

DELOITTE SUBMISSION TO THE STANDING COMMITTEE ON FINANCE IN RESPECT OF THE IRBA CONSULTATION PAPER: MEASURES TO STRENGTHEN AUDITOR INDEPENDENCE

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QUESTION 4: SHARE ANY OTHER COMMENTS YOU HAVE ON THE IMPLEMENTATION OF MAFR

Transformation

The IRBA acknowledges in the Paper that MAFR in itself will not achieve the transformation objectives required in the South African context. The Paper seems to deal with both market concentration and transformation of the audit profession (in terms of the BEE context) under the heading "transformation".

Deloitte is firmly committed to accelerated transformation, not only within our own Firm, but also of the profession as a whole and we agree with the IRBA submission that MAFR is not the appropriate vehicle to achieve these objectives. We have a number of programmes and processes in place to continuously increase our transformation results.

We currently have 45% black representation across our national audit practice. We have trained approximately 21% of all African Black CA's (SA) (audit elective); this is in the context that Deloitte's relative size in terms of number of trainees is approximately 14%. Further, Deloitte South Africa has 266 partners and directors, of which 95 are South African Black as defined in the Employment Equity Act 1995 and BBBEE Codes of 2007, constituting a 35.71% Black Equity Ownership.

42% of our audit partnership, that are fully involved in the audit practice, are black. Deloitte has 48 black audit partners, nine of whom sign audit opinions for large listed companies. It should be noted that partnership is for many a stepping stone to other careers. Since 1996 Deloitte has appointed 76 black Audit partners, 28 of which have subsequently withdraw from the partnership and now hold senior positions within Corporates and Financial Institutions in the South African economy.

At the SAICA Indaba it was noted that transformation of our profession remains an imperative and the suggestion was made that there was a need for a Transformation Indaba to discuss more broadly what companies and audit firms can do by working together to accelerate this process. We ask that the IRBA consider this.

Is there anything positive in the IRBA proposal?

- The IRBA process has created a platform for inclusive debate and discussion among all stakeholders on important matters, including audit quality, independence and transformation of the profession.
- The IRBA appears to have abandoned the need for mandating joint audits. We believe that this is sensible given the lack of evidence supporting the belief that the value of these arrangements outweighs the cost; and
- The IRBA proposal provides a reasonable time for implementation (2023) and a reasonable time frame for appointment (10 years).

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**QUESTION 2: QUANTIFY THE POTENTIAL COSTS OF IMPLEMENTING MAFR IN THE
LISTED COMPANY/AUDIT FIRM**

Costs

Implementation of MAFR is costly to both auditors and the companies being audited. In our experience the bid and targeting costs incurred by audit firms for a top 100 company amount to approximately 30% of the annual audit fees. For clients outside the top 100 we estimate bid and targeting costs to amount to approximately R500k per bid.

On transition, in our experience in the first year of the audit an additional 30% to 50% of the audit fee is spent on set up cost to understand the client's business. In our experience these costs are not borne by the client but by the audit firms.

The ability of audit firms to absorb these costs is limited and training and bursary spend would be redirected to bid and targeting efforts given the pressure on financial results.

We know from experience that transitioning an audit is also time consuming for management and audit committees of companies, with additional time spent as a result of the bid process, as well as in spending more time with audit teams as part of the year-end audit.

**QUESTION 3: SHOULD THE SCOPE OF MAFR BE EXTENDED BEYOND LISTED
COMPANIES TO OTHER ENTITIES THAT OPERATE IN THE PUBLIC INTEREST?**

We believe that, should MAFR be implemented, it should apply to all equity-listed companies and state-owned companies listed in Schedule II of the Public Finance Management Act. MAFR should NOT apply to public companies with listed debt, other public companies, private companies, non-profit companies, personal liability companies or pension funds. This is because the scale of such a change is significant and limiting its application to these companies allows audit firms to, as far as is possible, plan for and manage the process effectively.

