MINISTERIAL PANEL FOR THE

REVIEW OF THE DRAFT

ACCOUNTANCY PROFESSION BILL

REPORT

TO

THE MINISTER OF FINANCE

30 SEPTEMBER 2003

EXECUTIVE SUMMARY

Background

1. The Panel has considered the matters based upon an overriding intention to advance and maintain the probity of financial markets.

2. It has been recognised that there is an inherent potential conflict which exists as a consequence of the appointment of auditors being practically controlled by directors although the auditor's true client is the shareholder body with whom the auditor normally has no direct contact. This is an important concern which has underpinned many of the recommendations made.

3. It is necessary that steps be taken to enhance the regulatory framework relating to accountability of directors and the appropriate corporate governance practices pertaining to companies and auditors.

Regulatory Framework

4. The Accountancy Profession Bill should be renamed the Auditors' Act as it should deal solely with the auditing profession. Statutory regulation of those involved in accounting functions as contemplated in the Bill is considered impractical and unnecessary at the

present time.

5. The new regulatory body contemplated should subsume the Public Accountants' & Auditors' Board and be properly empowered to overcome certain inadequacies in existing legislation.

6. In order to ensure proper factual and perceived independence, auditors should comprise a minority of the members of the board of the regulatory body controlling the audit profession.

7. Since the regulatory body controlling the auditing profession will not be controlled by auditors and will require to be properly resourced, it will be necessary that all stakeholders and in particular government, provide funding for that body.

8. The disciplinary arm of the regulatory body controlling the audit profession is a matter of particular concern. The disciplinary body should be chaired by a retired Judge or senior counsel and legislation should provide for the proper empowerment for investigative procedures including the power of subpoena to compel the production of documents and the rendering of evidence.

9. The legislation should provide for the mandatory de-registration of auditors in respect of findings relating to fraud or other serious dishonesty.

10. An auditor should be statutorily obliged to report to the regulatory body any false representations or material non-disclosures by executive management and the regulatory body should be properly empowered to disclose such information to relevant parties if considered in the public interest.

11. A proper review needs to be performed in order to resolve the disjuncture which exists between the Accountancy Professions Bill, the Financial Reporting Bill and the Companies Act to ensure more efficient and effective corporate governance and a single arm of government to deal with such issues.

Audit committee

12. The establishment of audit committees comprised exclusively of independent non-executive directors should be made mandatory for all listed and other relevant entities.

13. Audit committees should not be considered as a panacea for all corporate ills and it must be recognised that there are practical limitations as to what can be achieved by an audit committee. The existence of an audit committee should not be used as exculpatory by directors of their responsibility to properly apply their minds in relation to the relevant issues.

14. Matters concerning the appointment of auditors and the approval of audit fees should lie exclusively within the power of the audit committee. Other statutory responsibilities of the

audit committee should include a consideration of all financial reports issued by an entity, the independence of the auditor and setting parameters for non-audit services which may be conducted by the external auditors. Outside of the appointment and fees issues, the audit committee should have no executive authority or exclusive responsibility.

15. It is not considered practical to statutorily limit the non-audit services offered or performed by an auditor to an entity. The nature and extent of such services is a matter which specifically requires consideration and pre-approval of the audit committee.

16. It is not considered efficient to introduce statutory term limits for auditors or statutory auditor rotation as these are practical resource contraints and it is unlikely that such legislation would achieve its desired objective, as is evident from international experience in this regard. The specific consideration of the independence of auditors by an audit committee should particularly cover matters pertaining to the continued relationship with an existing audit firm and, importantly, the length of time which a particular audit partner / audit team may conduct the audit of an entity.

17. Relevant legislation must be amended to require a formal report back from an audit committee in the annual financial statements dealing with the matters addressed by the audit committee.

Accountability

18. Legislation should be amended to require the auditor to be statutorily obliged to meet at least once per annum with the full board of listed and other relevant entities to discuss matters of relevance in relation to the financial statements and affairs of the company.

19. Legislation should be amended in order to preclude the appointment of an auditor who has any financial interest in the entity being audited.

20. Legislative amendments are required to make it a statutory offence for an auditor who knowingly or recklessly reports on financial statements.

21. The existing civil remedies against negligent auditors are considered adequate. The utilisation of the existing provisions relating to the establishment of a fund to compensate parties suffering loss as a consequence of audit negligence needs to be explored, particularly for parties that are financially inhibited from launching a civil action.

22. Appropriate legislation should be introduced to make it a statutory offence for executive management who make false representations or material non-disclosures to auditors.

23. Appropriate legislation should be introduced to provide for a statutory offence for all parties who are knowingly party to the preparation or presentation of financial statements which fail to fairly present (including those who may assist in that process thus including advisers, merchant bankers and others).

24. The reporting deadline for listed and other relevant entities should be shortened so that the financial statements must be issued within 4 months of the financial year end, in accordance with international norms.

Internal audit

25. Matters concerning internal auditing lie appropriately with the audit committees and cannot sensibly be legislated. Having regard to the nature of the internal auditing function, no regulation of internal auditing is considered practical or necessary.

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Section A

1. Introduction

"The issue of corporate governance and in particular the role of the auditing firms has once again dominated the headlines. The Enron debacle has brought into sharp review a number of key issues - weak or non-existent governance structures, the fiduciary responsibility of directors, negligent and sometimes reckless management, ineffective auditing, independence of auditors, and conflicts of interest arising from inadequate separation between auditing and consultancy. Closer to home, a number of corporate failures - Macmed, Leisurenet, Regal Treasury, and Unifer, to name but a few - have raised a similar set of issues. Many of these weaknesses were highlighted in the Nel Commission Report."

(From the budget speech of the Minister of Finance, South Africa, 20 February 2002)

1.1 Public faith and confidence in global financial markets has been severely shaken and eroded by corporate governance breakdowns, business failures, and high profile financial frauds. The trust and confidence of the investing public in the capital markets needs to be restored through improved corporate reporting and governance. The Enron and Worldcom scandals, amongst others, have focused attention on the institutions and preparers responsible for the information on which investors, customers, lenders and employees depend. For public trust and value

creation to be restored in public financial information, the purveyors of this information need to deliver sustained, high-quality, high integrity performance and to be accountable for sub-standard performance.

1.2 This report contains the findings from a project initiated by the Hon. Minister of Finance, Trevor Manuel, with the overall objective of promoting the continued integrity of financial markets.

1.3 The Panel was appointed on 5 December 2002, and was tasked to assess and advise on various matters impacting upon the public trust in the veracity and reliability of financial data and the culpability of management and auditors. The full terms of reference of the Panel are set out in the body of the report.

1.4 The Panel conducted its work from December 2002 to August 2003.

1.5 The members of the Panel were selected by the Minister and represent a broad cross-section of government, regulators, the accounting and auditing profession, business and academia. Only 2 of the 17 member Panel are auditors in public practice. Summarised *curriculum vitae* of the Panel members are set out in Section D of this report.

1.6 The Panel invited public comment and 45 submissions were received which were

carefully considered.

1.7 The University of the Witwatersrand School of Accountancy (Wits SOA) was utilised to conduct background research in relation to the matters under consideration. The Panel, where necessary, made use of the research conducted by the Wits SOA in its deliberations and report.

1.8 The Panel attempted to identify the underlying core issues which impact on the matters addressed. Global developments and trends were considered to determine their relevance and applicability to the South African environment.

1.9 The Panel in its deliberations considered, inter alia, various statements of the Technical Committee of the International Organisation of Securities Commissions (IOSCO) published in October 2002, the World Bank's Report on the Observance of Standards and Codes (ROSC), the Nel Final Report of the Commission of Inquiry into the affairs of the Masterbond Group and Investor Protection in South Africa, the King Report on Corporate Governance for South Africa, and the Sarbanes-Oxley Corporate Accountability & Fraud Act of 2002 in the United States.

1.10 The Panel also had due regard, inter alia, to the Public Accountants' & Auditors' Act, the Draft Accountancy Profession Bill, the Financial Reporting Bill, the

Companies Act, and other pertinent legislation. The April 2002 Report of the Joint Disciplinary Task Team (chaired by John Myburgh SC) commissioned jointly by the Public Accountants' & Auditors' Board and the SA Institute of Chartered Accountants, was also considered.

1.11 Through comprehensive review and debate it was possible to assess the South African legislative and governance framework against existing and evolving global benchmarks.

1.12 Certain other relevant matters pertaining to the Draft Accountancy Profession Bill were identified during the course of the debates on the subject matter and these have been included in the "Other matters" section of this report.

1.13 The report sets out the consensus view of the Panel.

1.14 The Panel has not taken a restrictive line on the wording of the terms of reference but has sought to provide input on matters in relation to the terms of reference, which will add value to the overall process and objectives.

1.15 Certain of the recommendations may result in additional effort and costs; the burden of which needs to be shared by government, investors, the relevant entities affected and the auditing profession. This additional burden is viewed as a small price to pay

for the restoration and maintenance of investor confidence.

1.16 Sustaining confidence and trust in the performance of the corporate system is a matter of serious and pervasive public concern. This is the challenge of enlightened leadership which is endorsed by the Panel whilst recognising its complex and difficult nature.

1.17 It is important to ensure a spirit of integrity, transparency and a culture of accountability of corporate management, audit committees, boards of directors and the accounting and auditing professions in the corporate reporting process. These are variables that should be non-negotiables to help restore investor confidence.

2. Applicability of Recommendations

2.1 In constituting the Panel, the Minister requested consideration be given to the applicability of the recommendations to be made.

2.2 Matters of corporate governance are of particular concern to all entities which have a significant effect on the public.

2.3 In the absence of a single piece of legislation, certain of the recommendations are not capable of implementation without changes to various different Acts of Parliament. If the Financial Reporting Bill is promulgated into law, then this will facilitate the broad ranging applicability of certain reporting requirements.

2.4 Unless stated to the contrary or obvious from the context, the recommendations in the report should be applied to all entities which impact upon the public interest. For this purpose, this should include all entities with instruments listed on the JSE, all public entities (as defined by the Public Finance Management Act of 1999), unit trusts (collective investment schemes) and asset managers, and retirement, pension and provident funds and medical schemes with more than 150 members. The threshold number of 150 was selected based on the Employment Equity Act of 1998 which uses this number of employees as the threshold of applicability. In addition, the recommendations should apply to any entity with turnover or assets

(owned or under management) of over R200m, being the level set as an intermediate size in the Competition Act 89 of 1998.

2.5 It is recognised that it will be necessary to provide for the exemption (on application or otherwise) of certain entities from the contemplated requirements.

3. **Abbreviations**

3.1 To facilitate reading of this report, various abbreviations have been used.

3.2 In the report the following abbreviations have been used:

3.2.1	"APB" -	Accounting Practices Board of SAICA.
3.2.2	"APC" -	Accounting Practices Committee of SAICA.
3.2.3	"Auditors' Act" -	successor legislation to the PAA Act.
3.2.4	"Banks Act" -	Banks Act No. 94 of 1990, as amended.
3.2.5	"BESA" -	Bond Exchange of South Africa.
3.2.6	"Companies Act" -	the Companies Act No. 61 of 1973, as amended.
3.2.7	"DAPB" -	Draft Accountancy Profession Bill, 2001.
3.2.8	"CA" -	Chartered Accountant.
3.2.9	"FRB" -	Financial Reporting Bill, 2002.
3.2.10	"FRSC" -	Financial Reporting Standards Council.
3.2.11	"GAAP" -	Statements of Generally Accepted Accounting Practice issued by SAICA.
3.2.12	"IOSCO" -	The International Organisation of Securities Commissions.
3.2.13	"ISA" -	the International Standards on Auditing formulated by the International Auditing and Assurance Standards Board.

3.2.14	"ISBA" -	Independent Standard-setting Board for Auditing contemplated by the DAPB.
3.2.15	"ISBE" -	Independent Standard-setting Board for Ethics contemplated by the DAPB.
3.2.16	"JSE" -	the JSE Securities Exchange South Africa.
3.2.17	"King Code" -	the Code of Corporate Practices and Conduct laid out in the King Report on Corporate Governance, 2002.
3.2.18	"Listings Requirements" -	the JSE Listings Requirements.
3.2.19	"relevant entities" -	those companies and other entities to whom the recommendations apply as set out above.
3.2.20	"PAA Act" -	Public Accountants' & Auditors' Act, 1991.
3.2.21	"PAAB" -	Public Accountants' & Auditors' Board established in terms of the PAA Act.
3.2.22	"Panel" -	Ministerial Panel for the review of the DAPB.
3.2.23	"RBA" -	Regulatory Board for Auditors contemplated in the DAPB.
3.2.24	"RCA" -	The Representative Council of Accountants contemplated in the DAPB.
3.2.25	"ROSC" -	Report on the Observance of Standards and Codes, 2002, issued by the World Bank.
3.2.26	"SAAS" -	Statements of South African Auditing Standards, issued under the auspices of the PAAB.
3.2.27	"SAICA" -	The South African Institute of Chartered Accountants.
3.2.28	"Sarbanes-Oxley" -	The Sarbanes-Oxley Corporate Accountability & Fraud Act of 2002 in the United States.

3.2.29	"SECA" -	the Stock Exchanges Control Act 1 of 1985, as amended.
3.2.30	"SENS" -	the electronic Securities Exchange News Service of the JSE.

4. Structure of the Report

4.1 The recommendations of the Panel with regard to each of the terms of reference is dealt with in Section B of the report.

4.2 The Minister's nine terms of reference correspond with sections 1 through 9 in Section B.

4.3 Section B also deals with certain other matters of relevance to the issues under consideration, which were noted by the Panel during its considerations.

4.4 Section C of the report sets out the background in relation to the issues under consideration and an analysis of global trends in relation thereto. This section assists in contextualising the debate. The references used in Section C are summarised in Section D.

4.5 Section D also sets out other pertinent information relating to the Panel.

Section B

1. **Term of Reference 1**

The appropriateness of the structure of the regulatory framework for auditors and accountants that is currently envisaged in the Bill in the light of international development and the debate around self-regulation.

Panel Considerations and Recommendations

1.1 It is considered that the DAPB is misconceived in so far as it attempts to regulate auditors and accountants (very broadly defined) in a single Act.

1.2 Auditing is a matter which should be dealt with separately in its own legislation and the DAPB should be divested of the attempts to regulate the accounting profession. Auditing is a function which impacts on the public interest in a manner different to adherence to accounting or reporting standards. It follows that the name of the DAPB is inapposite and should refer solely to the auditing profession, as opposed to the accounting profession.

1.3 South Africa is one of the few countries in the world where there is existing statutory regulation of the auditing profession. However, the auditing profession is at present substantially the subject of self-regulation. This has occurred by default as the government has not used its powers enshrined in the PAA Act to exercise meaningful oversight in terms of governance of the profession.

1.4 Corporate collapse and scandal have focused attention on auditors and the disciplinary process relating to errant auditors. It has become clear that the existing structure of the PAAB and the powers at its disposal require an overhaul. This is particularly so considering the public perception regarding the ability and willingness of the PAAB to regulate and discipline its members in light of its control and effective self-regulatory status where the majority of PAAB board members are drawn from the profession. Having regard to the above, it is considered appropriate that a new body be established but without losing that which is functional within the existing structure, which has operated relatively efficiently. In addition, despite some goodwill that may attach to the PAAB name, a new name for the regulatory body is required, eg. the Independent Auditors' Board, the Independent Auditors' Council or the Regulatory Board for Auditors.

1.5 The new body should be composed of members appointed by the Minister of Finance and should include all the relevant interested parties. In particular, the Minister should appoint the members of that body from the ranks of practising and

retired auditors, government, regulators, users and academia. These stakeholders should have the ability to nominate persons for appointment, to the Minister. The constituent element of the practising and retired auditors should constitute a minority of the members. However, since auditors are the most relevant party impacted by the legislation, the auditors should comprise the significant minority, eg. 4 out of, say, 10 members. (The UK Auditing Practices Board provides for 40% of the members to be practising auditors).

1.6 Financially and practically, it is senseless to destroy the existing infrastructure of the PAAB, whose functions should be subsumed by the new body. However, it should be clear that the new body is not simply the PAAB with a new name, but a significantly different new body with a particular public interest focus and objective.

