

**Institute of Directors
Audit Committee Forum
King Committee on Corporate
Governance**



**Comments on the Companies
Amendment Bill**

Institute of Directors Audit Committee Forum King Committee on Corporate Governance



Introduction

These comments represent the preliminary views of the Audit Committee Forum, an initiative of the Institute of Directors in South Africa, the Institute of Directors as well as the members of the King committee on corporate governance to which the Institute acts as the Secretariat. We are concerned that there has been insufficient time allowed to obtain comment from our broader constituency and subject to feedback received on this commentary we ask that we be allowed to submit further comment if needed.

In general, the respondents support the Companies Amendment Bill 2005, but we take this opportunity to provide additional input on certain amendments.

A major concern however is the impact that the proposed amendments will have on the number of suitably qualified directors that will be prepared to serve on Boards or Audit Committees. This was a problem before these amendments, as the level of risk had made the better candidates more circumspect in the acceptance of appointments while the more cautious withdrew from the market altogether.

The shortage that this has created will be exacerbated by some of the proposed amendments and in particular Section 287 and 287A. We fear that many more potential non-executive directors will be lost to the market.

We don't believe that this can be in the national interest as the expertise and experience that these people bring to bear on Boards is invaluable and vital to the success of our economy. We strongly believe that there needs to be some sort of limitation on the potential liability of non-executive directors and would urge the legislators to pursue this option.

General comment

Although most of the principles in the Companies Amendment Bill (the Bill) are clear, we wish to highlight specific instances in our view where ambiguity in drafting may result in the objective of the legislation not being achieved.

We highlight again that 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. Any changes to the Companies Amendment Bill should be reflected in the Audit Profession Bill, which is not available for public comment yet. From the previous comment periods it was evident that the requirements of the Audit Profession Bill were mirrored in the Companies Amendment Bill and vice versa.

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Section 1 (b): Public interest companies

Summarised comment(s)
<ul style="list-style-type: none">• The definition of “the public” should be clarified to determine the scope of application.

The definition of a public interest company is not well defined and will 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 which need clarification include:

- Listed entities – it is not clear if the definition only applies to entities listed on the JSE Securities Exchange or any other exchanges anywhere in the world. This confusion results from the lack of definition in the Bill of the term ‘the public’ to whom shares are offered.
- 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 problematic, as the group structure could include various dormant companies, unlisted entities and privately owned entities which may have minority shareholders making it difficult to obtain unanimous consent.

Some further potential problems are set out below.

We believe it is important that any restrictions and requirements be applied only to listed and other public interest companies. 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.

The inclusion of private entities and unlisted public entities is contrary to global trends, as the objective of the proposed restrictions and amendments are primarily 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 overseas parent company would probably represent the shareholder on the audit committee of the subsidiary. It may be difficult for them to meet the independence test, and the value of other independent non-executive directors in these cases is questionable.

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It is unclear which designations will be used to define the different types of companies in future and if it will be possible for a company to switch between public interest company and limited purpose company from one year to the next.

Section 8(1): Gross negligence

Summarised comment(s)
<ul style="list-style-type: none">• We support providing protection to the State, the Registrar, an inspector, or any officer or other person having duties to perform under this Act, unless gross negligence is proved.
<ul style="list-style-type: none">• We suggest that the contradictions in other sections in the Act dealing with offences by the above mentioned officers and regulators be removed. Consistency should be achieved through ensuring that all offences refer back to gross negligence.

It is unclear if section 8(1) supersedes any other section in the act dealing with offences and specifically extends to directors and auditors, for example:

- Section 286(B)(3) states that the auditor shall be guilty of an offence should he/she not attend the annual general meeting at which the financial statements are to be considered. It is unclear whether the section 8(1) gross negligence test will be applied in determining the offence.
- Both section 287 and section 440FF states that it will be an offence for any director to issue incomplete or non-compliant financial reports. We believe this should be applicable only in cases of gross negligence and that section 8(1) should provide some relief to directors in terms of offences as mentioned in section 287 and section 440FF.

