Building a better working world

15 March 2017

Honourable Chairman, Members of Parliament, Committee Members of the Standing Committee on Finance, colleagues in the Accounting and Audit Profession and other stakeholders,

Good Morning

Introduction

My name is Ajen Sita. I am the CEO of EY (Ernst & Young) in South Africa. Six years ago, I was asked by our partners across sub-Saharan Africa to lead the business across our continent.

It is indeed a privilege to have the opportunity to address this committee and I thank you for this.

Chair, I attended the last Parliamentary briefing on the topic of Mandatory Audit Firm Rotation ("MAFR") and noted that three topics dominated conversations. These were:

a) The need to strengthen 'independence and quality' in the audit profession;
b) The need to deal with 'concentration in the audit market'; and
c) The need to deal with 'transformation' in the profession.

Each of these issues is important, not just for our profession, but for investors and the capital markets. There is no doubt that these topics have brought out strong emotions as well as passionate arguments for and against MAFR. It is clear that we are dealing with a complex topic, which started as a desire to improve independence, then became about MAFR, which is now intrinsically linked to market concentration and transformation. Many commentators have already stated that each of these three challenges require individual attention and that MAFR is not the single solution to all. In fact, it may even deepen concentration and retard transformation.

Chair, a wide range of stakeholders, the accounting profession, various regulators, the IRBA, commerce, industry, as well as Parliament need more time to properly understand the impacts, unintended consequences and potential alternatives. This work is simply too important for our country to get it wrong.

For your benefit, I will provide my own perspective on these topics. I feel that there is a “better way” and will highlight this later.

Before, I do so, let me share more about myself.

About Ajen

Chair, I was born and grew up in a small town in Pretoria called Laudium, to parents who did not have the opportunity to complete school. Despite their lack of formal education, as committed citizens and parents, they understood their responsibility to give back to the community and prioritised education for their children. My father, like my grandfather on my wife’s side, Nana Sita, fought against the establishment of the tricameral political system and the Group Areas Act and suffered much at the hands of the security police. It was from an early age that as a young man I was taught to speak up for the rights of the less privileged, to give back to the community; and bring them along as I progressed.

As a student in an apartheid-styled school system, I was actively involved in student protests in the 80’s against the then apartheid regime. This activism, was sparked by an understanding of the need to create a more equal society.

Despite strong odds, through sheer dedication, hard work and a commitment to build and transform our profession, I was able to rise through the ranks of the profession and today to be able to lead one of the largest firms within it and more broadly, to play an active role in the President’s Business and CEO initiatives, as well as to play a leadership role in transforming our profession.

Chair, I will now turn my comments to the three topics at hand. Firstly, independence and quality.

Independence and Quality

Chair, independence and quality are the cornerstones of our profession. They are critical for instilling trust in our capital markets that international and local investors in our economy regard as critical and is therefore in the ‘public interest’. All efforts to protect and improve these should

be given due consideration. The principle argument advanced for having a check on independence is the ‘tenure of audit firm relationships with their clients’. As we consider this aspect, it is important to be aware of some of the regulatory and firm safeguards already in place to deal with this concern. Amongst others, these are:

a) All audit partners are today precluded from serving their clients for a duration of longer than five years – the so called partner rotation rule.
b) Audit partners in all of the big firms are not incentivised nor compensated for the sales performance on their audits. Their overriding measure of performance is ‘audit quality’.
c) All audit partners of listed companies and public interest entities are subject to an independent ‘engagement quality review’ prior to the issuance of their opinions – you might say a second opinion is sought to ensure quality of the judgements reached. These partners are also subject to rotation rules.
d) Audit partners, family members and those in their chain of command are barred from owning shares or having any other form of financial interest or business relationship with their audit clients, thus removing any self-interest threats.
e) The work of the audit partner is inspected by both internal reviewers as well as external regulators on a prescribed time interval, such as the IRBA or the US PCAOB for compliance with audit and ethical standards.
f) S90(2) of the Companies Act precludes the auditor from providing certain prohibited non-audit services to their audit clients five years prior to accepting an appointment so as to ensure that there are no self-interest threats.
g) The list goes on.

Chair, South Africa can pride itself that we are not aware of an audit failure in the last 20 years that is attributable to a failure of independence. Furthermore, the World Economic Forum’s assessment of SA audit standards and capital markets as being number one in the world for the last seven consecutive years is testament to the fact that existing regulations and practices are already working.