1.7 In order to function properly, it is necessary that the new body have appropriate fulltime executive staff. Since this is a public interest body and auditors will only be a minority on the controlling executive, appropriate government funding will be required in order to ensure that the new body can properly fulfil its mandate. It is clearly inequitable and inappropriate that the auditors or companies be required to solely fund such a body. Funding should reflect a shared responsibility for the maintenance of the integrity within the South African financial markets.

1.8 The new body should deal with the matters covered by the present PAAB and include:

1.8.1 accreditation of auditors;

1.8.2 examinations;

1.8.3 quality control, including practice review;

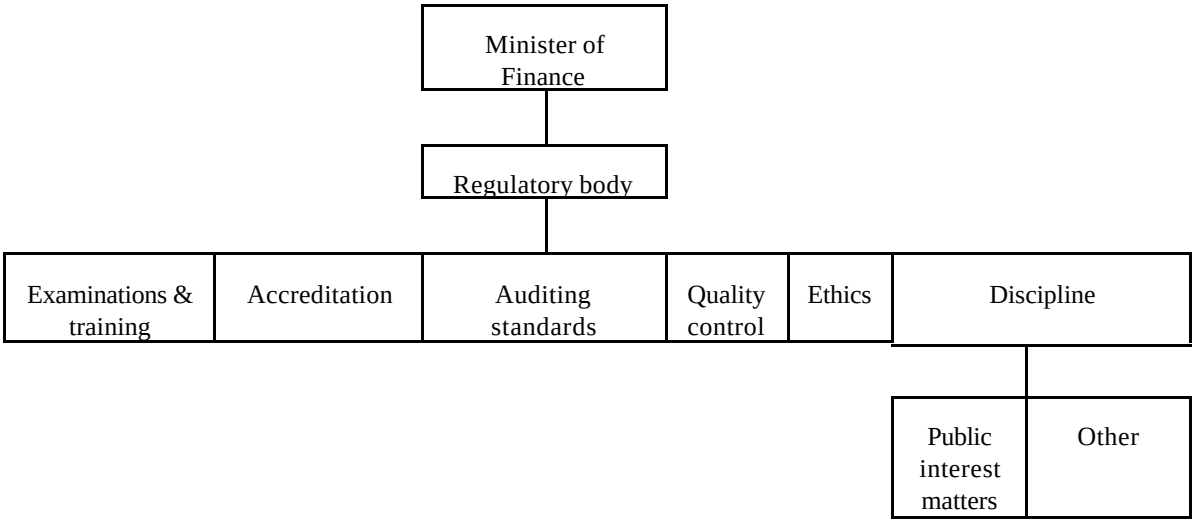
1.8.4 setting of auditing standards, professional ethics, etc.

1.8.5 discipline and compliance enforcement.

1.9 Appropriate committees (suitably named) will be required to deal with each of the above issues. The constitution of those committees should include the relevant stakeholders. Other than for matters concerning discipline and auditing standards, the membership of the other necessary committees should be practising or retired auditors and executive staff of the regulatory body. Membership of the auditing standards body should be constituted in a manner similar to that contemplated in the DAPB but should also include an academic and at least half the members should be practising or retired auditors. The recommended structure in relation to disciplinary matters is addressed in term of reference 5. These committees / boards will be

accountable to the controlling board of the regulatory body.

1.10 The appropriate contemplated structure is thus:



1.11 The preamble to the new Act (unlike the present PAA Act) should indicate that the regulation of the profession is aimed at the protection of the public.

1.12 The board established under the Auditors' Act should present an annual report to the Minister of Finance and to Parliament as it is a body created by it.

1.13 Ultimately, if the general international move continues and is followed in South Africa, it may be necessary to establish a single regulator of financial markets under which all the financial and related regulatory entities will fall. This would include the new regulatory body controlling the auditing profession, the FSB, the JSE, Banking Supervision, etc.

1.14 As regards "accountants":

1.14.1 It is considered important that the legislation relating to auditors not be clouded by attempting to deal with accountants. It is also considered impracticable and inapposite to attempt to include the vast array of so-called "accountants" as reflected in the DAPB and there is neither international precedent nor moves for such broad registration.

1.14.2 As regards the accountability of the preparers of financial statements, this has been dealt with in other terms of reference and there are provisions within the Financial Reporting Bill which covers this issue adequately.

1.14.3 Having regard to developments in the markets, the urgent matter to be addressed is that relating to the auditing profession. There may be a case for the registration of particular classes of accountants. There is, however, no international precedent of regulation of all "accountants" in a widely defined sense. Further research should be undertaken in this regard and action should be pended dependent upon the developments internationally in this area.

1.15 Summary of Panel recommendations:

1.15.1 auditing is a matter which should be dealt with separately in its own legislation and

the DAPB should be divested of the attempts to regulate the accounting profession. The name of the bill therefore appears to be inapposite and should refer solely to the auditing profession.

1.15.2 following upon international future developments, the overall regulation of so-called "accountants" should be reconsidered in the future.

1.15.3 the PAAB should be subsumed by a new body emanating from the new legislation, which regulatory body should have a new name, eg. The Independent Auditors Board.

1.15.4 the membership of the new regulatory body should be appointed by the Minister of Finance and should include members selected from the ranks of practising and retired auditors (as a minority of the members), government, regulators, users and academia. The stakeholders should have the ability to nominate persons for appointment to the Minister.

1.15.5 since the auditors' regulatory body is a public interest body (and auditors will only be a minority of the controlling executive), appropriate government funding will be required.

1.15.6 the new body should be properly empowered and deal with the matters covered by

the present PAAB.

1.15.7 an annual report to the Minister of Finance and to Parliament should be presented by the board created by the Auditors' Act.

2. Term of Reference 2

The desirability of separating the consulting and statutory auditing function within a firm.

Panel Considerations and Recommendations

2.1 Many audit firms provide non-audit services to their audit clients. Such non-audit services include consulting on business issues and the provision of various other services.

2.2 The underlying concern is that the provision of non-audit services to an audit client could be perceived as impairing the independence of an auditor. This is particularly so in circumstances where significant fees are generated from non-audit services provided to audit clients.

2.3 The matter of freedom of choice and ability to compete are also relevant in assessing this issue. Many companies utilise their auditors for non-audit services on the basis that there is already a relationship of confidence and trust with the auditor and the auditor has an intimate knowledge of the affairs of the company, and is thus well-placed to perform other services.

2.4 Apart from the provisions in the Public Finance Management Act (which provide that the external auditors may not perform internal audit functions) and the provision in the Companies Act (precluding an auditor of a public company from performing the duties of secretary or bookkeeper for the company), there is no restriction on the nature or extent of other services provided by an auditor to an audit client.

2.5 If it is appropriate to limit the provision of non-audit services (ie. consulting, etc.) by an auditor to an audit client, then it is necessary to consider whether such restrictions be enshrined in statute.

2.6 There is no consistent international position regarding the above. It is only in the United States that auditors are now, by law, precluded from providing various specified services to their audit clients, and audit committees are specifically required to pre-approve all other non-audit services. This applies to particular classes of companies, notably listed companies. In other jurisdictions, these issues are commonly dealt with as corporate governance issues which are not statutorily controlled.

2.7 It is considered undesirable for any auditor to perform any non-audit service which results in a position where the auditors may be auditing their own work (eg. doing the accounting work and preparing the financial statements, and then auditing those same records and financial statements for the purposes of reporting thereon).

2.8 It is also considered undesirable from an independence perspective for an auditor to generate a disproportionate level of fees from a client relative to the audit fees. Despite the lack of empirical data to suggest that such a situation does, in fact, compromise auditor independence, it is manifest that such a perception is created, which is unacceptable.

2.9 However, it is considered that these matters are such that they cannot be sensibly statutorily controlled in a detailed manner (but for the existing provisions referred to above) and should be covered by ensuring that a structure is in place to address the principle relating to the issue. A blanket prohibition on the provision of non-audit services by auditors should be avoided.

2.10 It is considered that, ultimately, the nature and extent of non-audit services provided by an auditor should be a matter for the audit committee of relevant entities to decide. These parameters for non-audit services should be set by the audit committee *before* such services are contracted or performed by the auditors to an entity.

2.11 Note that term of reference 4 deals with the recommendation regarding the requirement for the mandatory establishment of audit committees and the matters which should be within the exclusive domain of those committees. This specifically includes the setting of parameters (ie. nature and extent) for any non-audit services

which may be conducted by the auditors to the entity.

3. Term of Reference 3

The introduction of term limits for auditors and audit rotation.

Panel Considerations and Recommendations

3.1 The underlying concern in relation to this issue is the possible compromising of auditor independence as a consequence of a relationship between auditor and client that is too close and familiar and that such a relationship may occur if the same auditor conducts the audit over a lengthy period.

3.2 It is important to recognise that the above must be considered both from a factual point of view and the possible perception of such a relationship.

3.3 There is no empirical data to suggest that a lengthy auditor / client relationship necessarily leads to a compromising of independence. However, it is recognised that a perception in this regard exists.

3.4 The limited skills and resource base in South Africa makes the practical implementation of mandatory rotation of audit firms questionable. Moreover, it is considered that statutory intervention in this regard would not be sensible and may

result in unintended results, eg. in certain countries where statutory time limits have been imposed upon audit firms then, when a new firm was appointed, the particular audit partner of the erstwhile audit firm simply transferred to the newly appointed auditor, thus neutering the entire purpose of the exercise.

3.5 Moreover, audit firm rotation / term limits will certainly lead to increased audit fees as incoming auditors will not have the benefit of prior knowledge and experience relating to the entity. Frequent auditor changes also increases the potential for the non-detection of material mis-statement / manipulation as knowledge and experience relating to the audit risks of the particular entity is lost or limited.

3.6 It is considered that the most appropriate manner to deal with this issue is for the matter to be covered by the audit committee. The mandatory establishment of audit committees and the particular matters to lie within their exclusive domain, are dealt with in term of reference 4. This particularly includes the question of the assessment of auditors independence.

3.7 This should result in appropriate time limits being imposed on specific audit partners and senior audit staff conducting the audit of a client (preferably no more than 5 years) or, if considered appropriate, a term limit for the audit firm itself.

4. Term of Reference 4

A system of accountability between an auditor and their clients that addresses the issue of fees and the relationship between an auditor and directors and the board of a client company.

Panel Considerations and Recommendations

4.1 The underlying concerns inherent in this issue are:

4.1.1 how to attempt to ensure independence of the auditors from management which, practically controls the appointment and fees of the auditor. The above situation exists although the auditor reports to shareholders which creates ab initio a potential conflict;

4.1.2 on a related independence issue, how to reinforce the responsibility line between auditor and true client, being the shareholders to whom the auditor reports.

4.2 There is no clear international precedent and the situation is in a state of experimentation and flux.

4.3 However, the popular international trend is to make the establishment of audit committees mandatory (for listed entities) and even in some jurisdictions to allocate executive power on significant matters exclusively to the audit committees.

4.4 Various codes (and some legislation) include in the exclusive purview of the audit committee, the appointment or replacement of auditors and the approval of audit fees. The underlying intention is to remove those matters from the direct control of management.

4.5 There is no empirical research or evidence that the appointment of auditors and approval of the audit fee by executive management (as opposed to by an audit committee) is an area of compromise. However, it appears internationally that this is an area of concern and perceived sensitivity.

4.6 Audit committees do provide a formalised forum for the airing of concerns by auditors directly with non-executive directors. It is considered essential that a forum be created for the frank and confidential conveying of opinions by the external auditors to non-executive directors and that procedures be put in place to facilitate the conveying of any confidential or sensitive accounting information or concerns by any employees to the non-executive directors directly.

4.7 Audit committees are also important to formalise a forum to formally test the actual

and perceived independence of the auditor.

4.8 It is important that South Africa be seen to be in step with international developments regarding corporate governance and, in particular, the role of the audit committee. However, it is noted that in virtually all of the high profile corporate scandals and collapses, an audit committee was in place. Furthermore, in these cases, generally the audit committee was constituted in the manner contemplated by the various codes with, on the face of it, appropriate parties.

4.9 Having regard to the actual experience in relation to corporate scandal and collapse and what practically can be achieved by an audit committee, it is important that the strength, scope, and responsibility of the audit committee not be overstated. Realistically and practically it provides no more than a moral check on management.

4.10 The existence of an audit committee is and has been used by directors as exculpatory on all matters relating to the financial statements. The financial statements are ***the*** communication of management to the shareholders (and normally the only communication) and it is fundamentally important that the directors not be able to delegate, avoid or dilute their responsibility in this regard.

4.11 Directors have asserted and do assert that the primary responsibility for the financial statements lies with the audit committee and therefore they need not really apply

their minds in any sort of detail to the financial statements. In the view of the Panel this common perception is misguided and wrong. However, the large emphasis placed upon audit committees and the normally very onerous charters of the audit committees support the view that the board practically and effectively only have a secondary responsibility for the financial statements. It is essential that this misconception be defeated.

4.12 It is also noted that an audit committee would typically meet only a few times per year and each meeting would only last a few hours. Moreover, the meeting would cover a wide host of financial and other risk areas. Practically it is obvious that there is only a limited amount that the audit committee can realistically achieve.

4.13 Despite the above, it is the view of the Panel that the mandatory establishment of audit committees has value. It does establish the independent forum to reinforce the independence of the auditor and assist in the restoration of public trust in auditors and potentially management. The establishment of audit committees is also important to ensure the correct global perception of the South African corporate governance business environment. It is recommended that the establishment of audit committees be enshrined in legislation to make it mandatory for listed entities and other relevant entities.

4.14 The membership of the audit committee should be restricted to independent non-

executive directors. The appointment of the non-executive directors may require the utilisation of a nomination committee, however, this would be dependent upon the corporate governance structures within each particular entity.

4.15 The Sarbanes-Oxley model could be followed which would require amendment to the Stock Exchanges Control Act in order to ensure that it is a legal requirement that the JSE impose such a term within its listings rules. However, to ensure applicability to all relevant entities, the requisite provisions should be housed in the Companies Act and other relevant legislation.

4.16 The specific statutory responsibilities of the audit committee should be limited but specifically include the consideration of the following matters:

4.16.1 all financial reports to be issued by the entity;

4.16.2 independence of the auditor;

4.16.3 audit fees;

4.16.4 appointment, removal and re-appointment of auditors;

4.16.5 setting parameters for any non-audit services which may be conducted by

the external auditors before such services are contracted or rendered.

4.17 In order to ensure clear alignment with the current developments internationally, the appointment and remuneration of auditors must be within the exclusive power of the audit committee. The audit committee would then have the exclusive power to approve audit fees and, subject to shareholder approval, to appoint auditors. It should be made clear that outside of these two matters, the audit committee has no executive authority or exclusive responsibility for the other matters considered by it, which remains with the board.

4.18 The Companies Act and other relevant legislation should be amended to require a formal report back from the audit committee in the annual financial statements of the company or entity to confirm that it has satisfied itself regarding the matters required by the relevant Act (as is the case in the Public Management Act of 1999 read with the related Treasury Regulations).

4.19 In order to guard against the problems identified above, it is considered that in addition to the external auditors interacting with the audit committee in relation to the annual financial statements, the external auditors should be statutorily obliged to meet at least once per annum with the full board of listed and relevant entities to discuss matters of importance in relation to the financial statements and affairs of the company. The Companies Act and other relevant legislation should be amended to

provide that the existence and advice of the audit committee does not discharge the responsibility of the board of directors in relation to the financial statements and other financial matters not within the audit committee's exclusive statutory scope.

4.20 It is considered that there should also be a statutory duty upon the auditor to attend the annual general meeting of listed companies or other relevant entities. For smaller entities, the shareholders should have the right to demand that the auditor attends the annual general meeting. At present, the Companies Act only provides for the right of the auditor to attend and speak at the annual general meeting but not a duty in this regard.

4.21 It is further recommended that the legislation in the Auditors' Act include a preclusion on the acceptance of an audit engagement where the auditor has any financial interest in the entity being audited (over which the auditor directly or indirectly exercises control). The financial interest would obviously exclude fees to be received from the entity.

4.22 The above amendment is required in order to deal with the apparent anomaly in the Companies Act which precludes any person who is a director or was a director during the year under review, from acting as auditor but has no preclusion on the auditor having a financial interest in the entity being audited.