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Audit firm

- **Quality**

There is evidence that changing audit firms has a negative impact on the quality of the audit particularly in the first few years following the appointment of a new audit firm. Audit firms are aware of this risk and therefore invest significant effort in the first year of conducting an audit to mitigate this risk. This cost has to be borne by either companies or audit firms and means that investments that could be made in training and other quality initiatives have to stop or be deferred.

- **Talent**
 - At present audit firms are able to accurately forecast the annual work that will take place and the timing of this work. The experience in the UK and the EU is that as a result of MAFR, alternative delivery models are being actively pursued with less skilled audit work being offshored to India and Eastern Europe, given the uncertainty associated with revenue streams. We would expect South Africa to follow this trend on implementation of MAFR.
 - We would further expect, on the implementation of MAFR, less investment in people and training for trainees and more investment in managers and partners. This is because audit buying decisions will rest on the skills and experience of more senior resources rather the skills of audit trainees. This redirected training and development spend and effort is likely to impact on the quality and skills of trainees qualifying at the audit firms.
 - Audit partners and managers are attracted to the profession, to some extent, by the certainty associated with the role which is linked with professionalism, managing risk and audit quality. Attracting these sort of individuals with these mind-sets to a profession which will become increasingly associated with winning new audits and managing audit proposals with uncertain outcomes, is a difficult ask. Attracting the right type of talent to the profession will become a challenge.
 - Specialist skills are built up by audit firms over extended periods. On rotation, maintaining specialist skills may be challenging and this may mean that on the second round of rotation finding a credible firm with the required skills may be difficult.

Difficult economic times

The country is facing a possible credit-rating downgrade to junk status. Incurring these sorts of costs and making significant changes to the regulatory environment increases the cost of capital, making it increasingly difficult for companies to do business.

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Section B: Deloitte response to comment on the 4 specific matters posed by the IRBA

These comments should be read together with our comments in the Section A to this document

QUESTION 1: EXPLAIN THE PRACTICAL IMPLEMENTATION AND IMPLICATIONS OF MAFR ON THE LISTED COMPANY/AUDIT FIRM

Listed companies

Companies are of course best equipped to explain the impact and practical challenges of MAFR. Some of the challenges that we see facing companies are:

- The rapidly increasing complexity of today's business operations means that auditors examining a company's affairs for the first time face a steep learning curve. This is especially true for large listed companies and multinationals;
- A deep understanding of the business being audited is paramount to audit quality. Auditor rotation erases the cumulative knowledge of an audit firm;
- MAFR limits choice (incumbent firms cannot be considered for re-appointment, even if they provide the highest quality service);
- The introduction of MAFR would force the audit committee of a company to change its auditor and would deprive it of its right to make an informed decision in the best interests of the company;
- As the audit committee would be forced to change auditors and select from a smaller base, it could find itself having to appoint an auditor that it judged would not be able to provide either the quality or cost efficiency of the existing firm;
- Changing auditors is disruptive and time consuming and these costs need to be balanced against the perceived benefits;
- Auditors' existing knowledge of a client's business results in efficiencies being built into audit fees. Changing auditors means that this knowledge falls away and this cost has to be borne by either companies or audit firms; and
- The adverse effect on the incentives of the incumbent to perform well as the limit on its tenure approaches.

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- **Constitutionality of the consultation process followed by the IRBA**
In terms of South African law, Government needs to follow a formal public consultation process wherein ALL affected parties are provided with the opportunity to engage Government on proposed legislation. The process followed by the IRBA has not been transparent and did not allow any discussion on the IRBA's conclusions/findings. To date, none of the affected parties have been afforded an opportunity to comment on, or provide input, in a structured process based on a specific proposal with respect to the necessity and/or viability of the introduction of MAFR in South Africa. Rather, affected parties were merely provided with an opportunity to express their views on the concept of MAFR in general.