It should be noted that ‘ethics & independence’ was an inspection findings theme, which was only rated 14th amongst IRBA’s inspection theme findings. The ethics and independence findings comprised less than 2% of all the findings reported in the most recent IRBA’s Inspections Report published in December 2015.

Chair, audit committees of public companies have a statutory duty to assess the independence and quality of their choice of auditor and make a recommendation to their shareholders. Disempowering the audit committee from making its own choice due to a forced rotation, opens up a new risk in the topic of directors' liability – an example of an unintended consequence.

Chair, whilst MAFR may address the issue of perceived independence it does not address independence in fact. A new audit firm could be less independent than the incumbent. Given that the disadvantages of MAFR are manifest and outweigh the benefits, we would welcome the opportunity to work with others in our profession and the IRBA as well as other stakeholder groups to look at the real concerns and develop the appropriate rules and safeguards.

Chair, allow me to turn my comments to the second topic, 'concentration in the audit profession'.

Concentration in the audit profession

It is a generally held view that concentration in any industry constrains competition and reduces innovation. We must therefore be in favour of all efforts to deal with this important topic.

Chair, if I were to draw a parallel with another industry, the medical profession, it is safe to say that there is a much higher proportion of GP's who serve general medicine, to specialist doctors who perform the most complex medical treatments. Our profession is not dissimilar. The world over, you will find four to six large firms performing the largest, most complex audits, the next six to eight firms serving the next high end of the market and then a large number of smaller and boutique firms serving the rest of the market. The distinction of size comes about due to the scale of investments in people & specialisms, technologies and global footprints required to serve the largest companies in any economy.

Chair, again consistent with other markets in the world, we have recently been informed by the JSE that the four largest firms audit 66% of the companies listed on the JSE.

Chair, the largest 20 companies listed on the JSE each have operations located in anywhere from 10 to in excess of 100 countries. It is not a surprise that they need a firm, a specialist that can match their footprint delivering a seamlessly consistent audit of the group.

According to IRBA statistics, outside of the Big 6 firms, there are just over 2200 registered audit firms in South Africa. There is clearly a space for all to operate in this highly competitive market.

As the smallest of the Big 4 firms, you might expect us to be in support of MAFR. In fact the experience in other markets that have introduced MAFR, is that the largest audits simply rotated amongst the large firms. However, we have observed how MAFR has been a failed experiment in many markets either increasing costs to the economy or being suspended in its entirety, the most recent examples of this are Indonesia, Brazil and Argentina.

As firms, we are acutely aware of how vulnerable our profession is to the loss of critical talent during firm rotations due to the lack of work thus increasing the financial burden and making the profession less attractive. The number of registered auditors in South Africa has remained relatively static over the last decade. According to the most recent World Bank's ROSC report the number of auditors increased minimally from 4,197 in 2003 to 4,252 in May 2012. Presently there are 4,279 registered auditors according to IRBA's website. We believe that MAFR will merely exacerbate the loss of critical talent from the industry. In fact according to the most recent World Bank ROSC report on South Africa: "*The low increase is attributed to other competing opportunities: many qualified accountants want to work in commerce and business industries. There is minimal retention of auditors in the profession after they finalise practical training. There is a perception that the unlimited personal liability, the demanding technical knowledge, and the scrutiny by the independent regulator are factors contributing to low retention. The audit partnership law in the country does not allow protection of individual audit partner's assets. And, adding to this mix, the audit profession is no longer viewed as an attractive career."*

A final point I would like to make is that the requirements to become a Chartered Accountant and Registered Auditor who is accredited by the JSE are not determined by the audit firms. These requirements are set by the IRBA and the JSE. To meet these requirements, it often

takes between 12 and 15 years to reach the point where an individual can act as a JSE accredited auditor.

We would argue that as a profession, together with our regulator, we should be working together to develop ways to make the profession more attractive to new entrants.

Chair, allow me now to turn to the third topic of transformation.

Transformation

Growing up in a poor, uneducated family, brought in sharp focus for me the importance of creating an inclusive society. I am acutely aware of the many challenges that young graduates experience in trying to make a success of their careers not only in our profession but many others. I too had to deal with the burden of access to funding, challenges of transport, lack of role models and many other hurdles suffered in particular, by young black professionals.

Chair, both my firm and many others in our profession have made much progress on transformation. We can share statistics that show gains in our ownership demographics, the transformed make-up of our staff mix, or that our firms are led by a majority of black people. However, none of us can legitimately claim the journey of transformation is now over or that it is well anchored.