4.23 Summary of Panel recommendations:

4.23.1 the establishment of audit committees for relevant entities should be made legally mandatory by appropriate changes to relevant legislation;

4.23.2 the prescribed matters to be dealt with by the audit committee should include financial reporting, audit independence (including the provision of non-audit services), audit fees and appointment of auditors. The only matters which should lie within the exclusive purview of the audit committee should be the appointment of auditors (subject to shareholder approval) and approval of audit fees;

4.23.3 the legislation should provide that the existence and advice of the audit committee does not discharge the directors responsibility with regard to the financial statements and financial affairs of the company;

4.23.4 the external auditor should be statutorily obliged to meet at least once per annum with the full board of relevant entities to discuss the financial statements and any other relevant matters which came to the attention of the auditors in relation to the affairs of the company;

4.23.5 it should be a statutory duty upon an auditor to attend the annual general meeting of relevant entities and, for smaller entities, shareholders should have the right to demand that the auditor attends the annual general meeting. This will require an

amendment to the Companies Act and/or the Auditors Act;

4.23.6 the Auditors' Act / Companies Act should preclude the appointment of an auditor who has any financial interest (over which the auditor has direct or indirect control) in the entity being audited.

5. Term of Reference 5

An appropriate set of liabilities and disciplinary procedures for auditors that fail to properly report upon the true financial health of a company.

Panel Considerations and Recommendations

5.1 The underlying concerns in relation to this issue are:

5.1.1 the lack of speedy and public redress in respect of errant auditors;

5.1.2 the professional disciplinary body is not seen as independent and is not seen as a protector of the public;

5.1.3 practically, cases can legally and legitimately be prolonged pending the outcome of criminal and/or civil action;

5.1.4 the PAAB presently has no power to compel the production of evidence during its investigation process which impedes the manner and speed with which matters can be dealt with by the disciplinary body.

5.2 Thus the concerns which must be addressed from a professional disciplinary liability perspective are:

5.2.1 matters relating to independence of the body adjudicating;

5.2.2 the speed with which complaints can be dealt with and sentences put into place;

5.2.3 proper transparency of the process and of the final outcome;

5.2.4 appropriate penalties to act as a deterrent and as appropriate punishment;

5.2.5 powers of the investigating body to compel the production of documents and the rendering of evidence.

5.3 At present the provisions relating to the civil remedies against negligent auditors are considered appropriate subject to the matter relating to class actions referred to below.

5.4 Consideration should be given to confirming the legal legitimacy of class actions which would enable the persons of a class to access the courts in circumstances where individually the claimants could not afford such an action. However, since

this has far greater consequences, separate specific research and consideration is required by a more appropriately constituted body.

5.5 Statutory offences and fines should be considered for auditors (and audit firms) who knowingly or recklessly report on financial statements. This legislation should probably be housed in the Auditors Act and/or the Companies Act.

5.6 At present only the individual audit practitioners are liable to be charged for misconduct and the audit firms are not registered as practitioners. The Auditors' Act should enable the registration of firms and the firms should be charged in addition to the individual practitioners in the relevant cases. This would enable the censure / suspension / fines / termination of audit firms and not only individual auditors and make the imposition of more meaningful fines practical and fair. The sentence for the individual practitioner and for the firm should take into account both upholding the necessary professional repute of the auditing profession and the broader public interest.

5.7 The disciplinary arm of the body regulating auditors requires appropriate funding, which should include State funding, in order to ensure proper independence and sufficient funds to carry out its duties.

5.8 In order to address the perceived lack of independence, the disciplinary body

should be chaired by a retired judge or senior counsel sitting on a body of which 50% of the representatives should be practising or retired auditors. The non-auditor members (in addition to the chairperson) should be drawn from government, regulators and business. As a safeguard, the constitution of that body should be such that the retired judge / senior counsel would have the casting vote.

5.9 Only matters of public interest or matters which may undermine the public trust in the auditing profession should be referred to the disciplinary committee.

5.10 For other matters, eg. procedural complaints or less serious non-professional conduct, etc. these should be dealt with by a body of individuals, all of whom are auditors. The disciplinary body chairperson (ie. judge / senior counsel) should be determine which complaints or matters are dealt with by the two disciplinary units contemplated.

5.11 In matters of consequence considered by the disciplinary body, any judgment it reaches should be rendered on the basis that it may not be used against the practitioner or the audit firm in any legal proceedings. (A precedent already exists with regard to audit practice review). This should enable the disciplinary body to expedite matters which are otherwise delayed on the basis of potential prejudice to pending litigation.

5.12 There should be a mandatory expulsion without the possibility of re-admission (subject to the Constitution or other relevant law) in respect of cases where a practitioner is found guilty of fraud or other serious dishonesty.

5.13 Matters concluded by the disciplinary body should, in respect of guilty verdicts on matters of serious public interest, and where considered appropriate by the presiding officer, be published in the lay press including, where considered appropriate, the names of the practitioners and their firms and other summarised details, including sentence.

5.14 There should be a mandatory expulsion in respect of repeat offenders, eg. if there are 3 convictions on matters relating to public interest.

5.15 The Auditors' Act should include the power for the body, on good cause, to compel the production of documents and the giving of evidence during the course of any investigation conducted by it.

5.16 The potential for the body controlling the profession to use fines imposed to compensate complainants and other relevant parties for losses suffered as a consequence of the actions of an auditor requires further investigation. This would be particularly beneficial in dealing with those parties who, as a consequence of financial constraints, would be unable to seek redress. It is noted that the PAA Act

already empowers the PAAB to establish such a fund (section 13(1)(l)).

5.17 Summary of Panel recommendations:

5.17.1 the legislation should require the registration of audit firms in addition to individual audit practitioners and the firms should be subject to the same disciplinary rules as the individuals;

5.17.2 legislation should introduce a statutory offence with prescribed fines or penalties for auditors who knowingly or recklessly report on financial statements;

5.17.3 the legislation should provide for some State funding of the body controlling auditors;

5.17.4 the legislation should provide that the disciplinary body of the successor PAAB should be chaired by a retired judge or senior counsel. That disciplinary body should be constituted such that there is an equal representation of auditors and others but that the casting vote of the chairperson (retired judge / senior counsel) results in that body being controlled by non-auditors;

5.17.5 the presiding officer should determine which complaints or matters for investigation are to be dealt with by the full body and which other complaints or investigations

can be dealt with by the controlling body itself;

5.17.6 the legislation should provide that any judgement rendered by the disciplinary body should not be capable of being used against an auditor in any subsequent legal proceedings;

5.17.7 the Auditors' Act should provide for a mandatory expulsion for practitioners in respect of findings relating to fraud or other serious dishonesty;

5.17.8 the Auditors' Act should empower the imposition of appropriate fines / penalties and provide for the power to publish verdicts reached;

5.17.9 the Auditors' Act should provide for mandatory expulsion in respect of repeat offenders;

5.17.10 the Auditors' Act should empower the regulatory body to subpoena documents and compel the rendering of evidence in investigations conducted.

6. Term of Reference 6

An appropriate set of liabilities and disciplinary procedures for executive management of companies that fail to properly disclose the true financial health of a company to the auditors

Panel Considerations and Recommendations

6.1 This issue has been considered in two contexts:

6.1.1 liability of executive management for financial statements that failed to fairly present;

6.1.2 liability of executive management regarding misrepresentations (including omissions) by executive management to the auditor.

6.2 Auditors should be statutorily obliged to report any false representations or information or material non-disclosures by executive management to an appropriate authority. The appropriate authority should be the PAAB (or successor body controlling the auditing profession) and that body should have the power to disclose the information to any organ of State and bodies such as the JSE.

6.3 Statutory penalties should be imposed upon executive management of companies and other relevant entities in respect of such false or non-disclosures to the auditors of those entities. Such conduct should constitute a statutory offence. This legislation should probably be housed in the Companies Act and/or the Auditors' Act.

6.4 It is recommended that it should be a statutory offence for all parties who were knowingly a party to the preparation or presentation of financial statements which failed to fairly present. In particular, it is considered that the net should be extended to include advisers / bankers / attorneys / consultants or others who design or conceive schemes (or knowingly assist in the process) which impact on both the fair measurement in, and presentation of, financial statements.

6.5 The statutory offence should thus include all those who were knowingly a party to the action or assisted in the conduct.

6.6 The statutory penalties should be put into place which penalties should have the flexibility to link the quantum of a fine or extent of any jail sentence to the extent of the loss (or potential loss) suffered as a consequence of the misstatement of the financial statements.

6.7 The statutory provisions contemplated above could be contained within the

Companies Act. The provision relating to the onus upon the auditor to report a misrepresentation should properly be housed within the Auditors' Act.

6.8 The potential to use fines imposed on management (for mis-stated financial statements and/or misrepresentations or non-disclosures to auditors) to compensate complainants and other relevant parties for losses suffered as a consequence of the actions of an auditor requires further investigation. The existing provisions in the PAA Act may be instructive in assessing the possibility of establishing a fund for such a purpose.

6.9 The Sarbanes-Oxley requirement for the chief executive officer and the chief financial officer to certify the financial statements was carefully considered. In the view of the Panel, it is important that the board assume collective responsibility for the financial statements and accordingly such certification is not recommended. However, as a matter of sensible corporate governance, it would be anticipated that the board would require that the chief executive and the chief financial officer sign the financial statements of the entity.

6.10 Summary of Panel recommendations:

6.10.1 auditors should be statutorily obliged to report to the PAAB or its successor body any false representations or material non-disclosures by

executive management to the auditors. The PAAB or its successor body should have the power to disclose that information to any relevant person in the public interest;

6.10.2 appropriate legislation should be introduced to provide for a statutory offence and penalties upon executive management in respect of false representations or material non-disclosures to auditors;

6.10.3 appropriate legislation should be introduced to provide for a statutory offence and penalties for all parties who are knowingly party to the preparation or presentation of financial statements which fail to fairly present or assist in that process.

7. Term of Reference 7

The usefulness and appropriateness of accounting standards and disclosure rules and the feasibility of implementing a system of "current disclosures".

Panel Considerations and Recommendations

7.1 It is fundamental to faithful representation of transactions and events that these be measured and disclosed consistently.

7.2 For investment purposes, it is also fundamental that comparability exists between reporting entities. This means in particular that there is an accepted consistent method in which similar transactions and events are accounted for and disclosed by entities.

7.3 The existence of codified accounting standards provides the benchmark to ensure consistency and comparability. It is thus clear that codified accounting standards are necessary, useful and appropriate in financial reporting.

7.4 The codification of accounting standards is required in order to remove as much doubt as possible in relation to what is considered appropriate and fair accounting

practice both in matters of accounting measurement and disclosure.

7.5 To date, it has not been explicitly clear whether codified statements of accounting standards and disclosure rules had legal backing in terms of the Companies Act. It is necessary that the position is clarified to make it clear that compliance with codified accounting standards is mandatory for all companies and relevant entities.

7.6 In addition to a change in the Companies Act required in this regard, it is necessary to have reference to the Financial Reporting Bill. The FRB provides for the establishment of the Financial Reporting Standards Council which will issue financial reporting standards and have the power to supervise and enforce compliance with these standards.

7.7 The application of the FRB contemplates amendments to the Companies Act that annual financial statements be prepared in accordance with the financial reporting standards laid down by the Financial Reporting Council.

7.8 It is considered that the FRB is, in principle, properly conceived and should be put into effect as soon as possible. Other relevant entities should also be required to comply with the financial reporting standards as set in accordance with the FRB. This will require amendments to other legislation pertaining to the various relevant entities.

7.9 As regards the feasibility of implementing the system of "current disclosures":

7.9.1 all listed companies and other relevant entities should be required to issue their annual financial statements within 4 months of the financial year end, which would accord with the world norm for listed entities in this regard;

7.9.2 this will require an amendment, inter alia, to the Companies Act (in so far as it affects public companies) and to the various legislation governing the other relevant entities;

7.9.3 it is considered that the generation of quarterly reports by listed and other entities should not be a mandatory requirement. This recommendation is made having regard to the prevailing requirements of other stock exchanges around the world and with due regard to the resources in South Africa and the cost / benefit relationship in respect of such quarterly reporting, which is not necessarily meaningful;

7.9.4 the JSE Listing Requirements adequately cover the immediate disclosure of material information impacting upon the financial position of an entity. Similar requirements should be put in place for other relevant entities which will require amendments to the particular legislation in terms of which these operate;

7.9.5 immediate ongoing, online reporting of results is not considered necessary.

This issue may have to be revisited in the future dependent upon global trends and advances in technology and, more particularly, the reliability and accuracy of accounting data generated.

8. **Term of Reference 8**

The feasibility and appropriateness of incorporating the regulation of internal auditing, audit committees and their relationships to external auditors in the legislative framework

Panel Considerations and Recommendations

8.1 The issues relating to the establishment of audit committees and the matters to lie within the exclusive domain of audit committees are dealt with in term of reference 4. This covers the questions of the appropriateness of the establishment of audit committees and the relationship to the external auditors within the legislative framework.

8.2 As regards the regulation of internal auditing:

8.2.1 it is considered that this is a matter which should be determined by entities and cannot sensibly be prescribed;

8.2.2 it ordinarily would be covered as part of the corporate governance issues and the manner in which an entity considers it best to manage internal

control and other financial risks;

8.2.3 it is thus considered unnecessary to legislate for the regulation of internal auditing or to make internal auditing a mandatory requirement for relevant entities.

9. Term of Reference 9

The inter-relationships between the Accountancy Profession Bill, the Financial Reporting Bill and the Companies Act, 1973

Panel Considerations and Recommendations

9.1 In order to ensure that holistic improvements to corporate governance flow from the implementation of a re-drafted Accountancy Profession Bill and the Financial Reporting Bill, the Minister of Finance anticipated that amendments to the Companies Act might be necessary.

9.2 In addition, these three pieces of legislation need to be reviewed in the context of the Panel's overall recommendations to ensure consistency in terms of where certain groups of recommendations should be best housed. (A summary of the recommendations of the Panel in terms of legislative changes across all terms of reference is dealt with in section C).

9.3 It is not the Panel's intention to provide definitive answers to what are essentially legal drafting issues and questions. However, the Panel provides some guidance in this regard. The general approach is important to highlight because the legislative

framework with regards to corporate governance has a direct impact on the integrity of South Africa's financial markets.

9.4 The Panel believes that currently a disjuncture exists between the jurisdictions of the Minister of Finance and the Minister of Trade and Industry that impacts negatively on the effectiveness of the legislative framework to ensure adequate adherence to accepted principles and practices of good corporate governance.

9.5 The Minister of Trade and Industry has jurisdiction over the Companies Act whilst the Minister of Finance is held accountable for the integrity of South Africa's financial markets and has jurisdiction over the PAAB. This is evident in a number of ways, one of which is the World Bank's Report on the Observance of Standards and Codes for corporate governance is directed at the Minister of Finance who is required to give his approval for it to be published.

9.6 The Companies Act (which falls under the Minister of Trade & Industry) contains sections that determine the legal requirements for a public company and state the requirements for public offerings of securities. However, once a company is listed on an exchange, these responsibilities are essentially shifted to the JSE that is supervised by the Financial Services Board ("FSB") that ultimately falls under the Minister of Finance.

9.7 This disjuncture in jurisdiction and accountability was the subject of intensive discussion by the Panel that sought to identify options to remedy this.

9.8 It is accepted that all legislation relevant to corporate governance belongs in the Companies Act and legislation controlling other relevant entities. There are a number of reasons to support this view, including the fact that corporate governance requirements should apply to all types of companies and not just those that are publicly traded. In addition, the Companies Act creates the requirements for registration of a company and hence the jurisdiction for imposing sanctions against all registered companies.

9.9 However, in light of the disjuncture as explained above, the Panel is of the view that either the Companies Act needs to be placed under the jurisdiction of the Minister of Finance or alternatively, a separate piece of legislation should be created that removes all issues dealing with corporate governance from the Companies Act and this new legislation would then fall within the jurisdiction of the Minister of Finance. This would include the current requirements housed in the Financial Reporting Bill.

9.10 Consideration needs to be given to the manner in which a new regulatory authority would be funded if all corporate governance functions were to be located outside of the Office of the Registrar of Companies.

10. Other matters

10.1 In the course of the review the Panel identified certain other relevant matters which pertain to the DAPB but which are not contained in the terms of reference.