The section also refers to "...damage caused to any person as a result..." It is unclear if this section is applicable only in cases where natural persons sustained losses, or if the section extends to companies and other entities as well.

Section 148: Prospectus

Summarised comment(s)
<ul style="list-style-type: none">• We suggest the Bill be brought in line with the JSE Securities Exchange Listing Requirements.
<ul style="list-style-type: none">• Additional guidance will be needed on the procedures expected from the reporting accountant or the external auditor.

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In terms of the JSE Securities Exchange Listing Requirements, a complete reproduction of the prospectus is required in cases of errors, omissions or misstated prospectuses. These amendments are required to reflect the group situation. Currently the Bill requires an amendment of the company situation and not the group.

A reporting accountant and/or external auditor ordinarily limit their subsequent events procedures to approximately two days before an offer is issued. No additional enquiry or other procedures are performed to assess the accuracy of the underlying information and assumptions of an offer, which is usually open for more than 21 days.

This requirement in the Bill will necessitate additional enquiry procedures to be performed by both a reporting accountant and/or an external auditor to enable the identification of errors, new matters and changes. These additional procedures will significantly increase the costs to companies placing shares on offer.

Section 269A(2)(c): Independent non-executive director

Summarised comment(s)
<ul style="list-style-type: none">• We suggest that the number of independent non-executive directors be reduced to a more appropriate number.•
<ul style="list-style-type: none">• We suggest that a limitation be placed on the number of independent non-executive directorships one person can undertake.
<ul style="list-style-type: none">• The definition of independent non-executive director should be further refined to clarify if it is permissible for an independent non-executive director to hold shares or share options in the company or group.
<ul style="list-style-type: none">• We suggest the board of directors should comprise a majority of independent non-executive directors as per the King Code.
<ul style="list-style-type: none">• The term ‘issuer’ should be defined.

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We agree with the current definition of an independent non-executive director as stipulated in the Bill as it is in line with international trends.

There is no indication in the Bill if a limitation is to be imposed on the number of non-executive directorships a person can undertake. South Africa should not be in the position where certain individuals serve on more than three audit committees. Being a member of an audit committee is an onerous responsibility with increased risk attached to it and persons serving on a significant number of audit committees will not add value to the combined members and, in fact, will increase the risk to all members on the audit committee.

The Higgs report in the UK published in January 2003, stated that a full time executive director should not take on more than one non-executive directorship, nor become chairman of a major company. No individual should chair the board of more than one major company, while this seems unduly harsh, this requirement will have to be assessed for its practicality in South Africa. Some limitation on the number of independent non-executive directorships should be established.

Presently it is unclear if section 269A(2)(c) should be read in conjunction with the definition in section 269A or if this section overrides the preceding definition. It is also unclear from the wording "...and is not *connected*, directly or indirectly, from, for or with the company or any subsidiary or parent of the company...." if the independent non-executive director is precluded from holding shares in the company or in any of the companies in the group.

There is no requirement at present for the composition of the board of directors equal to that of the audit committee. The Smith report on the UK proposes that a board should comprise of at least three independent non-executive directors. The chairperson should further not be an audit committee member and appointments are for a period up to three years, extendable by no more than two additional terms of three years.

The Bill refers in this section to the term 'issuer'. There is no definition of this term in the Bill or the Companies Act 61 of 1973 and is a term used in the Sarbanes-Oxley Act in the United States. We suggest that the term be defined or be replaced with 'public interest company'. We believe the latter is the desired approach as it will clarify the applicability of this section in terms of existing definitions.

Errata: Section 269A(2)(c)(i): "...management of the business and has not in the last three years been employed...." should read "...management of the business and has not in the last three years been employed..."

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Section 270A(3)(a): Casual vacancies

Summarised comment(s)
<ul style="list-style-type: none">• We believe the Bill should clarify the additional process required for the annual appointment of the auditor.