It should be noted that this principle was confirmed in the recent Constitutional Court decision where the Land Restitution Amendment Act was declared unconstitutional after finding that Parliament failed to allow for proper consultation before passing the law.

We believe that only once a formal public consultation process which allows all affected parties to express their views occurs, and the IRBA has considered all submissions, may they proceed to consider the proposed promulgation of the regulation (which in our view requires amendments to the Companies Act).

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4. IS THERE EVIDENCE THAT MAFR WILL ENHANCE AUDITOR INDEPENDENCE AND AUDIT QUALITY?

The Paper does not provide a motivation for the selection of these particular MAFR measures (described below), nor does it indicate how it believes this particular set of measures will enhance/guarantee auditor independence within the South African context.

It is possible that these measures are merely based on those introduced in the European Union, but if this is the case, there is no consideration as to whether these are appropriate for local nuances in South Africa.

The Paper does not consider the existing measures (audit partner rotation, approval of non-audit services, IRBA Code Independence requirements, audit committee verification of auditor independence, etc.) and the effectiveness of these or how these could be enhanced.

Globally, there is no conclusive evidence or study that MAFR enhances auditor independence and audit quality.

5. IS AN AMENDMENT TO THE IRBA CODE OF ETHICS THE MOST APPROPRIATE WAY TO IMPLEMENT MAFR?

The Paper provides no justification for MAFR to be introduced via the IRBA Code, rather than through a legislative amendment of the Companies Act.

- **Does the introduction of MAFR fall within the ambit of the Auditing Professions Act, or the Companies Act?**

The Specialist Committee on Company Law ("SCCL") indicated that although the IRBA bears overall regulatory responsibility for oversight of independent auditors, the appointment of auditors for companies falls within the ambit of the Companies Act. As such the introduction of any additional measures pertaining to the appointment of the auditor must be promulgated through the Companies Act.

The Companies Act contains a range of measures to regulate the appointment of the auditor (sets out the process (section 90), provides for the disqualification of the auditor where certain non-audit services are provided (section 90(2)), regulates the rotation of the designated auditor (the audit partner) (section 92) as well as the resignation of the auditor and vacancies (section 91 and section 89)).

The introduction of MAFR will inevitably affect the rights of shareholders to appoint an auditor of their choice, and impact the rights and responsibility of the audit committee to act in the best interest of the company and nominate an independent auditor of their choice. In effect, the introduction of MAFR amounts to the regulation of companies (and their shareholders and audit committee), rather than the regulation of auditors.

As such we believe that MAFR is a matter that should fall within the ambit of the Companies Act.

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IFAC roundtable participants in Hong Kong and London also stressed that research and a clear evidence basis are vital to identify solutions most likely to be effective. This is all the more critical in light of the costs of regulation to businesses trying to operate in a global environment, and possible unforeseen consequences.

- **Lack of impact assessment**

The Paper provides no impact assessment. The experience in jurisdictions where MAFR was implemented indicated that there are significant costs related to the tendering process and especially the time required from both the new audit team and management to on-board a new audit firm.

MAFR may also have an impact on audit fees, and this matter needs to be considered more carefully. The impact of this on the South African market has not been quantified and the analysis presented in the Paper on audit fees following a change in auditors does not address this concern.

MAFR will inevitably impact the regulatory burden/cost on affected companies. The decision to change auditors or not should be that of the audit committee and the shareholders, and not the regulator - as such the audit committee and shareholders can make an informed decision in the best interests of the company as to whether or not, and when, to change audit firms.

According to the Memorandum on the Objects of the Red Tape Impact Assessment Bill, 2016 government mandated impact assessments for all primary and secondary legislation (an amendment to the IRBA Code of Ethics constitutes secondary legislation). The Memorandum states that "[I]n May 2015 the Presidency's Department of Planning, Monitoring and Evaluation issued the Socio-Economic Impact Assessment System (SEIAS) guidelines.... The SEIAS guidelines also provides that from 1 June 2015, all Cabinet Memoranda that seek approval for draft primary or secondary legislation must include an impact assessment that has been vested by the Central SEIAS Unit". Even though the IRBA does not need Cabinet approval to promulgate secondary legislation, it is submitted that all organs of state are bound by these SEIAS guidelines.