10.2 The matters highlighted below are not intended to be a comprehensive or an exhaustive list of other relevant issues but are those matters which were noted during the course of the debate in relation to the broader matters under consideration.

Examination process and access to the profession

10.3 The existing examination process is a matter of concern. The present system operates in the following manner:

- after qualification from universities accredited by the appropriate professional body (presently only SAICA), graduates are then entitled to write the so-called Part I of the "final qualifying exams";

- this Part I examination is set by the professional body and deals with financial accounting, managerial accounting, taxation and other related issues. This exam is normally written early in the year following the exit

from university;

- the PAAB, a statutory body, sets the so-called Part II examination, which deals with auditing (which, by its very nature, is inexorably linked to accounting and related matters). A candidate is only admitted to Part II if Part I has been successfully completed and this exam may only be written after completion of 18 months of traineeship.

10.4 The system imposes hurdles on admission to practice as an auditor and chartered accountant in that:

10.4.1 there is a lengthy delay between exiting university (where students are at their peak of learned knowledge and examination ability) and the date upon which the Part II examination is written. Thus, a person who successfully completes the requisite university degree will, because of the lengthy delay, have to re-study and re-prepare for the Part II examination (more than 18 months after the final university examinations). The delay is such that there is a marked decline in requisite knowledge for the examination in the 18 month period, hence a great deal of re-studying and re-preparation is required;

10.4.2 a further impediment has been imposed in that before admission to write Part II, candidates must have completed an "auditing specialism course" run by various

parties - this obviously involves further expense and another hurdle as that course must be successfully passed before admission to write the Part II examination (despite the fact that the person has successfully completed the university examinations);

10.4.3 from the trainers of potential auditors and chartered accountants perspective (ie. registered auditors and auditing firms), the system is ineffective, costly and nonsensical. Eighteen months into the trainees' contract when the trainees would be reaching some kind of seniority within their firms, their contribution and attention is significantly diluted for a period of at least 3 months in preparation for the Part II examinations.

10.5 These further hurdles - the lengthy delay, the further costs and the further intermediary examination (the auditing specialism course) pose unnecessary and unwelcome hurdles and are contrary to the interests of all, particularly previously disadvantaged candidates who would otherwise more readily access the profession.

10.6 It should be noted that the routing to a chartered accountant and auditor in South Africa is generally not the same as exists in the United Kingdom, where many chartered accountants have completely unrelated undergraduate degrees and hence do a conversion and write their examinations during their articles / traineeship. It is thus not comparable and should not be mirrored.

10.7 For completeness, it should be noted that examinations (and particularly in a discipline such as auditing) are by nature theoretical exercises (even if based on practical situations) and the 18 month delay provides very little by way of practical assistance in addressing an auditing examination, ie. Part II. This is borne out by data which indicates that at a time when universities presented candidates for the board examinations, many of whom had studied part-time (ie. had completed at least 3 to 5 years training contracts / articles) and many who had studied full-time, the full-time students outperformed the part-time students (who had practical experience) in the auditing examinations (despite the examinations being based on practical scenarios).

10.8 As regards practical proficiency, the present requirements should ensure that after completion of traineeship, the candidate seeking registration as an auditor and chartered accountant should be "signed off" (by the person or firm with whom the traineeship was completed) as having received proper training and having displayed the proper practical abilities during the period of traineeship.

10.9 It is thus recommended that, as soon as practically possible after completion of relevant university examinations, candidates should write <u>both</u> the so-called Part I and Part II of the final qualifying examinations (which should continue to be set or at least controlled by the PAAB or its successor body) as soon as practically possible after successful completion of the relevant university examinations.

10.10 As is the present requirement, a person should not qualify for admission as an auditor unless both "parts" of the final qualifying examinations process have been successfully completed and the necessary training contract (previously termed "articles of clerkship") are completed. (It bears repeating that auditing is inexorably interlinked with accounting). However, in order to facilitate accessibility to the profession, the present requirement that both the examinations need not be passed simultaneously should remain in existence.

10.11 For the sake of clarity:

10.11.1 the financial accounting and related matters examinations (the so-called Part I) should remain with SAICA (or other bodies accredited by PAAB or its successor body) and it will be up to the PAAB to assess the standard of that exam as an entrance requirement to the Part II examination;

10.11.2 the auditing (so-called Part II) examination should remain with the PAAB (or its successor body) and it will be up to SAICA to assess whether the standard of that examination satisfies its requirements for registration as a Chartered Accountant. Other professional bodies may or may not require successful completion of Part II for the use of their designation.

10.12 The above structure would certainly streamline the process, remove unhealthy and

unnecessary time, cost and admission hurdles. The structure would certainly be in the interests of the profession, unquestionably in the interests of graduates from university seeking to enter the profession and the previously disadvantaged, and has no negative connotations for the public. It will also mean that SAICA / PAAB will not need to duplicate their accreditation process - at present they are required to perform procedures to accredit universities and then a separate procedure to accredit "audit specialism courses".

Chartered Accountants Designation Act

10.13 There are matters which concern the public interest and public trust in relation to chartered accountants that should be addressed.

10.14 The term "chartered accountant" enjoys statutory protection in terms of an Act of Parliament (the Chartered Accountants Designation Act 1993, which was originally dealt with in 1927 legislation). Accordingly, the public is entitled to expect consistency as regards the body of knowledge to be expected from a "chartered accountant". It is important that the public not be confused in this regard. It is also important that persons should not be able to easily pass themselves off as chartered accountants if they are not entitled to such a designation.

10.15 Recently a version of a chartered accountant has been introduced by SAICA, viz.

"chartered accountant (financial accounting)". This "version" is an accountant who is less skilled and experienced in auditing. However, it is considered that such a version is confusing and the distinction is unknown to the public. Since the term is protected by statute, the public interest demands that there should be consistency and clarity regarding what skills a "chartered accountant" should possess. In the circumstances no alternative "version" of "chartered accountant" should be permitted - in particular, the public should be entitled to assume that any person entitled to the designation has covered the same body of knowledge and not some lesser extent, ie. excluding a high level of auditing knowledge. Thus successful completion of the so-called Part II of the final qualifying exam (discussed below) should be a pre-requisite before being entitled to use the designation. Practical and fair arrangements will have to be put in place to deal with those hitherto permitted to use the designation without completion of the Part II examination.

10.16 A further matter of concern which arises from the protected status of the term "chartered accountant" is the various tiers of membership of SAICA, which have been introduced by SAICA. These include, for example, an *associate* member of SAICA who need not have passed or even written any of the final qualifying examinations or, indeed, need not have even successfully completed the requisite university degrees for admission to write the final qualifying examinations. The public cannot be expected to distinguish between a "member" of SAICA and an "associate member" of SAICA. The burden of public trust is such that the public

should not be confused and passing off as a chartered accountant should not be facilitated by such tiers of membership -which effectively introduces classes of members of the SA Institute of Chartered Accountants including members who (somewhat absurdly) are not chartered accountants.

10.17 It is important that it is highlighted that there are no tiers of membership of other professions. By way of example, the point can be illustrated trenchantly: The public is entitled to assume that if a person is a member of the Society of Advocates then that person is a properly qualified advocate with the body of knowledge expected of advocates. There is no lower or intermediary tier of advocate (or other professionals) and this would be simply confusing and contrary to the public interest.

10.18 It is recognised that SAICA will have certain practical problems in deconstructing these tiers. These tiers of members have been "admitted" to membership of SAICA and presumably have paid membership fees. Thus the deconstructing of that process will have to be done in a fair manner, presumably by establishing some other voluntary organisation for such persons, eg. a student society.

Material Irregularities

10.19 The PAA Act (at section 20(5)) contains a "whistle-blowing" provision which is also taken up in the DAPB. This provision provides that:

"If any person acting in the capacity of auditor to any undertaking is satisfied or has reason to believe that in the conduct of the affairs of such undertaking, a material irregularity has taken place or is taking place which has caused or is likely to cause financial loss to the undertaking or to any of its members or creditors, he shall forthwith despatch a report in writing to the person in charge of that undertaking giving particulars of the irregularity, at the same time drawing the attention of such person in charge to the provisions (below) *and requesting him to acknowledge receipt of such report in writing.*

Unless within 30 days after an auditor has despatched such a report, he has been satisfied that no such irregularity has taken place or is taking place, or that adequate steps have been taken for the recovery of any such loss so caused, or for the prevention of any such loss likely to be so caused, he shall forthwith furnish the board with copies of the report and of any acknowledgement of receipt thereof and reply thereto and such other particulars as he may deem fit.

The board may disclose any information supplied to it ... to any attorney-general or the Registrar of Banks or any officer in the public service or any member or creditor of the undertaking concerned or any

juristic person of whom the undertaking is a member or who has control over the undertaking or who has the power to take disciplinary steps against the undertaking, or to the committee of any stock exchange on which shares of the undertaking are listed, or if the board believes it to be in the best interests of the public, to any other person, institution or body."

10.20 The above "material irregularity" provision is most unusual and is not found in the major markets of the world.

10.21 Major practical problems have been encountered in the interpretation of this section. If it is considered necessary to retain this provision, then the wording should be made explicit to remove doubts regarding its intention and applicability, eg. whether the materiality should be assessed objectively or in relation to the entity; whether irregularity includes a contravention of any law, memorandum and articles and contractual arrangements, etc.

Multi-disciplinary practices

10.22 The DAPB provides for multi-disciplinary practices, ie. for auditors and other professionals to operate in a single practice. Moreover, the DAPB provides that auditors need not constitute a majority of such a partnership or firm. (The DAPB

obviously limits the ability to perform audits to the auditors).

10.23 It is recognised that many audit practices currently operate multi-disciplinary practices and are commercially embarrassed by the provisions of the PAA Act which limits the membership of an audit firm to auditors only and prohibit the sharing of profits with non-auditors.

10.24 It is necessary that the Auditors' Act recognises the commercial reality of multi-disciplinary practices and thus permits (in controlled circumstances) the sharing of profits by auditors with non-auditors who operate at senior level within the broader practice.

10.25 However, in the view of the Panel, having regard to the position of public trust of auditors, the principals, ie. partners or directors, of audit firms should remain exclusively auditors. It follows that the provisions in the DAPB allowing not only non-auditors to be principals within what could be known as an audit practice but also that the auditors could constitute a minority of such principals, is considered inapposite and misguided.

Powers of successor body to PAAB

10.26 The DAPB does not provide for certain required powers and duties which the

auditor controlling body requires in order to operate optimally. The Auditors' Act should, accordingly, in addition to the other matters set out elsewhere in this report, explicitly provide for powers and duties relating to:

10.26.1 prescription of accreditation standards;

10.26.2 enabling the accreditation of programmes of professional bodies that meet those standards;

10.26.3 enabling the monitoring of accredited programmes;

10.26.4 other relevant enabling clauses covering fees payable in respect of accreditation, structures to determine the extent to which programmes of professional bodies meet and continue to meet prescribed accreditation standards;

10.26.5 ensuring the existence of clear requirements to be complied with by any persons wishing to register and for professional bodies seeking accreditation and for the maintenance of professional competence;

10.26.6 clear requirements for the maintenance of accreditation.

Registration of auditors

10.27 Auditing is ultimately a matter of public trust. The present position is that the word "auditor" is not a protected term other than to the limited extent referred to below. Thus many versions appear, eg. "freight auditor", "quality control auditor", "internal auditor", "media auditor", etc. Furthermore, parties (who are not registered auditors) can (and do) in certain circumstances indicate that data is "audited". It is thus easy for the public to be mislead regarding the qualification or accreditation of an "auditor" and the standard applied in reporting on any matter as "audited".

10.28 The PAA Act does provide that only persons registered with the PAAB may engage in public practice as an auditor and accept appointment as auditor where the appointment is required by law. The Auditors' Act should, however, also provide that no party may use the term "auditor" (or derivative thereof) unless accredited with the controlling successor body of the PAAB. This should not apply to the use of a term internally by an organisation.

10.29 Legislation should also be introduced to provide that the words "public", "national", "registered", and "certified" should not be capable of being used with the word "accountant" unless such a description has been approved by the Department of Trade & Industry / Department of Finance. The same should also be applied to the letters "CPA" which is a well-known professional designation in the United States of

America and elsewhere. Such legislation is required in the public interest to ensure that there is no confusion as regards the potential particular titles.

11. **Conclusions**

11.1 It is necessary for the Government to be seen to be taking action to assist in the restoration of public confidence and trust in financial reporting and auditing.

11.2 The adoption and implementation of the Panel's recommendations relating to various corporate governance and auditor control measures will assist in creating the overall appropriate atmosphere in the milieu of the business world and financial markets.

11.3 South Africa will then be clearly in step with the best international principles and practices relating to corporate governance and the legislative environment affecting companies, preparers and users of financial statements, government and the broader public interest.

Section C

Background and Analysis of Global Trends

TERM OF REFERENCE 1

The appropriateness of the structure of the regulatory framework for auditors and accountants that is currently envisaged in the Bill in the light of international developments and the debate around self-regulation.

1. Background

1.1 This term of reference considers the appropriateness of the structure of the regulatory framework for auditors and accountants that is currently envisaged in the Draft Accountancy Profession Bill, 2001 (DAPB) in the light of international developments and the debate around self-regulation. The regulatory framework encompasses structures for the co-ordination, promotion, development and regulation of the accountancy profession.

1.2 The preamble to the DAPB states that the structure of the profession should be such that it can render efficient service to all sectors of the South African economy and that it should function in an open, responsive and accountable way, in accordance with the spirit of the democratic constitutional order.

1.3 Since the publication of the DAPB, confidence in global financial markets has been seriously eroded by the events surrounding the collapse of Enron and other corporate scandals. Governments, notably in the United States of America and the United Kingdom, have responded to the many issues arising, including the regulation of auditors.

1.4 This emphasis on the regulation of auditors has brought into question the advisability of continuing with broadly focused legislation concerned also with regulation of the accountancy profession. Accordingly, we consider the form and content of legislation best suited to implement our recommendations.

1.5 Global practice in the regulation of auditors and accountants varies from country to country. The regulatory regimes lie at different points between complete self-regulation (by the professional bodies themselves) at the one extreme to comprehensive independent regulation (in its strictest form, direct State regulation) on the other.

1.6 Self-regulation cannot be seen to function in an open, responsive and accountable way unless it is subject to rigorous oversight in the public interest. The need for independent oversight of the professional bodies, therefore, increases proportionately to the degree of regulation they exercise.

1.7 The perceived quality of regulation of auditors and accountants is an important factor in promoting the efficiency of capital markets and the functioning of the South African economy.

1.8 Because regulation and oversight impose a cost burden, the relative importance of their outcomes must be assessed against their benefits. Higher standards are generally appropriate where the public interest is greater. Internationally, such considerations have meant that auditors, in particular those of companies whose shares are publicly traded, are subject to the highest standards.

1.9 In South Africa, there has been State regulation of the public practice of accountancy for more than fifty years. Members of an accountancy body entering public practice are

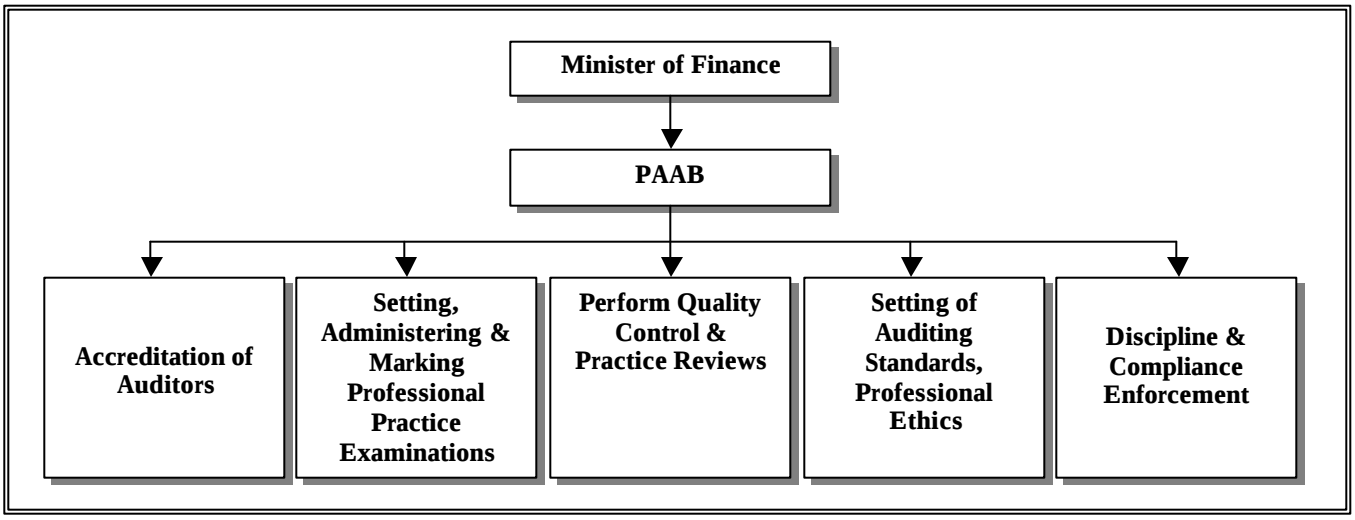
required to register with the statutory body, the Public Accountants' and Auditors' Board (PAAB), and are governed by its regulations.

