third party. We would consider it undesirable to require the profession to report its clients to the regulator without notifying the client of the fact that this has been done. We can understand the notion of the desirability of provoking regulatory intervention in cases involving conduct which may give rise to prejudice on the part of fraudulent or dishonest management, but if that is the intention then the circumstances under which the auditor is to report anonymously should be stated explicitly so that the profession is in no doubt as to the circumstances in which this extraordinary activity is required of them.*

Section 22(3)

We refer to our comments in relation to the factors about which an auditor should be satisfied. Within the periods contemplated the auditor could generally only be in a position to report positively on action taken to stop a particular course of conduct or to initiate steps to prevent its repetition. In regard to recovery procedures, the initiation of appropriate steps can generally be reported not the completion thereof.

Section 22(4)

We are troubled by the stipulation that the IRBA has an obligation to report to the regulator, but is forbidden to disclose the source of the report. Without any statutorily created special status of confidentiality or privilege, any report by an auditor to the IRBA will be a discoverable document in legal proceedings and under legislation affording parties the right to seek access to information in the hands of administrative bodies. It is also not clear how the regulator will be able to act upon anonymous information and how the source of that anonymous report will in fact be protected in the proceedings which flow from regulatory intervention. We do not understand what objective is sought to be achieved by rendering the source anonymous. There is also a conflict between this stipulation and the express provision of section 22(7) permitting the IRBA to disclose any information to a broad range of parties.

Section 22(7) and (9)

We are concerned by this section which permits the IRBA to disclose the information relating to an entity provided to it under the section to a variety of parties (such as members, shareholders or creditors) who have no regulatory power or authority. In the context of the wider non-discretionary reporting obligations which section 22 imposes, we are concerned that such disclosure may expose the auditors who make the report to actions by third parties. The similar provision under the previous Act dealt with final reports made by auditors after the client had failed to satisfy them within 30 days that no material irregularity existed. The new provision relates to all reports made, whether or not the client has had the opportunity to respond or satisfy the auditor. A report made *bona fide* but in error may give rise to damages claims if published. Such actions may not necessarily be covered by the indemnity contained under section 9. It would be appropriate to extend the indemnity provisions contained in section 22(9) to protect the auditor against any action arising out of the issue of any report under this section.

M J HART
DENEYS REITZ

28 January 2005

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