This section states that the auditor shall be deemed to be reappointed at any general meeting unless during the tenure of the audit committee. It is not clear whether the audit committee itself therefore merely re-appoints during its tenure and without reference to the shareholders. It should be noted that the tenure of the audit committee may not be coterminous with that of the auditor.

This requirement is in line with international trends, where the auditor declares his/her independence to the audit committee on an annual basis. It is unclear if this section will result in an additional legal process whereby the auditor is re-appointed on an annual basis and the necessary CM forms resubmitted to the Registrar.

Section 270A(1): Appointment of the audit committee

Summarised comment(s)
<ul style="list-style-type: none">• We support legislating the role of the audit committee.
<ul style="list-style-type: none">• We propose that the audit committee should recommend an auditor to the board and shareholders for appointment.
<ul style="list-style-type: none">• 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.
<ul style="list-style-type: none">• The audit committee should review the financial statements and recommend them for approval by the board of directors.
<ul style="list-style-type: none">• The audit committee should focus their review on the appropriate application of accounting policies and principles in terms of the appropriate financial reporting framework.
<ul style="list-style-type: none">• We suggest that the proposed amendments include a requirement that the audit committee should consist of at least a majority of financially literate members.

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We support legislating the role of the audit committee and we agree that a properly constituted audit committee should be responsible for recommending to the board the appointment, reappointment and removal of the external auditor. **We do not believe that the audit committee should assume the responsibilities of the board of directors.**

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

The Bill indicates that all public interest companies require an audit committee which will be responsible for the appointment of the auditor. In the case of a limited purpose company, the Bill does not impose the requirement of an audit committee on such a company, and is not sufficiently clear on the process of appointing an auditor at a limited purpose company. This may be interpreted as limited purpose companies not being required to be subjected to an external audit, which we do not believe should be the intention of the Bill. It is important to note that there is no section defining which companies require an audit.

The Smith Report in the UK states that the audit committee should have the primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. This recommendation is made to the board and to the shareholders for their approval in general meeting.

If the board does not accept the audit committee's recommendations, it is required to include in the director's report a statement from the audit committee explaining its recommendations and set out the reasons why the board has taken a different position.

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 Bill should also include a restriction on the audit committee to delegate this requirement of pre-approval to management which approval should be obtained 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 formally 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 all applicable laws and that the auditor is independent of the company.

We strongly disagree with this proposal as it is totally impracticable to expect members of an audit committee, particularly non-executive directors, to be fully conversant with every law applicable to companies. There is a plethora of legislation pertaining to business and it is difficult for a qualified lawyer to be up to date with every aspect. The complexities and state of

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flux with the introduction of the new International Financial Reports Standards are also such that even the audit profession is having difficulty interpreting them.

To expect members of the audit committee to assert that the financial statements comply with these standards is unrealistic and will be another factor that makes it impossible to get suitable individuals to serve on these committees.

The DTI expect independent non-executive directors to perform the same role and function as the companies' auditors in this regard. Some form of limited liability is essential for such a requirement to be feasible. At the most, and in fact in terms of international trends; the audit committee should review the financial statements and recommend them to the board of directors for approval.

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 various laws and regulations is currently a hotly debated issue. For an audit committee this would be an even greater exposure to risk to certify that the financial statements are prepared in terms of all applicable laws 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, and require reported compliance, 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 have financially literate members. Internationally, as well as in South Africa, there are various requirements regarding financial literacy of audit committee members and also the right for the committee to access skilled professionals, where necessary.

King II on corporate governance requires the majority of members of the audit committee to be financially literate and we support this recommendation.

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 financial 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;

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- 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 comprise a majority of financially literate individuals.

Section 270A(2): Appointment of an auditor other than the nominated auditor

Summarised comment(s)
<ul style="list-style-type: none">• We believe that this section be clarified with regards to the intention of the legislation.