1.10 The PAAB functions in terms of the Public Accountants' and Auditors' Act 80 of 1991 (PAA Act). The main functions of the PAAB are:

- Registering training contracts;
- Setting, administering and marking the Professional Practice Examination;
- Performing practice reviews;
- Investigating alleged offences of registered members;
- Hearing allegations of improper conduct by registered members; and
- Imposing punishment on registered members found guilty of improper conduct.

The current functional organisational structure of the PAAB is shown in Figure 1 below.

Figure 1 : Functional Structure of the PAAB



1.11 The Public Accountants' and Auditors' Act sets out the manner in which the PAAB should be constituted. Appointment to the PAAB is by nomination to the Minister of Finance who then confirms the appointments. The current membership of the PAAB includes representatives of:

- Office of the Auditor-General;
- Registrar of Companies;
- South African Revenue Services;
- Financial Services Board;
- National Treasury; and
- Academic institutions.

1.12 The PAAB currently comprises 16 members: 9 are accountants in public practice, 2 are academics (also qualified accountants) and 5 represent State departments and institutions.

1.13 Critics of the PAAB have drawn attention to its apparent lack of independence from the accountancy profession. It is wholly funded by the profession, which has a majority of members. It perpetuates itself through membership nominations to the Minister and effectively excludes those not able to volunteer considerable unremunerated time.

1.14 Although the PAAB is a statutory body and has government representatives as members, there are no formal reporting requirements. The role of the government representatives is unclear and there is no detailed public oversight of its operations. This results in a public perception that, in effect, the system is one of self-regulation and self-interest with little focus on the public interest.

2. Global Trends

2.1 Worldwide, there has been a trend towards accountancy bodies being more open in their governance and regulatory processes and for there to be more independent oversight or regulation in areas of greater public interest. As well as the emergence of effective global standards for financial reporting and auditing, the accountancy profession is now moving quickly towards global enforcement of standards in ethics, education and indeed most aspects of the organization of accountancy bodies.

2.2 Governments have also sought more effective means of oversight or regulation and this trend was accelerated by the Enron scandal. Although post-Enron developments have been dramatic, particularly in the USA, many countries had already moved much of the way towards changing the balance away from self-regulation of the accountancy profession.

2.3 In this part, we examine the post-Enron response in the USA and in the UK. The latter must be seen in the context of the European Union (EU), where the European Commission (EC) has also responded, in part to address the extra territorial impact of measures implemented in the USA.

United States of America

2.4 As the country most affected by the Enron scandal, the USA reacted strongly and legislation was passed with little time for consultation. The Sarbanes-Oxley Act of 2002 only applies to public companies that make filings with the US Securities and Exchange Commission (SEC). It addresses issues such as: auditor independence, corporate responsibility, enhanced financial disclosure, conflicts of interest and corporate accountability and risk to issuer business. The Act also establishes a non-governmental Public Company Accounting Oversight Board (PCAOB) which is a non-profit corporation.

2.5 Until the PCAOB is fully in operation, the detail of its rules and operating methods remain uncertain. It has sought to be transparent and publishes a wide range of information on its website. The PCAOB may set its own budget and has wide powers to both set standards and enforce them for public accounting firms (registered firms) that prepare audit reports for public companies. It is funded by a levy on public companies and by registration and annual fees from each registered firm. It may establish, adopt, or modify auditing, quality control, ethics, independence and other standards for public company audits and has powers to:

- Register and inspect public accounting firms (registered firms) that prepare audit reports for public companies;
- Investigate registered firms for potential violations of applicable rules relating to audits;

- Enforce compliance with the Act, the rules of the Board, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the related obligations and liabilities of auditors; and

- Impose sanctions for violations.

2.6 The Act requires that the five members of the PCAOB be prominent, "financially literate" individuals of integrity and reputation. They serve on a full-time, remunerated basis and are subject to stringent requirements to be independent of any public accounting firm. The PCAOB is expected to employ a substantial number of full-time staff in order to fulfill its regulatory functions. It will also make use of standing advisory groups to provide expertise, such as in standard setting.

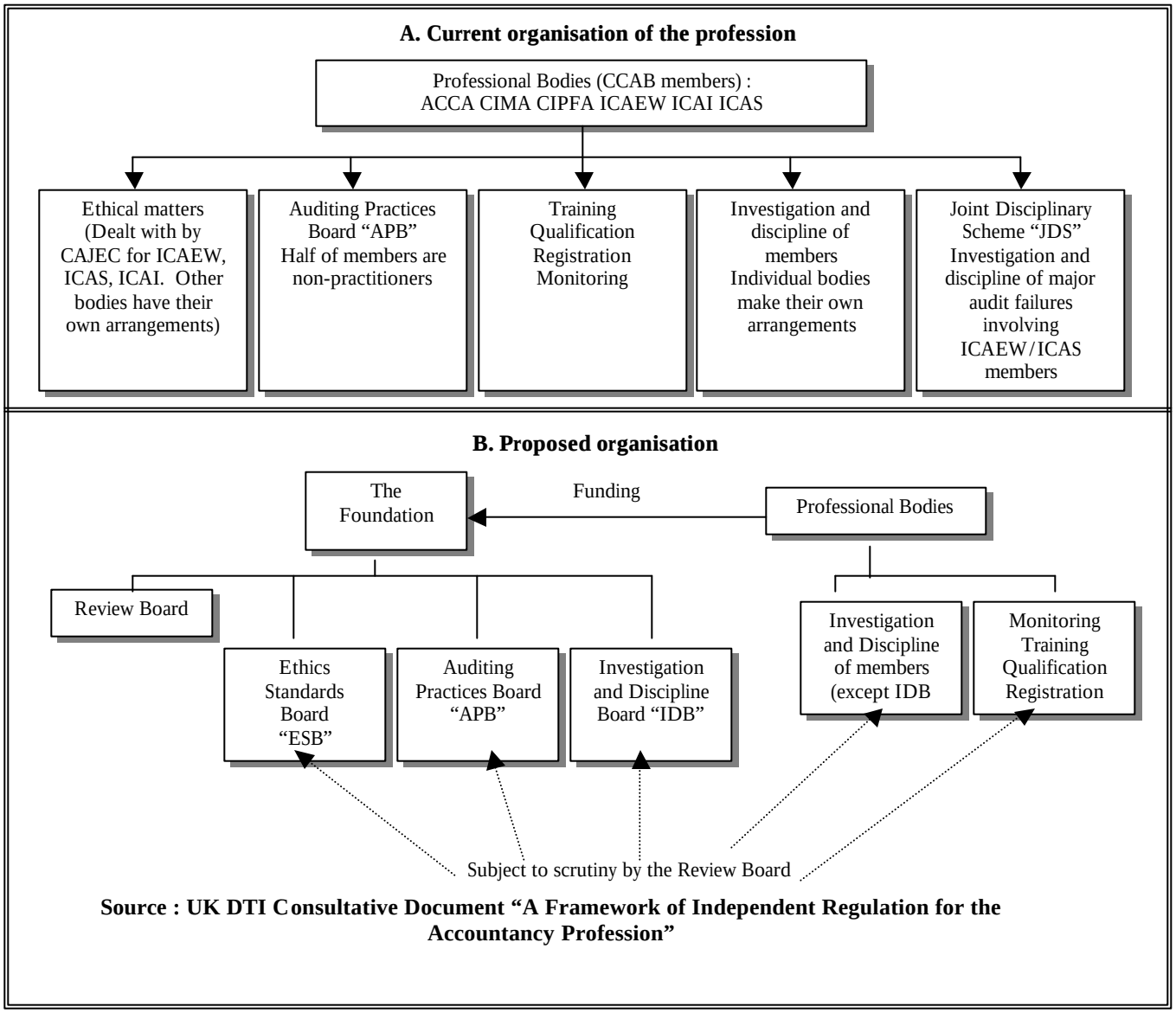
2.7 For public company auditors the PCAOB has taken over the standard setting and enforcement role of the American Institute of Certified Public Accountants' (AICPA). Structurally, the rules of the PCAOB are submitted to, and do not take effect until approved by, the SEC.

United Kingdom

2.8 The UK has recently carried out a broad review of corporate governance and the regulation of the accountancy profession. The resulting action is being taken in advance of the outcomes of EU initiatives. The EC presented its action plan for the improvement of corporate governance and statutory audit throughout the EU on 21 May 2003. Through it, the EC seeks to further EU market integration and to answer the extra-territorial influence of the Sarbanes-Oxley Act, in particular by requesting exemption from registration with the PCAOB of affected EU auditing firms. The plan requires further development and then eventual implementation through either (i) non-binding recommendations or (ii) directives to each Member State to achieve the result, with room for national authorities to choose the form and methods. Thus, there are no immediate regulatory consequences.

2.9 In the UK, the regulation of the accountancy profession had undergone reorganization following a review in 1998. Many public interest functions had been transferred from the control of the professional bodies to a separate body (the Accountancy Foundation) and an oversight function had been introduced (the Review Board). While the membership of these bodies was independent of the accountancy procession, their funding was not.

Figure 2 : United Kingdom Pre-Enron Reorganisation



Source : UK DTI Consultative Document "A Framework of Independent Regulation for the Accountancy Profession"

2.10 The post-Enron review concluded that while there was no evidence that the existing regulatory system was seriously flawed, there were concerns about the perceived independence of key aspects of the arrangements and about its complexity. Although the UK Government is still to enact the precise statutory measures, the revised structure is now decided and has begun operations.

2.11 The change makes use of an existing UK body, the Financial Reporting Council (FRC) which has hitherto been concerned only with financial reporting. The FRC is constituted as a company limited by guarantee. Its Council comprises the Chairman, three Deputy Chairmen and up to thirty members. The Chairman and Deputy Chairmen also act as directors of the company. The directors normally include representatives from the accountancy profession, the London Stock Exchange, and commerce and industry. The Chairman and Deputy Chairmen are appointed by the Secretary of State for Trade and Industry and the Governor of the Bank of England acting jointly. The FRC is

funded by the profession, companies, banks and government and it funds the Accounting Standards Board (which sets accounting standards) and the Financial Reporting Review Panel (which investigates complaints about the financial statements of public and large private companies).

2.12 The FRC takes on the functions of the Accountancy Foundation and becomes the independent regulator taking over responsibility for various subsidiary boards. Its costs are to be broadly shared by government, business and the professional bodies, with the exception of disciplinary costs (funded by the professional bodies) and the cost of the independent audit inspection unit (funded by audit firms).

2.13 The Secretary of State now delegates the government recognition role (for supervisory bodies and auditor registration) to the independent regulator acting through a Professional Oversight Board (POB), which takes over from the Review Board. The POB retains the Review Board's wider accountancy remit, but its primary focus is the oversight of audit.

2.14 A new audit inspection unit is created, which reports to the POB within the independent regulator. It takes over from the professional bodies responsibility for monitoring the audit of those entities whose activities have the greatest potential to impact on financial and economic stability – specifically listed companies and major charities and pensions funds.

2.15 The Ethics Standards Board (which did not set standards but exercised oversight) is dissolved. The Auditing Practices Board (APB) takes over the professional bodies' responsibility for setting standards for independence, objectivity and integrity for auditors. Responsibility for setting all other ethical standards remains with the professional bodies and is subject to oversight by an appropriate board within the independent regulator. The APB's Chairman is a lawyer; its membership is limited to 40% of practising auditors, with the remaining 60% bringing a truly independent and impartial perspective.

2.16 The Investigation and Discipline Board (the operation of which had been delayed) is to be brought into operation without further delay as a subsidiary of the independent regulator to provide, as intended, a demonstrably independent forum for hearing significant public interest disciplinary cases. It will handle cases referred to it by the professional bodies and those which it decides to investigate. It is able to impose appropriate sanctions including removal of eligibility to audit.

Elsewhere in the World

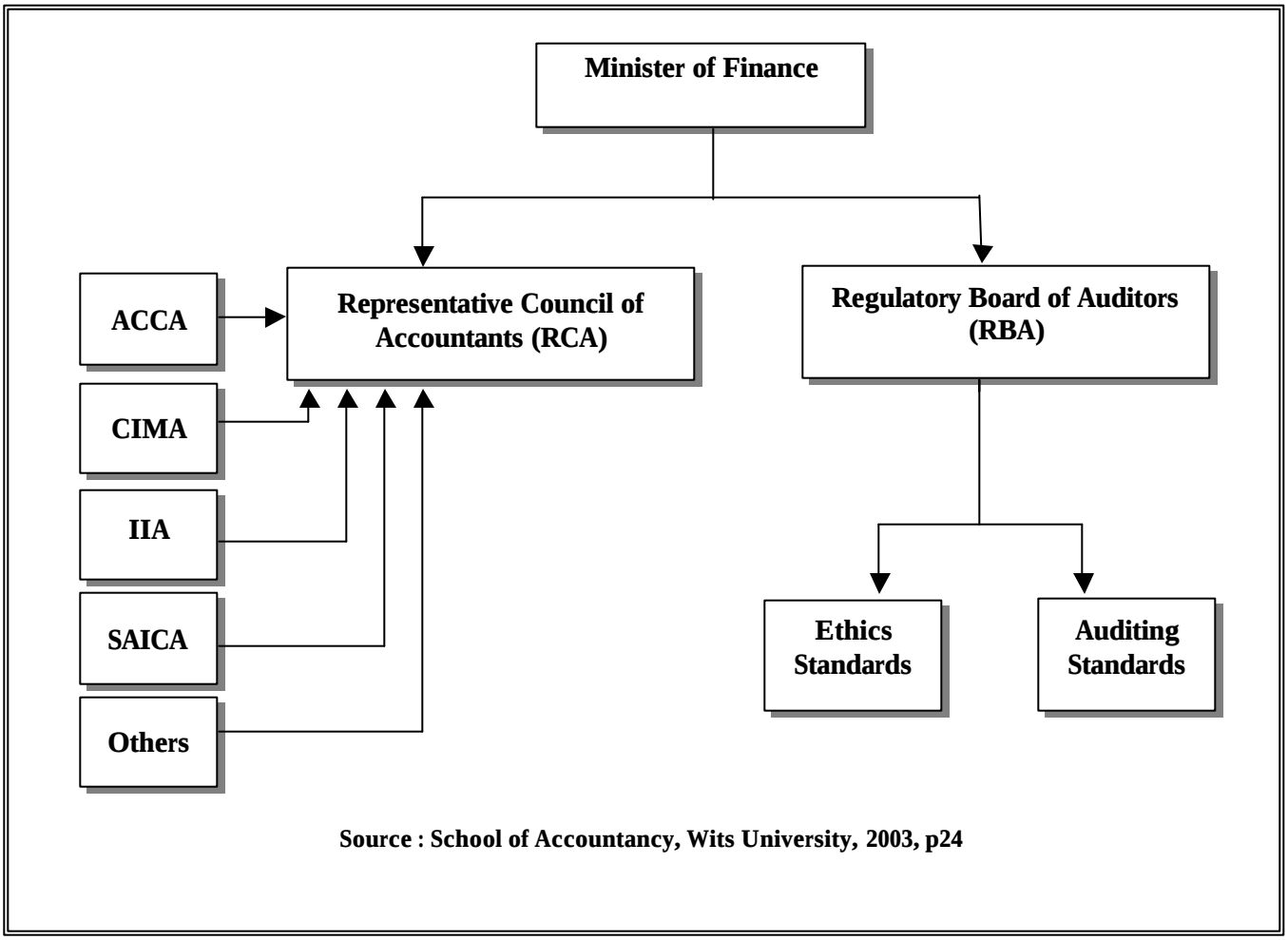
2.17 Outside of the United States of America, the United Kingdom and the member states of the European Union, much activity has taken place around the regulatory framework for auditors and accountants, as well as improvements to local corporate governance frameworks. The Panel considered the two major international comparative reports that were published on its deliberations (OECD, 1998 and Weil, Gotshal & Manges LLP, 2003). These reports addressed the position and status of the issue in the Americas, Europe, Asia and Africa.