The Paper does not provide a response to the myriad of concerns and questions raised by listed companies, the CFO Forum, the IoD, and audit firms pertaining to the effectiveness of MAFR in other jurisdictions, or its appropriateness in South Africa. Particularly, the role of the audit committee within the current regulatory framework is largely ignored (this argument formed the crux of the decision of the US House of Representatives to reject MAFR). Also, the lack of an independent impact assessment (to consider financial and other costs) and approach needs to be considered.

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3. IS MAFR AN APPROPRIATE MEASURE THAT WILL SIGNIFICANTLY ENHANCE INDEPENDENCE IN A COST-EFFECTIVE MANNER?

- **Lack of evidence that MAFR will enhance independence**

There is no justification set out in the Paper as to how MAFR will in fact address the alleged independence concerns, and why a renewed focus on the range of existing measures cannot sufficiently deal with these concerns. Clearly, MAFR will directly impact the **perceived** lack of independence in the case of long firm tenure. However, since the introduction of the IRBA requirement for firms to disclose the length of audit firm tenure at a particular client, audit committees and shareholders (especially the Public Investment Corporation) are well aware of this matter. We have seen this issue receive attention at both audit committee level and at companies' annual general meetings with a number of listed companies either already changing audit firms or initiating a process to consider a change in audit firm.

We believe that this is a sensible approach as those charged with governance, and shareholders, are best placed to balance the risk of long tenure (e.g. perceived or actual lack of independence) with the benefits thereof (e.g. knowledge of the business, understanding of the key risks, etc.).

It is important to evaluate the potential effectiveness of MAFR in view of the range of existing measures aimed at audit quality and auditor independence.

These measures include:

- partner rotation;
- independent audit committees to ensure auditor independence;
- appointment of the external auditor by the shareholders;
- pre-approval of non-audit services;
- the prohibition of certain non-audit services (both by section 90(2) of the Companies Act and the IRBA Code of Ethics);
- Independent Regulatory Oversight - regular external inspections of audit firms by the IRBA, as well as the PCAOB (the USA Regulator), which has resulted in positive changes to audit firm oversight and improvements in audit quality; and
- Internal engagement quality control reviews in terms of ISQC 1 which strengthens audit quality.

Not all jurisdictions that implemented MAFR felt that the change was a success and in fact some have reverted back to previous practice. For example the Monetary Authority of Singapore has discontinued MAFR and many other countries are at various phases of implementing or discontinuing mandatory audit firm rotation.

South Korea, Argentina, and Brazil have implemented and discontinued the policy for certain sectors; the EU is now implementing with numerous variations across Member States - some of which, such as Spain and Italy, had previously implemented and discontinued the policy; and the US House of Representatives in 2013 voted 321-62 to prohibit the Public Company Accounting Oversight Board from requiring MAFR.

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2. THE IRBA CONSIDERED OTHER MEASURES AND MAFR REMAINS THE BEST OPTION TO IMPROVING AUDITOR INDEPENDENCE

- **Biased argument**

In our view, the Paper presents a biased argument in favour of MAFR. There seems to be no independent and objective evaluation of the arguments for or against the introduction of MAFR, the positive and/or negative experiences in other jurisdictions, or any alternative measures in lieu of MAFR.

In order to provide the context for an informed and objective consideration of this matter, it would have been useful for the IRBA to reference international research, including experiences in other jurisdictions where MAFR was introduced and later repealed.