This section allows the public interest company to appoint an auditor other than the one nominated by the audit committee if the audit committee validates the appointment through sections (a) and (b).

It is not clear from the section which body will be responsible for appointing the auditor as the section refers only to 'the public interest company', which could be the board of directors, shareholders or any other representative of the public interest company.

Section 270A(3): Status of the audit committee

Summarised comment(s)
<ul style="list-style-type: none">• We believe that the status of the audit committee should be redefined as a sub-committee of the board of directors in all aspects of their duties.

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This section aims to emphasise the authority of the board, other than the appointment, fees and terms of engagement of the external auditor.

Nothing in legislation should be interpreted as a departure from the principle of the unitary board. All directors should remain equally responsible for the company's affairs as a matter of law. The audit committee, like other committees to which particular responsibilities are delegated remains a committee of the board. Any disagreement with the board, including disagreement between the audit committee's members and the rest of the board, should be resolved at board level. This should include the process for nominating an auditor for appointment as discussed previously in this document.

This legislation should not aim to diminish the authority of the board.

Section 270A(5)(c): Annual independence assessment by the audit committee

Summarised comment(s)
<ul style="list-style-type: none">• We suggest alternative wording for this section to avoid unintended consequences.
<ul style="list-style-type: none">• We believe the audit committee should receive an annual declaration of independence from the auditor to assist the audit committee in evaluating independence.

We agree that the audit committee, in nominating to the board and shareholders an auditor for appointment, should evaluate the independence of the auditor.

This section currently requires the audit committee to assess whether the auditor's independence may have been prejudiced as a result of **any** previous appointment. The sentence should read: "consider whether the auditor's independence may have been prejudiced as a result of previous appointments as auditor to the public interest company."

It is also 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.

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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 assurance team should not have a financial interest in, or other self-interest conflict with, an assurance client)
- **Self-review threat** (an auditor should not audit his or her own work / the assurance team should not include a person who was previously a director or officer of the client)
- **Advocacy threat** (a firm or member of the assurance 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 assurance team may not have a close relationship with an assurance client, its directors, officers or employees that could cause a biased attitude to the client’s interests)
- **Intimidation threat** (when a members of the assurance team may be deterred from acting objectively and exercising professional skepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client).

Section 274: Appointment of firm as auditor

Summarised comment(s)
<ul style="list-style-type: none">• We agree in principle with the proposed amendment that, in addition to the name of the firm, the name of the individual registered auditor who will be responsible for actually supervising the audit and sign the audit opinion.
<ul style="list-style-type: none">• We believe that the comparison in the membership of the firm should be performed at the time of the annual appointment of the auditor.

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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 selected by the local statutory company.

The legislation should be clear on where the appointment vests legally. Should an audit firm elect to move an audit partner who is designated as the individual responsible for the accounts, the question may arise if this will result in a casual vacancy. We believe that this is not practical.

Section 274(3) states that a significant change in the composition of a firm will result in a casual vacancy. We believe that the objective of this section is to ensure the independence and competence of the auditor. The audit committee is tasked to not only appoint the auditor originally, but evaluate the independence and competence of the auditor on an annual basis. We believe that the objective of this requirement is adequately addressed through section 270(A).

Section 274(3) requires a comparison to be performed with the membership at the time of the appointment. It is unclear if this section refers to the original appointment or the annual re-appointment. We believe the comparison should be performed by comparing the membership to the membership at the time of the previous annual appointment.

Generally the composition of a firm changes from one year to a next with new appointments, retirements and transfers. The effect of these normal changes will be of greater importance in the medium to small firms. This requirement with reference to the membership at the time of the original appointment will be onerous for medium to small size firms and will result in a barrier to entry.