3. South Africa

3.1 In this section, we examine the relevant provisions of the Draft Accountancy Profession Bill, 2001 which have been subjected to much debate and discussion over the past decade. We take into account the views expressed to us in relation to whether the proposed structure of the regulatory framework for auditors and accountants remains appropriate in the light of post-Enron global trends.

3.2 The DAPB proposes that accountants and auditors are regulated under a single act. The regulatory structure envisaged in the DAPB is shown in Figure 3 below. The DAPB does not address the costs of establishing these structures, nor how the costs are to be met.

Figure 3 : Regulatory Structure as envisaged in the Draft Accountancy Profession Bill, 2001



Source : School of Accountancy, Wits University, 2003, p24

3.3 The Representative Council of Accountants (RCA) is to be established for the coordination, promotion, representation and development of the accountancy profession, but is not concerned directly with regulation. The Regulatory Board for Auditors (RBA) is to promote and regulate the auditing profession. The RBA has as related structures the Independent Standard-setting Board for Ethics (ISBE) and the Independent Standard-setting Board for Auditing (ISBA).

3.4 The objectives of the RCA are not concerned with regulation except insofar as they are concerned with educational standards. Accreditation by RCA provides a quality threshold for the profession. The DAPB sets out the following objectives for the RCA:

- "To represent, co-ordinate and develop the accountancy profession and to promote its interests;
- to promote appropriate standards of qualification in the accountancy profession;

- to ensure proper funding for itself and its committees in order to perform their respective functions and carry out their duties in terms of this Act or any other law;

- to provide a forum where members of the RCA can formally share their knowledge and expertise in the furtherance of the education and training of accountants;

- to provide a forum where professional bodies accredited by the RCA can interact in furthering the interests of the accountancy profession and in the pursuit of the objectives of the RCA; and

- to liaise with the RBA on matters of common interests" (DAPB, p11).

3.5 The DAPB sets out the following objectives for the RBA:

- "To endeavour to protect financial interests in the Republic through services rendered by registered auditors;

- to liaise with and support the ISBE in the promotion and maintenance of internationally comparable standards of professional ethics for registered auditors;

- to liaise with and support the ISBA in the development and maintenance of internationally comparable auditing standards in the Republic;

- to promote appropriate standards of qualification in the auditing profession;

- to promote the image and interests of registered auditors;

- to ensure disciplinary action in terms of this Act;

- to provide a forum for interaction among professional bodies accredited by the RBA;

- to ensure proper funding for itself, the ISBE, the ISBA and relevant committees;

- to maintain a registration system and a register for registered auditors;

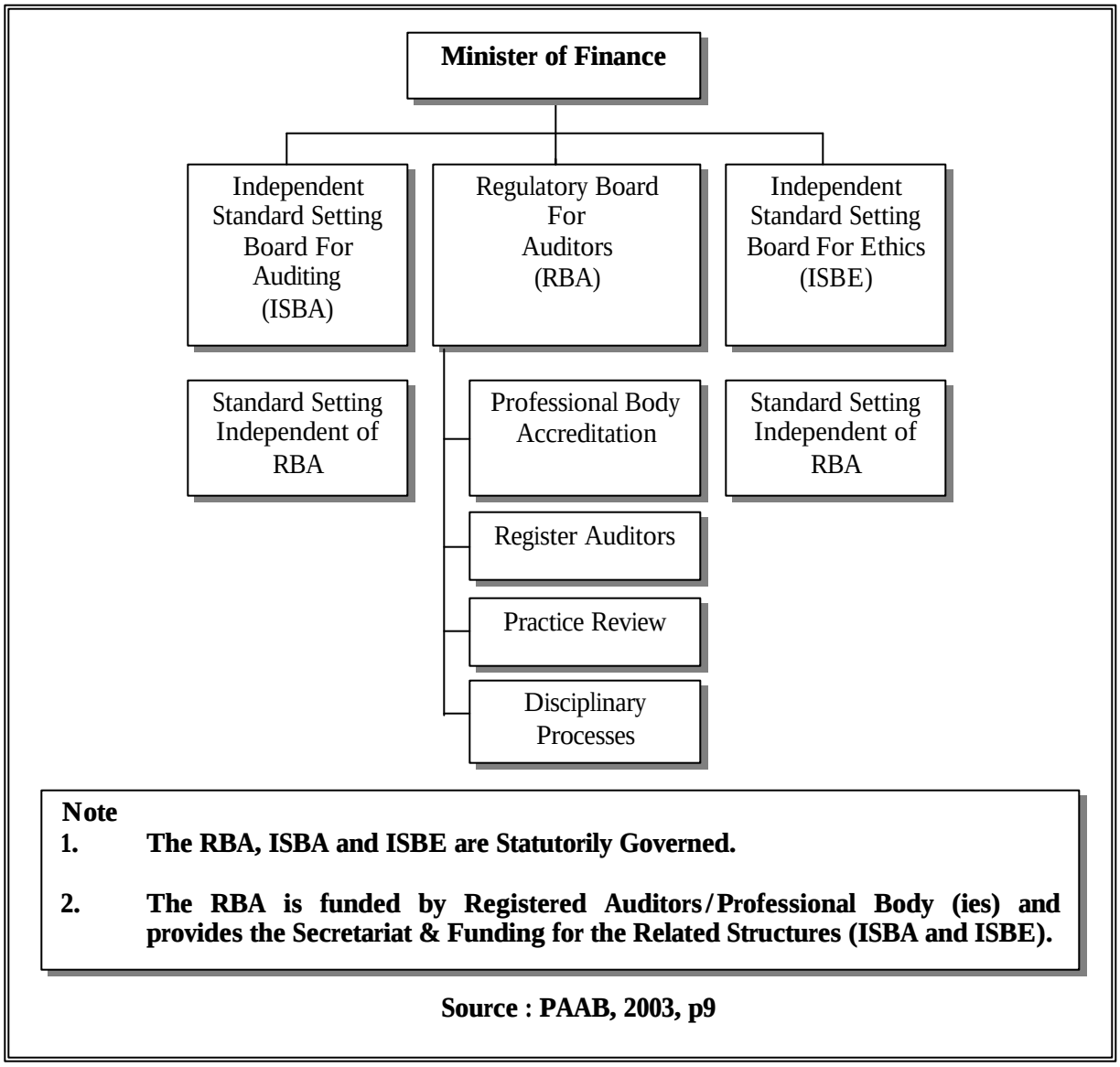
- to monitor the provision of adequate continuing professional education for registered auditors; and

- to liaise with the RCA on matters of common interest" (DAPB, p8).

3.6 The accreditation of professional bodies by the RBA will be substantially different from the existing practice, where SAICA has provided "…the only learning path for entry into the registered auditing professions" (PAAB, 2003, p5).

3.7 A further refinement of the Operational Structure of the RBA, ISBA and ISBE has been submitted by the Public Accountants' and Auditors' Board and is reflected in Figure 4 below. The PAAB currently carries out the disciplinary processes for its members, and should the PAAB be subsumed by the RBA or another similar body, then this function would vest with that body. The figure also recognizes that standard setting may be required other than that for auditors: for example, the professional bodies may deal with ethical standards for general professional behaviour.

Figure 4 : Operational Structure of the RBA, ISBA and ISBE



3.8 The composition of the RBA is dealt with in considerable detail in the DAPB. In summary, the membership is to comprise:

- Eight registered auditors nominated by professional bodies accredited by the RBA;
- A nominee of the Association for the Advancement of Black Accountants of Southern Africa;
- A representative of preparers of financial information (nominated by the JSE Securities Exchange South Africa);
- The incumbent of the office of Auditor-General;

- Four State employees selected by the Minister (such as the Commissioner for the South African Revenue Service, the Executive Officer of the Financial Services Board, the Registrar of Companies and Close Corporations and the Registrar of Banks);

- A person nominated by the RCA; and

- A representative of users (nominated, for example, by the Investment Analysts' Society).

3.9 The membership of the ISBE is to be appointed by the Minister as follows:

- "Five registered auditors, nominated by the RBA;

- two persons representing users of audit services, nominated by the RCA;

- one person representing users of audit services, nominated by NEDLAC;

- one person representing and nominated by the Johannesburg Stock Exchange, or its successor; and

- one advocate or attorney with at least ten years' experience in the practice of law nominated by the RBA" (DAPB, p24).

3.10 The membership of the ISBA is to be appointed either by the Minister or as set out below as follows:

- "Five registered auditors, nominated by the RBA;

- one person nominated by NEDLAC;

- the incumbent of the office of the Auditor-General, or a person nominated by that incumbent;

- the incumbent of the office of Executive Officer of the Financial Services Board, or a person nominated by that incumbent;

- one person with experience in the teaching of accountancy at any higher education institution in the Republic which is recognised or established in terms of the Higher Education Act, 1997, which person must be nominated by a suitably qualified body representative of higher education institutions, designated by the Minister in consultation with the Minister responsible for higher education; and

- the incumbent of the office of the Registrar of Banks, or a person nominated by that incumbent" (DAPB p27).

3.11 Those commenting to the Panel have highlighted the following major deficiencies which they perceive with the DAPB structures as set out above.

3.11.1 The DAPB does not address the need for or structure of a Public Oversight Board as such. Different forms of oversight boards have been established in the United Kingdom, Canada, Ireland and the United States of America. In Australia, the Ramsay report recommended the introduction of an oversight board for that country (School of Accountancy, Wits University, 2003, p26).

3.11.2 "KPMG South Africa supports the formation of an independent oversight body for the accounting profession in line with global trends. The members of this

independent oversight body will have to have an integral understanding of the scope, purpose and limitation of an audit of an entity. The existence of such a body could enhance the credibility of the South African profession and encourage investors in our economy" (KPMG, 2003, p8).

3.11.3 "ACCA is firmly of the view that regulation of the accountancy profession should be independent of those regulated. This is emerging as a fundamental principle in virtually all of the countries which have seriously addressed the loss of confidence in financial reporting and auditing which followed the Enron and WorldCom scandals. While accountants should continue to contribute expertise to the various independent regulatory agencies, they should not do so as representatives of particular accountancy bodies nor should they constitute a majority" (ACCA, 2003, p10).

4. Deliberations

4.1 In this part, we set out the deliberations of the Panel in relation to the regulatory framework and other related, relevant issues. The recommendations arising from these deliberations have been summarized in Section B of this report.

4.2 Underpinning our deliberations is the recognition given by the term of reference for this part to the fact that international developments have been significant and that what might have been appropriate may no longer be so in the post-Enron era. Nevertheless, the DAPB was the result of considerable due process over an extended period and we are confident that it is an appropriate starting point for our considerations. "The PAAB believes that the DAPB, appropriately reviewed to take account of the major events that have occurred subsequent to its finalisation, provides a sound framework to achieve appropriate regulation (PAAB, 2003, p7)" Our recommendations are to strengthen, not weaken, legislation built on the DAPB's foundations.

4.3 We have considered the following other matters to be fundamental to our detailed conclusions:

- "As an emerging economy, South Africa needs to be able to attract foreign investment to the country and be seen to adopt international standards and policies. To be able to remain competitive in the global market, the accounting profession in South Africa must be in line with global trends" (KPMG, 2003, p8).

- "… the preferred structure should be relevant to the South African environment. It should be cost-effective, not unnecessarily burdensome on auditors and it should not result in unnecessary duplication of tasks and responsibilities, while providing the necessary skills and expertise to all role-players" (SAICA, 2003, p2).

- "…public confidence would be enhanced if any change was made obvious rather than by alteration of the powers and membership of PAAB. Without a fundamental shift in the nature of the regulatory infrastructure - and especially if the profession is perceived to be controlling, or funding the new regulatory board - it is likely that the public's perception will not change and that confidence will remain low" (ACCA, 2003, p18).

4.4 While the changes to be introduced by the DAPB can be seen as considerable, we nevertheless consider that it is worthwhile to employ devices to increase the public's perception of change. Financially and practically, it is best not to destroy the existing infrastructure of the PAAB but to transfer it to a new body. The body should, however, have a new name (we accept the name the Regulatory Board for Auditors or Institute of Auditors) which emphasizes its particular public interest, focus and objective.

4.5 We also recommend a change to the name of the DAPB to focus more on auditors and indeed for the reasons we have set out in Section B of this report that the Bill could be taken forward without its wider coverage of the accountancy profession. This is not only a cosmetic device but also a realization that the focus on auditing should not be diluted.

4.6 Under the DAPB, it is proposed that the objectives of that RCA include, "To represent, co-ordinate and develop the accountancy profession and to promote its interests". Moreover, the objectives of the RBA include "to promote the image and interests of registered auditors". While the public interest may be served by enhancing the reputation of auditors and others who help secure the good conduct of business, the Panel sees a conflict between such representation and the needs of effective regulation. This conflict is an essential reason why self-regulation by the accountancy profession is no longer acceptable. In order to address this, we consider that it is necessary to go further than simply deleting such objectives. The DAPB should concentrate on the regulation of auditors and not be diluted by wider considerations of the accountancy profession.

4.7 A further issue of perception is the potential criticism of the membership of the RBA and its subsidiary standard-setting boards because the demands of public credibility require that such structures always have a majority of "lay" members. While we recommend that this perception be addressed, we also recognize that the operation of a regulatory framework for auditors necessarily requires considerable expertise, particularly of those in standard setting, monitoring or disciplinary roles. Such expertise is normally found in those who are regulated, not those in government or the independent members of boards and regulatory committees. While bodies such as the US PCAOB are in a position to hire full-time expert staff, and indeed to remunerate and educate lay members, we do not believe that this is appropriate for South Africa. We consider that the regulatory framework should make full use of the resources of professional bodies to the extent that that is compatible with the regulatory function. We further believe that the responsibilities and powers of regulatory bodies should be such that they continue to attract nominees for membership of the highest integrity and good reputation.

4.8 In deciding the appropriateness of the structure of the regulatory framework for auditors and accountants, it is necessary to strike an appropriate balance between the need for regulation and its cost. Because of its high public interest, the audit of listed companies is rightly given prominence. However, there is also legitimate public interest in non-listed financial and savings institutions, public entities, pension and provident funds, large charities and public interest enterprises. The substantial contribution made to the economy by small and medium-sized enterprises should not be ignored. Moreover, it is not just audit that contributes to the economy, as many accountants work in senior positions in industry and the public sector, where their failure to comply with professional standards may have serious consequences. In the Panel's view, an appropriate response to this is to recognize that no single mechanism is ideal. We are attracted to the solution adopted in the UK whereby there is a graduation in the extent to which independent regulation is applied, depending on the public interest. However, in any particular country, a balance must be sought between the public interest and the cost to the public purse of regulatory structures. In assessing cost and benefit, it is important to take account of all significant impacts that a regulator regime may have on business or the accountancy profession.

4.9 Where a professional body carries out self-regulation, it necessarily bears that cost. To the extent that independent oversight is exercised, the cost of such a mechanism might be borne by the professional body or by government or by those who directly benefit from the professional services. The latter option may not be appropriate where it is impractical to identify those who directly benefit from the professional services or to collect funding in an efficient way. Similar funding options arise in respect of independent regulation. The US PCAOB funding model involves collection of a levy from public companies and charges to audit firms for registration. We favour such a

mechanism above either funding from the accountancy profession generally or from government as it more closely matches cost and benefit.

4.10 To the extent that proper regulation relies on the self-regulatory activities of the professional bodies, it is necessary for there to be oversight in the public interest. The oversight function is seen as important internationally but where there is already a system of State regulation, it is of lesser value. We do not consider that it is necessary or cost effective to put in place a separate oversight board. Instead, the functions of the RBA should explicitly include oversight where necessary.

