Date: 8 February 2005

Re: **The Draft Auditing Profession Bill , 2004**

Fax no.: 012-315 5890 / 5790

From: CR Follett-Smith

Fax comprises 3 pages inclusive of this.

....

I would like to offer the following comment on the Draft Auditing Profession Bill, 2004.

Yours truly,

....
CR Follett-Smith

THE AUDITING PROFESSION BILL – A SUBMISSION

The substance of this submission is that any committee which is empowered in terms of the Bill to discipline members, ought to include a person trained in matters of jurisprudence. The reason therefor is that a lawyer is better placed to evaluate what evidence is relevant and is better positioned to exclude prejudice.

There are circumstances contemplated in the Bill where disciplinary committees **comprised solely of registered auditors** may hear a matter and impose any prescribed punishment in respect of their findings.

It appears that the Tribunal President (who is to be either a judge or senior counsel) will determine whether an allegation is one which, if it were proved, would affect public trust in the auditing profession. If so, the matter will be heard by the Tribunal. If however, he considers that the matter falls outside that scope, the alleged misconduct would be referred to a committee comprised solely of registered auditors.

But, for example, a registered auditor might do a business valuation without properly familiarising himself with the sale agreement. In terms of the Bill, anyone prejudiced thereby could complain to the IRBA. However, a 'business valuation' would not, perhaps, be associated with the audit profession by the general Public. Hence, the Tribunal president might conclude that the matter should be heard by a disciplinary committee, which would be comprised solely of registered auditors.

But in either event, the committee would surely benefit from the perspective a legal mind would add to proceedings.

The Existing System

Under the current system, complaints about the conduct of a Public Accountant and Auditor (PAA)were heard in secrecy by a committee usually comprised purely of PAA's. If the committee was satisfied that the PAA had acted reasonably, the complainant automatically assumed the role of a 'pariah' because the complaint was 'evidently' unjustified. The complainant could do nothing to absolve himself because secrecy enveloped the matter.

The Bill proposes a new transparency which is welcomed.

But I submit the involvement of a lawyer on these otherwise auditor-exclusive committees would also be complementary to the Bill's objectives.

A Complaint to the Public Accountants and Auditors Board

The following is offered as a example of prejudice a complainant might suffer.

Some time ago, an associate of a major firm of chartered accountants approached the proprietor of a service business with a view to selling it. However, the fee was to be time-based rather than outcomes-based and, while it might have resulted in a charge comparable to the amount of commission payable to an agent on the successful sale of the business, that success was not guaranteed.

Accordingly, the proprietor of the business refused the offer.

A short while later, I was asked to try to sell the business on an agency basis and I found a buyer. As a result the parties, at their joint cost, employed an attorney to draw an agreement. But, in the meanwhile it was suggested to the buyer that he should confirm that the valuation was reasonable.

The buyer therefore took the matter to a partner of the auditing associate of the entity who had previously sought to sell the business. He chose to value the business using the capitalisation of earnings method.

For those unfamiliar therewith, the basic elements of this technique are (1) a determination of earnings, which are then (2) multiplied by a factor to obtain the valuation. (The concept is similar to that by which the after-tax profit of quoted company is multiplied by its p/e ratio - the factor - to obtain its market value).

The valuer established the components that comprised earnings from the latest audited figures. He then reduced the amount by 'interest on member's loan account' to which the purchaser was entitled because ***"it was, in any event, debited to the Income Statement"!***

The business being sold had been owner-managed. The valuer now reduced the earnings to be capitalised by allowing for the retention of a manager because he deemed the purchaser (who was a member of an appropriate professional body and had been engaged in a closely allied environment for some time) was insufficiently experienced to run the business himself.

But for these exclusions, the factor he applied to the capitalised earnings would have yielded a very similar valuation to that which appeared in the sale agreement. In the event, the value actually indicated was about half that amount.

However, the valuer was to add that the business ***his associates had offered to sell had a poor name*** in the market-place.

The matters in contention were referred back to the valuer via the purchaser. The valuer declined to change his position.

Citing that on this basis the business was over-valued, the purchaser avoided the sale.

At no stage did the committee call for a copy of the sale agreement on which the valuation was based.

The committee found the valuer's conduct justified.

The prejudice suffered was not only the seller's 'lost sale' but the loss of income honestly earned and unreasonably denied.

CR Follett-Smith CA(SA)
8 February 2005