Section 274A: Rotation of auditors

Summarised comment(s)
<ul style="list-style-type: none">We agree that mandatory partner rotation should address the perceived relationship build-up between senior client staff and the audit firm.
<ul style="list-style-type: none">We believe that the time limit of four years as proposed in these amendments should rather be in line with international trends.
<ul style="list-style-type: none">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.

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The Bill refers to the term “nominated” auditor. This term is not defined and we believe that the correct term in the remaining sections of the Bill 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.

Such a limited period for the individual to serve on the client will raise the following concerns:

Limited auditing resources in South Africa

There are already severely limited high-level specialist auditing resources in South Africa and in respect of certain industries there are not enough partners with the required level of specialist skills to allow rotation to take place effectively. This argument is used especially in the context of financial institutions where many already have joint auditors. Financial institutions and larger groups require a high level of skills, which are built up over time and they exist in very few firms. Indeed, it is argued that even in these firms it is difficult to maintain the required skills because of emigration and the flow of key people to commerce and industry.

Undermines audit effectiveness and increases audit risk

Knowledge of the client’s business, which is built up over a number of years, is the cornerstone of an effective audit. Experience of working with a client is now more important than ever, as it is increasingly difficult for auditors to obtain knowledge of the client’s business due to the rapidly increasing complexity of today’s business operations in terms of technology, business processes, the structure of transactions and financial control procedures, especially in cases of large groups of companies which have operations in countries other than South Africa.

An audit is a complex project involving judgements about the appropriateness of accounting policies chosen by management, the values ascribed to assets and the estimates made for liabilities. The knowledge that the auditor needs in order to perform an effective audit is not only of the business itself but also how the business processes relate to an increasingly complex set of external reporting requirements.

The current audit approaches adopted by the “big 4” audit firms require a clear understanding of the client’s business model to enable the auditor to understand and challenge the accounting consequences. There are no generic pre-determined audit procedures, but appropriate procedures are designed and tailored to the risks at the client being audited. Client

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knowledge is therefore crucial to the audit approach and to thoroughly acquire this knowledge.

A rotation period of 4 years would undermine the accumulation of knowledge and has a negative effect on the audit itself. Research conducted by the AICPA in the US into over 400 cases of alleged 'audit failure' between 1979 and 1991 that the alleged failures occurred almost three times as often when the auditor was performing his first or second audit of the company, compared to the third and subsequent audits.

Increases audit costs

New auditors invest more learning time in the early years of the audit relationship, which obviously has an attendant cost both to the auditor and the company.

Management also face the disruption, expense and additional time involvement each time a partner rotates. The advantages of having an auditor who knows the business are lost, as are any efficiencies developed over the years by the preceding audit partner.

Creates significant practical problems in a global context

Given the nature of the global markets, the management and control over a global audit will become increasingly difficult where national regulation requires rotation after different periods e.g. nine years in one country, five years in another and so on. This is even further exacerbated where South Africa's major trading partners such as the US and Europe follow the rotation requirements set out in the Sarbanes-Oxley Act and the International Federation of Accountants' Code of Ethics.

Complex assignments

Cumulative knowledge and experience within the audit team is lost when a four year rotation cycle is imposed and this can be especially important in cases of greater client complexity.

Audit quality could deteriorate

In a four year mandatory rotation cycle, there is no reward for good quality work and the audit partner will be rotated irrespective of how well he/she performs or the quality of the audit.

In addition, the regulators have forgotten the stringent internal quality procedures that an audit firm has to address. An audit is often perceived entirely as a routine, number-crunching or a simple verification exercise. What is often not appreciated is that an audit is a complex project involving judgements about the appropriateness of accounting policies chosen by management, the values ascribed to assets and the estimates made for liabilities. For some of these issues there is no obvious right answer and there is judgement involved in getting the balance right and in justifying the treatment adopted. Auditors are requested to challenge the judgements made by management and the transparency of the disclosures.

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.

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Section 275A: Non-audit services

Summarised comment(s)
<ul style="list-style-type: none">• 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.
<ul style="list-style-type: none">• 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 best practice and global trends.