4.11 Insofar as the structure of the regulatory framework includes the interaction between the accountancy bodies and the regulator, a major change contemplated in the DAPB, and which we support, is that the RBA will take on the mantle of an accrediting body. The RBA will accredit professional bodies that are able to demonstrate to its satisfaction that they qualify for accreditation in terms of Section 3 (5) of the Bill. Only members of accredited bodies would then be considered for registration as auditors by the RBA. This is a significant change to the current situation where the PAAB is directly involved in the training and education of registered practitioners. Although we do not make a specific recommendation on this issue, we note that the success of this change will depend on the further development of the PAAB Recognition Model, which is currently used to evaluate the education and training programme of SAICA.

"The PAAB fully supports the proposed change, especially as it will provide a mechanism for a shift over time away from the present situation where the SAICA route is the only learning path for entry into the registered auditing profession. The PAAB considers that the opening up of alternative learning paths to the profession will be a critical success factor to ensuring that the objective of transformation is achieved"(PAAB, 2003, p1).

4.12 The Panel believes that registered public auditors should undertake a minimum amount of professional development on an ongoing basis. In addition, the existing practice of periodic peer quality reviews of registered auditors should be extended to include the audit firms as well.

TERM OF REFERENCE 2

The desirability of separating the consulting and the statutory auditing function within a firm.

1. Background

1.1 The issue under consideration is the desirability of an audit firm contemporaneously performing non-audit services for audit clients. Consulting services are services other than those provided in connection with an audit or a review of the financial statements.

1.2 An effective audit process is integral to the success and public confidence in the effective operation of financial markets. Every public interest enterprise must be audited annually by a firm of independent auditors. Over the past few years, there have been crises involving companies, both internationally (Enron, Worldcom, Tyco, Xerox, Cendant) and locally (Unifer, Regal, Saambou, Macmed) which have focussed increased attention on the integrity of the audit process and its oversight, as well as the independence of the auditors and the growth in consulting services being provided to audit clients.

1.3 It is universally accepted that the independent auditor plays a vital role in providing independent credibility to published financial statements used by investors, creditors and other stakeholders as a basis for making capital allocation decisions. It is fundamental to public confidence that external auditors are seen to operate in an environment that supports objective decision-making in the preparation and publication of financial statements (IOSCO, 2002 (b) pp2-3).

1.4 Currently, the large audit firms perform audit and large-scale consulting and advisory work for their clients, which is increasingly being seen as being incompatible with the practice of audit. The provision of significant non-audit services by the audit firms has been criticised on the basis that it removes focus from their statutory audit and poses a potential conflict of interest.

1.5 The global trend has been to emphasise the independence of the auditors. Audit firms have had to limit their services to their clients to performing statutory audits and providing certain closely related services that did not affect their independence.

1.6 The independent auditors are required to audit the financial statements in accordance with relevant legal and regulatory requirements and auditing standards; review whether the Corporate Governance Statement included in the annual report complies with the provisions of the King Code specified for the review, and read the other information contained in the annual report and consider whether it is consistent with the audited financial statements (The Auditing Practices Board, 2002, p9).

1.7 Auditor independence has received considerable attention in recent years. While there appears to be limited empirical evidence that the provision of consulting services by audit firms has in fact impaired the independence of auditors, there has been a global trend to limit the services that auditors can contemporaneously provide to their audit clients. It has been argued frequently that by providing non-audit services to the audit client, the auditor's independence and objectivity are impaired or are seen to be impaired.

1.8 Independence is defined as being "a quality which enables a member or associate in public practice to apply unbiased judgement and objective considerations to establish facts in arriving at an opinion or decision. To be recognised as independent, the member or associate in public practice must be free from any obligation to, or interest in the client, its management or its owners. Members or associates in public practice, when

undertaking a reporting assignment, should be independent in fact and appearance" (Code of Professional Conduct – Section 11, par .01-.03).

1.9 Over the past decade, there has been concern with the growth in non-audit services being offered and provided to audit clients. It has been debated that through the provision of certain significant consulting services and the dependence on the income generated therefrom has the potential to create conflicts of interest. The provision of non-audit services to an audit client could, under some circumstances, pose a threat to the auditor's independence. In some controlled instances, the provision of such services to an audit client will not impair an auditor's independence. A pragmatic approach may be to assess the impact of non-audit services in the light of particular facts and circumstances pertaining to each situation.

1.10 It has been repeatedly stated that independence (ACCA, 2003, pp25-26) may be threatened when a firm carries out consultancy (non-audit work) for an audit client. Two threats are evident:

- the self-interest threat, where the quantum of consultancy fees are so large that the auditor's objectivity may be influenced. It is argued that the provision of additional services strengthens the economic dependence of the auditor on the client. It is suggested that the auditor's objectivity is affected by the threat of losing the assignment. It is also alleged that auditors are more prone to compromise or accept the client's position and be less forthcoming in highlighting irregularities when they identify them.

- the self-review threat, where the auditor has to form an opinion on something which the consultancy practice has performed, such as advising and implementing new software, the danger being that the auditor will be constrained from criticising such work.

1.11 Auditors have vigorously defended their position, stating that the holding of an objective and professional approach and of high ethical standards is a business imperative for the profession. The ongoing success of auditors is dependent on offering a quality service, accompanied by their reputation for unqualified integrity, honesty and objectivity.

2. Global Trends

2.1 In the USA, the independence provisions of the Sarbanes-Oxley Act of 2002 and the SEC rules prohibit registered audit firms from performing specified non-audit services for audit clients. The Act and the rules do not prohibit auditors from providing any services to their non-audit clients. Registered firms may be engaged to provide any permitted non-audit service for an audit client as long as the issuer's audit committee pre-approves that service, subject to *de minimis* limits. We attach the prohibited non-audit services under the SEC's new rules as Annex 1.

In the new rules it issued in August 2002, the New York Stock Exchange tasked the audit committee with approving any significant non-audit relationship with the independent auditors.

2.2 The United Kingdom has followed the recommendations of the IFAC Code (2001) in supporting a principles based approach, as opposed to the United States of America which has followed a rules based approach. Extensive work has been undertaken in the United Kingdom in the past year on the nature of services that a client can access from their audit firm. The United Kingdom has resisted from ruling on an outright ban on the provision of non-audit services to an audit client. The United Kingdom's Co-ordinating Group on Audit and Accounting Issues (CGAA) (2003, para 1.35) "…recommended that

each type of service which auditors currently provide should be assessed against a number of key principles, in particular that:

- auditors should not perform management functions or make management decisions; and
- auditors should not audit their own work".

The CGAA stated further that UK requirements in relation to non-audit services should continue to be based on principles rather than rules.

2.3 The Panel examined the conclusions of the Group constituted under the chairmanship of Sir Robert Smith (Audit Committees Combined Code Guidance, Report to the Financial Reporting Council, January 2003) including that:

> " 5.26 The audit committee should develop and recommend to the board the company's policy in relation to the provision of non-audit services by the auditor. The audit committee's objective should be to ensure that the provision of such services does not impair the external auditor's independence or objectivity.
>
> 5.29 In determining the policy, the audit committee should take into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm, and in principle should not agree to the auditor providing the service if, having regard to the ethical guidance, the result is that:
>
> - the external auditor audits its own firm's work;
> - the external auditor makes management decisions for the company;
> - a mutuality of interests is created;
> - the external auditor is put in the role of advocate for the company.
>
> 5.30 The annual report should explain to shareholders how the policy provides adequate protection of auditor independence."

2.4 The January 2002 European Commission's Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States examined the codes of practice and relevant legislation in Europe. In November 2002, the High Level Group of Company Law Experts presented their final report on a Modern Regulatory Framework for Company Law in Europe. It recommends that the audit committee should be responsible for monitoring the provision of non-audit services. While the Group did recognise the case of prohibiting them altogether, they also conceded that it should be closely monitored as long as it is not prohibited.

2.5 In Ireland, the Review Group on Auditing requires the audit committee to monitor the provision of non-audit services by the audit firm.

2.6 In France, the Bouton Report ("Promoting better corporate governance in listed companies") was issued in September 2002. The report's key recommendation regarding audit committees included regularly interviewing the statutory auditors, and driving the process of selecting the auditors. The audit committee should also be informed of the fees paid by the company to the audit firm and ensure that the amount and proportion of the fees do not jeopardise the independence of the auditors.

2.7 In terms of the Canada Business Corporations Act, listed companies are required to establish audit committees. The charter for the audit committee sets out its roles and responsibilities, covering, inter alia, the relationship with and expectation of the external auditors, including the establishment and confirmation of the independence of the external auditor.

2.8 In Australia, there is a mandatory requirement for the top 500 listed companies to have audit committees, (CLERP 9, 2002). The Australian Stock Exchange's Corporate Governance Council is developing best practice standards which tasks the audit committee to review and assess non-audit service provision by the external auditors, giving particular consideration to the potential for the provision of these services to impair or appear to impair the external auditor's judgement or independence in respect of the company.

2.9 A comparative analysis has been undertaken of global trends and the approach to addressing this matter; this appears as Annex 2 to this report (page 130).

3. South Africa

3.1 To date, there has not been any statutory requirement for auditors or companies in South Africa to separate the consulting and statutory functions.

3.2 In examining the issue of complete separation, we are mindful that prohibition of all forms of non-audit services would be in conflict with other prevailing legislation in South Africa (e.g. the Banks Act and its Regulations, Public Finance Management Act and its Regulations, and other legislation) that require the auditor to perform additional services for audit clients such as:

- Reviewing and reporting on the system of internal control;
- Reviewing and reporting on various returns that have to be submitted to the regulatory bodies.

3.3 The Public Finance Management Act (No. 1 of 1999) states in Regulation 27.2.4 that "[t]he internal audit function may in accordance with preferred tendering procedures, be contracted out to an external institution with specialist audit expertise, provided that the external auditors may not perform the internal audit function."

3.4 Some large public interest entities have voluntarily decided to split the internal audit function they have outsourced to their external auditors in the past and have sought independent service providers.

3.5 In a developing economy such as South Africa's, it is important not to lose sight of the importance of small and medium enterprises (SMEs). It is recognised that it would be both burdensome and expensive for SMEs to comply with onerous and demanding requirements and recommendations, including the separation of the consulting and statutory audit service provided by their existing audit firm. The Companies Act currently does not restrict certain non-audit functions, (e.g. advisory, tax and other consultancy work), to be performed by the auditor. A balance needs to be reached between independence and public protection on the one hand and the challenges facing SMEs on the other. It has been submitted that a public interest approach be supported, where some of the more stringent requirements (including the establishment of an audit committee and the restriction of certain non-audit services to audit clients), are imposed on public interest entities only.

3.6 The King Report on Corporate Governance (2002, p139) states that where the auditors supply non-audit services to the audit client, the audit committee should review the nature and extent of such services, seeking to balance the maintenance of objectivity and value for money.

4. Deliberations

4.1 The audit committee should pre-approve all non-audit work to be performed by the auditors to the entity and of its related entities, after having satisfied itself that the performance of such work will not adversely affect the independence and objectivity of the auditors during the performance of their audit duties.

4.2 The audit committee needs to be informed if this is likely to bear on the audit firm's independence and the objectivity of the audit engagement partner and the audit staff.

4.3 Two approaches have been adopted in addressing the issue. The first approach is to use the law or regulation to outlaw the provision of specified non-audit services; the alternative is to adopt a principles-based approach, which requires audit firms to evaluate threats to independence and establish appropriate safeguards. In the absence of safeguards, both from audit clients and audit firms, firms are effectively prohibited from providing non-audit services.

4.4 The threat that non-audit services pose to auditor's independence has been extensively debated. Where accounting standards are increasingly detailed, complex, difficult, costly to apply and rules-based, these permit financial and "accounting engineering" to structure transactions 'around' the rules. It has been argued that where fees from non-audit services significantly outweigh those from the audit, then the audit partner may compromise his judgement in protection of those fees. This was an obvious issue before some of the "Big Four" audit firms split their IT and consulting practices from audit.

4.5 The above argument has been challenged. The proponents of retention of non-audit services charge that any threat, real or perceived, to an auditor's independence is not a function of the audit / non-audit split, but the total amount of fees from the client. With the larger firms, this did not pose a threat, and there was no pressure for the audit partner to compromise on auditing standards, due to the relative size of the fees generated from a single audit client. An auditor who depends on a single client for a sizeable portion of annual firm revenues risks compromising his independence.

4.6 In a robust and effective economy, it is imperative for clients to access non-audit services externally, instead of developing limited internal underutilised capacity.

4.7 Where an audit firm has professionals with these special skills, there may not be sufficient audit work to justify their continued employment, and they need to be engaged on consulting and advisory assignments for the audit firm to be financially viable. These professionals need to be at the cutting edge of their specialisation and be intellectually and professionally challenged. Without their involvement in non-audit services, the attractiveness of the auditing profession recedes. Outright restrictions on the non-audit services provided by these specialists may well result in the attractiveness of employment by audit firms declining, resulting in the audit firms not having the requisite skills to perform these complex and specialised audits. Further, the existing position is justified on the basis that:

4.7.1 It would be dangerous for audit firms to access these skills on an outsourced basis, as it places them at risk, not only in continued availability of the specialist skills when needed, but also as far as the outside specialists not being subject to auditor independence rules.

4.7.2 It is obvious that audit firms need to possess very specialised skills (such as financial instruments, network security, international taxation, derivatives, valuations, etc.) to allow them to perform audits at certain clients. South Africa has very limited resources in many of these highly skilled and specialised areas.

4.7.3 By having these expert services within audit firms, enables the firms to have better trained auditors who would be able to perform the audits more effectively, benefiting their clients in the process.

4.8 It is imperative for a clear distinction to be drawn in respect of the recipient of non-audit services; while public interest enterprises (including listed companies) may be regulated, owner-managed enterprises on the other hand may be excluded. In these instances, the enterprise's auditor may be the professional best equipped to provide advice on a cost-effective basis, due to the auditors existing knowledge of the business.

4.9 The Panel considers that a principles-based approach should be followed rather than attempting to set out detailed rules to suit every occasion. The principles set out in the IFAC Code of Ethics (2001) provides a useful guide in this respect. In essence, these are:

- an auditor should not have a self-interest in an audit client;
- an auditor should not have a mutual or conflicting interest with an audit client;
- an auditor should not audit his or her own work;
- an auditor should not act as management or an employee of an audit client;
- an auditor should not act as an advocate or representative for an audit client;
- an auditor should not have too close a relationship that results in the auditor being too sympathetic to an audit client's interest or failing to exercise adequate professional skepticism.

4.10 The International Federation of Accountants (IFAC, 2001) identified various categories of non-audit services as having the potential to pose a threat to an auditor's independence. These services, are, inter alia,

- preparation of accounting records and financial statements;
- valuation services;
- provision of internal audit services;
- provision of IT services;
- assigning temporary staff;
- acting for or on behalf of an audit client in dispute resolution or litigation;
- provision of legal services;
- recruiting senior management for an audit client;
- provision of corporate finance and similar activities.

4.11 IOCSO (2002(b), p4) points to the growing consensus that holds that the establishment of standards governing auditor independence are not sufficient in themselves to confirm that auditors are in fact independent; the standards need to be supported by robust and rigorous requirements for the audit firms to establish and maintain effective internal mechanisms to monitor, identify and ensure compliance with the standards.

The potential threats to an auditor's independence have been clearly enunciated by the International Federation of Accountants in their Code of Ethics for Professional

Accountants. They have also suggested safeguards to each of the threats. We summarise the potential threats them in Table 1 below:

Table 1 : Potential Threats to an Auditor's Independence Identified by IFAC

Threat	*Example*
Self-interest	Where an auditor could benefit from a financial or other form of interest in or relationship with the company being audited, e.g. an investment in the company or undue dependence on fees from assurance or non-assurance services.
Self-review	Performance of services for an audit client that results in the firm auditing its own work.
Advocacy	Acting as an advocate for an audit client's position in dealings with third parties.
Familiarity	Long association of an audit engagement partner or other key engagement personnel with a particular client or a recent member of the audit firm serving in a key management role at an audit client.
Intimidation	Threat of replacement of an auditor over a disagreement on the application of accounting principles.

4.12 It would be useful to analyse the nature of consulting services in greater detail; for example, in the area of taxation, it is usual to provide a certain amount of general tax advice which can be done without impairing objectivity; however, independence may be impaired when the audit firm promotes, participates and profits from the implementation of certain tax schemes.