No mention is made of the past experience of countries that had implemented some form of MAFR and then withdrew these requirements such as Canada, Czech Republic, Korea, Latvia, Singapore and Slovak Republic. There was also no mention of the significant debate and outright rejection of MAFR by the United States of America. This suggests a biased position which does not explore all the arguments in support of or against MAFR.

- **IRBA has not considered alternative mechanisms for enhancing auditor independence**

As we note above, the IRBA Paper argues only one side of the MAFR debate, and does not evaluate the potential impact on audit quality, the risk of audit failure or other means to enhance auditor independence (e.g. strengthening audit committees, stricter rules pertaining to non-audit services (including a cap on the value of non-audit services), enhanced independence inspections and the publication of very specific findings, etc.).

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Services Board, JSE, Specialist Committee on Company Law, etc.) participants requested the IRBA to provide proper evidence that there is an independence problem within the audit profession. To date no evidence has been provided.

- **There is a "close relationship" between the external auditor and the company particularly the CFO and audit committee chair and this gives rise to a threat to independence**

The Paper notes that there is a "cosy" relationship between audit committee members, finance executives and audit firms. The evidence supporting this is that, allegedly:

- 18% of financial officers of the top 40 companies were previously employed by their audit firms, and
- 25% of audit committee chairs of the top 40 companies were previously employed by their audit firms.

No evidence is provided to support the contention that this allegation has given rise to auditors performing less robust audits, nor does the Paper provide any reference to IRBA inspection findings in this regard.

Given that the CA(SA) designation requires the holder to have completed a three year training contract, and given that the "BIG 4" have trained the majority of CA's(SA) who are now CFO's, it is unsurprising that 18% of CFO's will be employed by companies who are audited by the firm they trained with. MAFR will not change this statistic. The same would apply to audit committee chairs.

The Paper further ignores the existing independence practices of Big 4 firms around such appointments. These comply with recognised global ethical and independence requirements and are acknowledged as sufficiently stringent.

- **Long audit tenure of audit firms**
No evidence has been provided that long audit tenure has given rise to a lack of independence on the part of the auditors and as noted above, the IRBA's own inspection analysis bears this out. The Paper further ignores the fact that audit partner rotation every five years provides a fresh pair of eyes and negates the risk that long audit tenure may lead to audit firms not completing an independent and challenging audit.
- **Audits taken back by AGSA from audit firms**
The Paper stated that the AGSA had noted ethical and independence concerns about some audit firms from which it retracted State Owned Entity audits. We note that on 11 November 2016 the IRBA was forced to withdraw this allegation which indicates that there was no merit to this assertion.

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Section A: Why we do not believe the IRBA has made the case for MAFR?

1. SO IS THERE AN AUDITOR INDEPENDENCE PROBLEM IN SOUTH AFRICA?

South Africa has been rated number one in the world for the strength of its auditing and reporting standards as rated by the World Economic Forum's ("WEF") Global Competitiveness Index. It appears unlikely that this rating would be achieved if auditors and companies in South Africa were not properly applying their minds in the preparation of their financial reporting.

The Paper's evidence that there is an independence problem are:

- **Results of inspection findings as these pertain to independence**
The IRBA's Public Inspections Report 2014/2015¹ splits findings between those against firms: systems of quality control, and those arising on actual engagements.

Firm inspection results

37 firms were inspected in 2015 and independence findings were made against 43% of these. The IRBA inspection report indicates that these findings do not all relate to independence findings. The inspection report unfortunately provides no contextualisation as to whether or not these findings relate to listed companies, or against large or mid-tier audit firms. If these findings relate to unlisted public and/or private companies, the MAFR proposal will not address these concerns. The proposed measures will apply to the auditors of listed companies only.

The Paper indicates that "numerous contraventions" of section 90(2) were found. If these findings related to listed companies it is assumed that all of the top- and mid-tier audit firms would have been aware of these findings as they would have resulted in the immediate disqualification of the audit firm responsible for the audit of the relevant listed company, with the results being subject to re-audit. Given that this has not happened we can only conclude that these findings did not apply to listed companies and therefore that the larger audit firms' (as they generally tend to be auditors to listed companies) processes of quality and independence are largely effective.