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 line with the international trends and 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 conflict of interest and 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.

Section 275A(3)(b): Auditor having financial interest in a company

Summarised comment(s)
<ul style="list-style-type: none">• We support the requirement in the Bill that 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”.
<ul style="list-style-type: none">• We support using the IFAC definition of financial interest in the Draft Bill.
<ul style="list-style-type: none">• We recommend that this requirement be amended to require the auditor to dispose of financial interest before or on appointment as auditor.

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The definition of financial interest in the Bill is unclear 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.

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 a financial interest within a specified timeframe before or on appointment as auditor.

Section 280: Reportable irregularity

Summarised comment(s)

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

The proposed definition of reportable irregularity in the Bill includes “any unlawful act or omission”. 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 Bill does not provide for overlapping reporting obligations which arise from other legislation, for example the Financial Intelligence Center Act.

Section 286: Accounting standards

Summarised comment(s)

- **We support the need for legal backing for financial reporting standards.**
- **Limited purpose accounting standards need to be developed as a matter of urgency before the requirements in this section of the Bill can be enacted.**

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We support legislating International Financial Reporting Standards for Public Interest Companies and Limited Purpose Companies.

Section 286(2)(i) allows limited purpose companies to depart from any requirement of financial reporting standards if the particulars of the departure and reasons for it are disclosed in the financial reports.

The International Standards on Auditing require the auditor to evaluate the measurement, recognition, presentation and disclosure of an entity's financial statements in terms of a 'recognised framework'. In the absence of a framework, the auditor is unable to express an unqualified opinion. The recognised framework must allow for consistent evaluation by different parties and result in a similar opinion on the financial statements.

The departure of limited purpose companies will not comply with the requirements of a recognised framework, and although the Companies Act will allow such departures, the auditor will be unable to express an unmodified opinion.

These 'standard' modifications will negatively impact on the public perception of the company and could in fact deter the user's attention from other significant modifications such as going concern problems. Modified opinions will result in increasing difficulty for limited purpose companies to obtain funding from banks and other financial institutions.

The establishment of limited purpose accounting standards has been planned for an extensive period of time. The timeframe for enactment of this requirement should be brought in line with the completion of such standards to allow auditors to report on a suitable recognised framework for limited purpose companies.

Section 286(B): Attendance of auditors

Summarised comment(s)
<ul style="list-style-type: none">We agree in principle with the requirements for the auditor to meet with the audit committee for both the public interest company and limited purpose company.

This section requires the auditor to reasonably respond to any question which is relevant to the audit. Such requirement may result in sensitive information being disclosed at an annual general meeting and, in fact, may be beyond the scope of the Promotion of Access to Information Act. We suggest the Bill should address some form of limitation and protection to the company, its directors and its auditors in such situations.

It should be clarified if the requirements of this section will be superseded by section 8(1) and an offence will be considered only in cases of gross negligence.

This section also refers to the 'nominated' auditor who fails to attend the annual general meeting. It has been established in the Bill that a different auditor than the nominated auditor may be appointed by the audit committee. This section will result in the 'nominated' auditor being guilty of an offence even if he/she did not perform the audit. We suggest that any reference to 'nominated' auditor be amended to 'appointed' auditor.

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Section 287: Offences for directors

Summarised comment(s)
<ul style="list-style-type: none">• We believe that a dispute resolution process should be legislated in cases where the directors and auditors cannot achieve agreement on the application of Financial Reporting Standards.
<ul style="list-style-type: none">• If not covered by Section 8(1) limitation of non-executive director liability needs to be introduced

Section 287 stated that directors will be guilty of an offence where incomplete or non-compliant financial reports are issued. Practically, certain financial reporting standards allow for differing interpretations and treatment of measurement and recognition of the underlying financial information and there will be many cases where the directors and auditors cannot agree on the most appropriate treatment in terms of reporting standards.