Just some of the present challenges we face are:

a) The limited number of black auditors who are available to serve JSE listed companies.
b) The difficulty in raising funds to start or grow your own businesses.
c) The regulatory restrictions that prevent audit firms from appointing suitably qualified non auditors as partners in audit firms.
d) The lack of funds available at historically disadvantaged universities to develop, accredited accounting programmes aimed at new generations of black accountants.
e) The poor maths results at school level that prevent many promising young learners from entering the audit profession.
f) The list goes on…

With this in mind, internally at EY, I have committed the firm to make transformation a strategic priority. At the appropriate time, I will be happy to share some of the progress we are making and the success we are enjoying.

Outside of EY, I am the Chairman of the Thuthuka Education Upliftment Fund. Thuthuka is the single largest vehicle driving the transformation of our profession, and is recognised by the Department of Higher Education as the best delivery vehicle for producing more black graduates and professionals in our country. Chair, some statistics on the Thuthuka programme:

a) Annually the Fund provides support to more than 100 000 school learners;
b) Annually we bursar about 300 black students at universities and today have a cohort of fully funded students in excess of 1,000;
c) Thuthuka provides direct support to many of the historically disadvantaged universities to assist them with obtaining accreditation from the SA Institute of Chartered Accountants;
d) We provide direct support to black and coloured students to support them with Board Exam preparations. This is mostly directed to students who have studied part time on distance learning programs such as offered by UNISA; and
e) The Fund is currently running the pilot Ikusasa Student Financial Aid Programme (ISFAP), which is a programme that enjoys the support of the Department of Higher Education and the Business Community as a model that will systemically deal with the challenge to funding for both the poor and the ‘missing middle’ students in not only the accounting profession, but also, doctors, engineers, actuaries, nurses, etc.

Last week, I participated in a Transformation Indaba hosted by the South African Institute of Chartered Accountants (SAICA), which was attended by a diverse group of stakeholders in our profession from large firms to small, global to local, etc. It was encouraging to see how we as the profession came together and coherently and consistently articulated our challenges and made many positive recommendations, which covered amongst others, strategies to improve pass rates for Black students at universities, funding for young black academics and the development of target’s to measure the progress of transformation.

Chair, as leaders in our profession we are doing some introspection and I am pleased by the passion displayed by all role players to move us forward. We need deep and lasting solutions

to transformation and to achieve our ideals of radical economic transformation. We need to support the process initiated by Dr Terence Nombembe, the CEO of SAICA, who is bringing the profession together to find lasting solutions that go beyond compliance with a scorecard. Chair, this process will take some time and we need to give it a chance. Should we not, MAFR runs this risk of benefiting a few large firms and hurting our prospects for sustainable transformation.

Conclusion

In conclusion Chair and Honourable Members, I am grateful to you for giving me an opportunity to share our views on the IRBA's decision to introduce MAFR. Whilst the IRBA has stated that MAFR is not intended to deal with transformation, the debates about MAFR have almost exclusively focused on this topic. For this we should be grateful to the IRBA – for reigniting a much needed conversation.

Chair, in my opening I said that there is a 'better way'. As a profession, we have not had the opportunity to look at and debate a number of accelerators that can foster greater competition and enhance transformation. Some of these could include:

a) A review of the current education model that requires a 12-15 year cycle for graduates to become partners;
b) A review of the ownership models in audit firms to create space for new entrants;
c) Creation of support mechanisms to encourage small and medium sized black firms to enter the profession and succeed;
d) Developing innovative funding models to support the setup of new black firms;
e) Encouraging the private sector and listed companies to make greater use of black firms
f) The development of a South African 'Transparency Report' requiring all public entities to annually report on their progress on transformation;
g) And there are many more …

Chair and Members of the Committee, investors internationally and locally remind us all the time of the critical role external auditor's play in their capital allocation decisions. Simply said if investors have doubts as to the quality of assurance being provided by auditors in South Africa, their capital will flow elsewhere.

Accordingly, I humbly request that more work be done to understand the impact and consequences of MAFR in South Africa. We do not have a known crisis of ‘independence’, so we should not be rushing to an experimental solution.

As leaders in our country, we must acknowledge that the dreams and hopes of too many young black South Africans have been put on hold. This situation cannot continue. It would be a powerful message for this Standing Committee on Finance to ask the profession through the SAICA to gather its membership base and put forward new and innovative solutions to sustainably deal with market concentration and transformation in the profession and report back on these measures to this Committee.

As leaders it is our obligation to provide hope to young black South Africans and translate ideas to action so that the vision of a better life for all can be realised.

Thank you

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Chief Executive Officer