Audit engagement inspection results

These reviews would indicate whether a lack of appropriate systems of quality control at a firm level had given rise to inappropriate audit work on engagements. The IRBA report indicates that of the 1 054 findings made, 2% relate to ethics and independence. Again the IRBA report does not indicate the nature of these findings or the firms where these arose. In our view, this statistic is not indicative of a significant independence problem within the audit profession.

At the SAICA Indaba held on 10 November 2016 (attended by a wide range of stakeholders including large, medium and small audit firms, audit committee members, CFO's of listed companies, the IoD, National Treasury, Financial

¹ <https://www.irba.co.za/guidance-to-ras/inspections/reports>

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CONCLUSION

The debate as to how to best achieve auditor independence and audit quality is an important one and the IRBA-led MAFR discussion has highlighted the key role of the auditor in ensuring companies report reliable, balanced and fair financial results. We do not believe that the debate is over but encourage the IRBA to consider the views of all stakeholders in an open and transparent fashion.

The potential ramifications of MAFR are significant, and untested, as evidenced by the fact that capital markets of the world do not have a consistent view on the matter.

Globally, research into the advantages and disadvantages of MAFR continues. Furthermore, local research is required to ensure that, in the South African context, the relevance and importance of the audit profession continues, that we remain in line and indeed ahead of best practice globally, ensuring that auditors are equipped and encouraged to discharge their obligations in an independent fashion.

It may be that adopting a "wait and see" approach with a renewed focus on the matters that are most pressing and within our sphere of influence is appropriate. These are:

- transformation of the Audit profession, and the business community in general, and
- further enhancing audit quality.

We look forward to working with the IRBA and other stakeholders as we continue on this journey.

Yours sincerely



Lwazi Bam
Deloitte Africa
Chief Executive Officer

13 February 2017

DELOITTE SUBMISSION TO THE STANDING COMMITTEE ON FINANCE IN RESPECT OF THE IRBA CONSULTATION PAPER ("THE PAPER"): MEASURES TO STRENGTHEN AUDITOR INDEPENDENCE

Attention: Hon YI Carrim, MP, Chairperson: Standing Committee on Finance

C/O Committee Secretaries, Ms Teboho Sepanya, tsepanya@parliament.gov.za and Mr Allen Wicomb, awicomb@parliament.gov.za

INTRODUCTION

Deloitte remains committed to enhancing the public's trust in capital markets and confidence in the role of the auditor in particular. Deloitte supports efforts to bring about change that will enhance audit quality and trust in financial reporting, and strengthen the independence of the auditor and the role of the audit committee.

We support any measure that enhances audit quality and auditor independence, however there is insufficient evidence that a problem currently exists. Furthermore, there is insufficient evidence that the introduction of the said measure will result in the desired outcome of enhanced quality as a result of improved auditor independence.

We do not believe that the IRBA has provided compelling evidence that:

1. There is an auditor independence problem in South Africa and that this is negatively impacting the profession in terms of poor audit quality and lack of challenge to companies in the preparation of annual financial statements;
2. Other measures have been considered and MAFR remains the best option to improving auditor independence;
3. MAFR will enhance auditor independence and audit quality and will achieve this in a cost-effective manner;
4. There is a direct link between the introduction of MAFR and enhanced auditor independence and audit quality; and
5. An amendment to the IRBA Code of Ethics is the most appropriate way to implement MAFR.

IN THIS DOCUMENT

Under section A to this document we explain why we do not believe the IRBA has made the case for MAFR.

Under section B we comment on the 4 specific matters posed by the IRBA.

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A full list of partners and directors is available on request

* Partner and Registered Auditor

B-BBEE rating: Level 2 contributor in terms of the Chartered Accountancy Profession Sector Code

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