In situations where agreement cannot be achieved, the auditor is required to assess the affect on the fair presentation of the financial statements. In cases where the financial statements are materially misstates, a qualified audit opinion will be expressed. Should the effect be material and/or pervasive, the auditor will express an adverse opinion.

In terms of section 287 of the Bill, the directors will be guilty of an offence in cases where the auditor expressed either a qualified opinion or an adverse opinion. This will force directors to agree with auditors and will ultimately result in directors not taking ownership and responsibility for the financial statements. This effect will not meet the intended objectives of the amended legislation.

We suggest that an appropriate dispute resolution process be included in the Bill which will allow for an independent third party to mediate in cases of disagreement. We suggest that such cases be brought to the Financial reporting Investigations Panel for resolution. Should the outcome be considered unfavourable by the directors, the matter should be escalated to the High Court, whose decision will be final and binding.

Appropriate provisions should be made for the fair and equitable distribution of costs incurred during the dispute resolution process.

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Section 287A: False or misleading statements

Summarised comment(s)
<ul style="list-style-type: none">• We believe that the directors of a company are 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.
<ul style="list-style-type: none">• We also believe that the board of directors should carry Directors and Officers Insurance.
<ul style="list-style-type: none">• We believe the Bill should allow for the limitation of liability of independent non-executive directors in line with international trends. Consideration should be given to limiting liability to a reasonable multiple of their fees.

Management has an overall responsibility to the stakeholders for reporting the health of the company through the financial statements. 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.

The UK Companies Act revision in October 2004 allows for the protection of directors against third party civil claims, which qualify for the third party indemnity provision in section 309(B) of the revised Act.

Directors remain liable to the company or any associate company for liability incurred, fines imposed in criminal proceedings, or a sum payable to a regulatory authority by way of a penalty in respect of non-compliance with any requirements of a regulatory authority.

We believe that the board of directors should carry Directors and Officers Insurance. The liability of the directors should be in line with global trends and regulation.

It is 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.

Section 287A(1) refers to any person who is a party to the preparation, approval, publication, issue or supply of misleading financial reports. This process will include accountants, typists, printers and couriers who are not intended to be included in the section. We suggest the

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wording be refined to refer to any person who is a party to the preparation and approval of the financial statements, which include directors and auditors.

Should the intention be that this requirement extend to analysts and other key role players in the financial reporting cycle, the wording should be further refined to include 'reporting' on financial statements.

Section 290: Group financial statements

Summarised comment(s)
<ul style="list-style-type: none">• We believe that limited purpose accounting standards should be developed for limited purpose companies.
<ul style="list-style-type: none">• The unanimous consent of shareholders should be obtained before the limited purpose company can elect not to prepare consolidated annual financial statements.

Section 290 allows the directors of limited purpose companies not to consolidate financial statements if certain criteria are met. We believe that this decision should be taken through unanimous consent of the shareholders and not solely by the directors. The financial report is a vehicle to report the financial results of the company to the shareholders and as such the shareholders should be afforded the right to elect the manner in which the information is conveyed.

International Financial Reporting Standards (IFRS) require entities to prepare group financial statements in all group situations. Although section 290 allows for a legal departure from IFRS, this form of presentation and disclosure does not constitute a suitable framework as discussed in section 286. The auditor will be unable to express an unqualified opinion on the financial statements in this situation.

We suggest that this departure from IFRS be defined in the limited purpose accounting standards framework, once completed.

Section 300: The auditor's opinion

Summarised comment(s)
<ul style="list-style-type: none">• We believe that the auditor's opinion be kept in line with the current requirements of the International Standards of Auditing.

International Standard of Auditing (ISA) 700: The Auditor's Report on Historical Financial Information, requires the auditor to express an opinion whether the financial statements 'fairly presents the financial position of the company and the results of its operations in conformity with generally accepted accounting practice'.

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The wording of the opinion in the Bill should be in line with the wording required by the ISA and not merely refer to 'comply' with the financial reporting standards. The unintended consequence of this provision will result in directors being guilty of an offence in cases where the auditor expresses a qualified opinion due to a disagreement.

Section 440P: Establishment of Council

Summarised comment(s)
<ul style="list-style-type: none">We believe that the number of auditors represented on the Council should be brought in line with international trends.

The current requirement of allowing the Financial Reporting Council (FRC) to consist of only three auditors is contrary to international trends. Globally there are four major accounting firms with the expertise and available resources to assist with the standard comments and exposure process. Internationally it is recognised that standards bodies should consist of a representative of the four major firms and one representative from a medium or small firm.

The comments and exposure is a long, intensive process that requires input from a wide body of specialists within the firm and a significant time commitment to attend various discussion meetings. Many of the medium or small firms have limited resources to assist in such a process.

A representation of five members from the profession will not affect the majority of the FRC and the objective of this Council will be achieved.

Section 440S: Functions of the Council

Summarised comment(s)
<ul style="list-style-type: none">The development of limited purpose accounting standards is debated internationally and the FRC should adopt such standards as soon as possible.

The Bill should require the FRC to adopt International Financial Reporting Standards (IFRS) once these standards have been issued by the International Accounting Standards Board. The reference to 'develop' financial reporting standards in section 440(S)(1) should be removed as it may be interpreted that South Africa will not harmonise fully with IFRS. In cases where local guidance need to be developed for specific South Africa legislation, for example STC, such directives need to issued in a more appropriate format with similar legal backing.

As highlighted previously in this submission, the issue of a limited purpose accounting standards framework is an international issue that should be resolved by the International Accounting Standards Board. The FRC should ensure that appropriate comments are submitted on all exposure drafts of these standards, and that these standards will be practical and appropriate for use by limited purpose companies in South Africa.

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Section 440(U)(2): Approval of accounting standards

Summarised comment(s)
<ul style="list-style-type: none">• We believe that a properly constituted Financial Reporting Council is the appropriate body to approve Financial Reporting Standards.

It is unclear if the 'Minister' referred to in section 440(U)(2) is the Minister of Trade and Industry or the Minister of Finance. We do not believe that an additional approval layer should be built into an already long and resource intensive process.

We believe that the composition and mandate of the FRC will afford such a body with the necessary skills and experience to assess and comment on all new and revised IFRS. If the process of approval and publication of standards as set out in the Bill is followed, it will be unnecessary to include the additional approval by the Minister.

The accounting standards are updated and issued at significant rate. In 2004 alone 18 IFRS's were revised and 6 new IFRS's were issued. This exposure and approval process will be expanded to include the GRAP standards and the limited purpose financial reporting standards which will increase the approval and publication rate exponentially.

Section 440(V): Monitoring

Summarised comment(s)
<ul style="list-style-type: none">• We believe that the interaction between the Securities Regulation Panel, the Financial Reporting Investigations Panel and the compliance officer in this section should be clarified.

Presently the JSE Securities Exchange reviews financial reports of listed companies for instance of non-compliance with Generally Accepted Accounting Standards. These cases are brought to the attention of the GAAP Monitoring Panel, which investigates all cases brought before them.

It is unclear from Section 440(V)(1) if this process will involve the JSE Securities Exchange and what the interaction will be between this 'compliance officer' and the Financial Reporting Investigations Panel.

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Section 440AA(5): Financial Reporting Investigations Panel

Summarised comment(s)
<ul style="list-style-type: none">• We suggest the composition of the Financial Reporting Investigations Panel be further refined

Section 440AA(5)(b) requires a person that is qualified in law to serve on the Panel and section 440AA(5)(c) refers to two persons qualified in accounting.

Due to the specialised nature of this function and the activities and status of the Panel, we suggest that the requirement be further defined to refer to “a person qualified and experienced in commercial law” and “at least two persons qualified and experienced in accounting”.