The audit committee also needs to ascertain whether or not audit partners' / directors' earnings are significantly influenced by selling other services to clients. The committee needs to ensure that audit partners' / directors' are focused on quality control, risk management and providing audit services to clients with integrity and independence.

4.13 An effective audit committee, coupled with full disclosure in the annual report to shareholders, may be an appropriate mechanism to address concerns regarding the provision of consulting work to an audit client. A blanket prohibition on consulting work by an audit firm should be avoided, as it would harm audit quality, the ability to recruit and the broader public interest.

4.14 Audit firms should not be prevented from supplying non-audit services to entities, which are not statutory audit clients. With regard to separating the consulting and auditing functions within a firm, audit firms should have internal checks and balances to deal with the independence issues.

4.15 The audit committee can help safeguard the auditors' independence by ensuring that the committee has received written confirmation from the auditors on their independence, their understanding of disclosed relationships and the applicable safeguards.

4.16 The audit committee should be responsible for recommending or establishing policies relating to non-audit services provided by the entity's external auditors to the entity and other aspects of the entity's relationship with the external auditor that may adversely affect that audit firm's independence.

TERM OF REFERENCE 3

The introduction of term limits for auditors and audit rotation.

1. Background

1.1 In this part, a detailed analysis is provided on the subject of term limits for auditors and auditor rotation.

1.2 The introduction of term limits for auditors and audit rotation is based on the principle of improving auditor independence. In bringing objectivity into their reporting, auditors need to be and seen to be independent of their clients. It is claimed that auditor rotation provides a fresh look at the entity's business and financial reporting. This issue has also been subject to extensive debate over many years internationally.

1.3 A distinction needs to be drawn between audit firm and audit partner rotation. Rotation of either is undertaken to promote the independence of the auditors. Auditor rotation is not a new concept. The international accounting firms have long practised the rotation of lead partners on assignments. A few countries, such as Italy, Brazil and Singapore, have gone as far as to make firm rotation mandatory.

1.4 Critics of the audit profession have stated that the use of the same audit team and personnel on a client over an extended period of time may lead to a weakening of audit independence as the individuals may become too familiar and sympathetic to the client's interests. Further, the closeness of the relationship and familiarity that can develop between an audit partner and company executives is also a potential cause for concern.

1.5 It has been universally accepted that confidence in capital markets and integrity in financial reporting are dependent on objective and independent audits. The CGAA in their 2003 final report stated that the confirmation by the independent auditors of the reliability and confidence of the entity's financial statements supports the efficiency of capital markets, thereby contributing to the lowering of funding costs of capital. The CGAA stated further that audit quality depends critically on both the competence and the independence of the auditors.

1.6 The changes in audit firm appointments have been driven by either the client or the auditor. Audit firms are known to resign from risky clients, where unrealistic fees have been received and inter-personal relationships have been difficult. Corporate action, through mergers or acquisitions, also result in the new owners appointing their preferred audit firms.

1.7 It has long been practised in certain jurisdictions (USA, UK, etc) that the rotation of audit personnel is appropriate. Cognis ance needs to be taken of the balance between the threat posed by the long association and the additional audit risk that arises from auditor replacement, either in start-up or exit years.

1.8 The issue of mandatory audit firm rotation has been considered by many countries over the past decade, and not legislated or implemented. In addition, the rotation of audit firm partners has also been considered and implemented in certain countries.

1.9 There is little evidence to confirm that mandatory audit firm rotation would overcome corporate or audit failure. Research has been conducted into both firm and partner rotation, and the findings are attached (Annex 2).

Attention has recently been focused on whether auditors are sufficiently independent of management and the perception by investors of their independence and objectivity. When circumstances can put into question the audit firm's independence, the audit committee usually considers the rotation of the audit firm. The issue is considered below.

Factors that could point to circumstances that would merit consideration of audit firm rotation would be where the audit firm has been engaged by the entity for an extended period of time, former senior management (partners and managers) of the audit firm are employed by the entity and significant fees are generated from non-audit services, even though the audit committee may have approved the services.

The issue of partner rotation has also received extensive attention, which is examined comprehensively below.

(a) Audit Firm Rotation

1.10 In calling for the rotation of audit firms, a number of arguments are advanced.

1.10.1 Long-term economic relationship

Proponents of this view hold that through a long-term economic relationship with the client, the auditor may become too dependent and close to management, and not be as skeptical or as diligent as is necessary to sign off on an independent, objective audit. The long stay may lead to deterioration in audit effort and quality, thereby affecting independence.

1.10.2 Fresh pair of eyes

Audit independence is improved through regular firm rotation, bringing a "fresh pair of eyes" to the assignment, as well as enhancing the integrity of the audit process. The incoming audit firm would view the assignment with the benefit of a fresh pair of eyes, examining the entity's finances, accounting practices and quality of the former firm's audit.

1.10.3 Prior "cover-ups" quickly identified

Audit quality would be enhanced as prior unsatisfactory audit decisions would be identified by incoming auditors, and addressed, rectified and communicated more quickly to management, investors, creditors and other stakeholders.

1.10.4 Audit and non-audit fees

It may facilitate a greater distinction between audit and non-audit fees as different firms can be engaged to perform the different assignments.

1.10.5 Encourages competition

Competitive audit fees may be offered through firm rotation, as firms vie with each other for new clients and additional business.

It needs to be borne in mind that this argument may not be persuasive as the costs of audit tender / bid preparation, audit familiarisation and knowledge acquisition needs to be borne by the audit client, as audit firms would be loathe to further erode their profit margins in the long term.

1.10.6 Improved service

In pursuit of the new assignment, audit firms will attempt to offer an even more acceptable and improved service to their clients, to remain competitive and attract new business.

1.10.7 Addresses the issue of auditors auditing their own work

There will be greater choice and access to work by more firms, reducing the risk of auditors auditing their own work.

1.10.8 Joint audits improve audit quality

Joint audits have taken place successfully in banks and certain public entities in South Africa (see 1.11.11 below) over a number of years. The quality control procedures in such assignments (through the mutual agreement or mandatory rotation of activities performed between the audit firms over agreed time periods and the inter-firm concurring partner reviews) have contributed to improved audit quality and effectiveness.

1.11 Arguments have been advanced against audit firm rotation, in South Africa, as well as elsewhere, and they are discussed below.

1.11.1 Deterioration of the quality of the audit through firm rotation

The Banking Council of South Africa (2003, p2) have alluded to a number of studies confirming this:

- A Securities Exchange Commission review of 406 cases in the USA found that allegations of audit failure occur almost three times more often when the audit firm is performing its first or second audit;
- The Treadway Commission concluded that a significant number of fraud related cases involved companies that had recently changed their auditors;
- The General Accounting Office concluded (in 1996) "measures that would …mandate changing auditors are outweighed by the value of continuity in conducting audits…"
- The Smith Report for the Financing Reporting Centre in the UK has just recommended that audit committees should rather do a formal annual assessment of external auditor performance than "a fuller, periodic review, such as triennially…" or "a "backstop" of ten years when the audit should be put out to tender". The Report notes that, ultimately, how audit committees manage external auditor performance should be determined by each company in the context of its specific circumstances".

1.11.2 Escalation of costs through rotation.

There would be an escalation in costs to the auditor and the entity due to start up and development time necessary to accept the assignment and gain sufficient knowledge of the client's business. Rotation of audit firms would result in unrealistic costs and inefficiencies for the auditor and the client on an ongoing basis. This would also be disruptive for the management of the entity and the auditors.

The additional costs of tender submission and client familiarisation arising from firm rotation would result in higher audit costs being charged to the client on a reduced audit firm term appointment.

1.11.3 Specialist industry knowledge is scarce

Specialist auditing skills are scarce in South Africa in respect of complex businesses and transactions (e.g. banking, financial instruments, insurance, derivatives, international taxation, IT, etc), which would limit the extent to which rotation could be effectively and efficiently achieved. These special skills are built up over time and exists in a limited number of firms. There is much knowledge which the new auditor has to acquire, how the business is run, what controls are in place and what records are maintained, which takes time and requires considerable effort.

A possible consequence of auditor rotation is that some audit firms may be unable to staff the audit engagement team with sufficient partners who are qualified to understand some of the complex issues the audit client faces. This is particularly true in industries where there are specialised transactions and regulatory processes.

1.11.4 Cumulative knowledge of existing audit team is lost through firm rotation

The accumulated knowledge (permanent files on systems, flows, management functions, deal structures, processes and procedures) of a client's business is lost if audit firm rotation is enforced. The incoming firm does not have access to the proprietary material of the exiting firm.

1.11.5 Evidence of higher instances of failure subsequent to firm rotation

International empirical research has evidenced the higher incidence of audit failure occurring in the first two years of the appointment of a new auditor (see 1.11.1 above).

1.11.6 Firm rotation distorts consumer choice

The appointment of an entity's auditors is the right and responsibility of its shareowners. By enforcing audit firm rotation, this right is removed from shareowners, thereby reducing freedom of choice, and placing it in the hands of parties who may not have a financial interest in the outcome.

1.11.7 Rotation has challenges for multinational entities

Group auditors to multinational entities face the prospect of different term limits, quality, range of services, year-ends, costs, country conditions and firms being used in different countries. This reduces the effectiveness and efficiency of the audit, as well as adds significant cost and inconvenience.

1.11.8 Firm rotation will affect concentration of auditors ("Big 4")

There are limited, highly skilled specialist auditing resources in South Africa. There is an insufficient number of firms with the required level of specialist skills and expertise to allow effective firm rotation to take place.

There are four major international audit firms with the expertise, resources and connections to be appointed to conduct the audits of certain entities e.g. multinational and bank audits. In the case of joint bank audits (discussed in 1.11.11 below), significant practical difficulties will arise in relation to the appointment, retirement and "cooling-off" period of the auditors. Audit firm rotation may seriously challenge the efficiency and availability of audit services and may make it inoperable.

1.11.9 Demise of small firms through firm rotation

Small firms may lose critical assignments and capacity through firm rotation, and may not have the resources or will to re-build that in the expectation of receiving assignments in future.

1.11.10 Developing emerging Black audit firms would be slowed

The collective professional commitment to developing and transferring skills to the emerging Black firms in South Africa would be slowed through their short term appointments (together with the associated costs) and the non-recovery of incurred costs and investment. This would not be a positive development for the previously excluded and disadvantaged members of the auditing profession.

1.11.11 Appointment of joint auditors affects firm rotation

The challenges facing banks (and certain public entities in terms of the Public Finance Management Act) in South Africa that have joint audit firms that may have to be rotated, is formidable. The Companies Act, 61 of 1973, as amended, together with the company's Articles of Association, regulates the appointment of auditors in general.

As far as licensed banks are concerned, they need to comply with the requirements of the Banks Act, No 94 of 1990, as amended, and its Regulations.

1.11.11.1 Sections 61 and 63 of the Banks Act stipulate, inter alia, that

- the appointment of the bank's auditors must be approved by the Registrar of Banks;
- banks exceeding R10 billion in assets must appoint at least 2 independent auditors; and
- the auditor's must make certain additional reports to the Registrar of Banks, or provide the Registrar with any additional information requested.

1.11.11.2 Regulation 45 under the Banks Act specifies certain additional reporting duties for the independent auditors, and the regular returns by the banks that also need to be signed by the auditors. Form DI006 is the application form for approval of the appointment of an external auditor of a bank. There is extensive focus in this form on the audit firm's capacity, resources, experience and international links (Banking Council, 2003, p1).

1.11.11.3 It is obvious that over a number of years the external auditing of local banks has been subjected to extensive and detailed additional responsibilities, including the mandatory appointment of joint auditors. These developments are of particular relevance in a review of the term limits for auditors and audit rotation.

1.11.11.4 Where there is a proposal to enforce mandatory rotation of auditors, it must of necessity also specify a "blocked" or "cooling off" period during which a rotated auditor may not be re-appointed. Any such proposals will present significant risks to the banking sector, given its unique characteristics and external audit regulation regime. This "blocked" period may also be at variance with the Constitution of the Republic of South Africa, and may be viewed as an unfair labour practice.

1.11.11.5 The deterioration in the quality of the audit has been addressed in 1.11.1 above.

There is a practical difficulty with requiring audit firm rotation, as most foreign banks are obliged to have the same audit firm for all their subsidiaries and branches (an obligation imposed on them in the light of the BCCI debacle) (Banking Council, 2003, p2). It is obvious that an obligation for mandatory audit firm rotation required in South Africa would be in conflict with the legislation under which these banks conduct their principal business.

It is also conceded that the principles of sound corporate governance may be compromised if different audit firms were appointed to conduct audits of different parts of the same international group.

(b) Partner Rotation

1.12 The aim of the audit partner rotation rules is to provide a fresh look at the entity's business, its financial reporting and the audit engagement. The accounting profession has long recognised its benefits.

1.13 Audit partner rotation promotes and upholds auditor independence.

1.14 Global practice has been to extend the rotation of partners beyond the engagement partner, to other partners engaged on the audit of the client and its subsidiaries and associates.

(c) Hiring of Members of the Audit Engagement Team

1.15 It has been debated in the past that there is the potential for actual or perceived impairment of independence when partners and other members of the audit engagement team accept employment or join the board of directors or management of an entity they had audited. The SEC in the USA requires a one-year long "cooling-off" period before audit engagement team members can accept employment at the entity in a "financial reporting oversight role".

1.16 The "cooling off" of "block out" rules indicates that an accountant, including a registered public accounting firm, will not be deemed independent from an audit client unless the rotation requirements have been met.

1.17 Exemptions have been provided for certain audit engagement team members from the one-year cooling off period. The exemptions apply to

- persons other than the lead or concurring partner who provided less than ten hours of audit, review or attest services;
- individuals whose employment arose from a business combination that was not contemplated (here the audit committee needs to be made aware of the earlier employment relationship); and
- certain extremely rare circumstances (here again, the audit committee must assess whether that relationship is in the interests of investors).

2. Global Trends

2.1 International practice, except for Italy, Brazil and Singapore, is for partner rotation to take place instead of mandatory firm rotation. In the United Kingdom, the rotation of audit partners has long been the practice. The USA's Sarbanes-Oxley Act of 2002 limits both the lead and concurring partners to a maximum of five consecutive years of service in those roles and requires them to rotate off for at least five years. Mandatory audit firm rotation is not required at this stage in the USA, though the issue may be re-visited, depending on experience over the next year. Australian practice, supplemented by the Ramsay Report of 2001, recommended the rotation of audit partners engaged in listed clients every seven years. Many of the members of the European Union (EU) have had partner rotation, with the EU now requiring regular audit partner rotation. Canada and Ireland have has also followed this trend.

The arrangements in the USA can be summarised as follows:

Table 2 : Partner Rotation Requirements

Lead Partner	Concurring or Reviewing Partner	Other Engagement Team Partners
Five consecutive years on	Five consecutive years on	Seven consecutive years on
Five-year cooling off	Five-year cooling off	Two-year cooling off

The application of audit partner rotation rules needs clarification. The most comprehensive guidance has been provided by the SEC in the USA which concluded that the rotation rules should apply to more partners than just the lead and concurring partners.

2.2 Guidance is also awaited from IFAC's International Audit and Assurance Board on their recommendations on audit independence and audit partner rotation.

2.3 An audit partner has been defined as any partner, principal or shareholder who is a member of the audit engagement team who has responsibility for decision making on significant auditing, accounting and reporting matters that affect the financial statements or who maintains regular contact with management and the audit committee.

2.4 For clarity, the following are included in the definition of audit partner in terms of SEC rules:

- lead audit partner;
- concurring partner;
- client service partner (those other partners who "maintain regular contact with management and the audit committee");
- audit partners (excluding "speciality" partners) at their entity (i.e. parent) level, who provide 10 or more hours of audit, review, or attest services;
- lead audit partners on significant subsidiaries (a significant subsidiary is defined as a subsidiary of the issue entity whose assets or revenues constitute 20% or more of the assets or revenues of the entity's respective consolidated assets or revenues).

3. South Africa

3.1 To date, South Africa has not had a statutory requirement for firm or partner rotation, although the Office of the Auditor-General has from time-to-time called for audit firm rotation in public entities. Within audit firms, the practice varies, with some firms rotating partners every five to seven years as their internal quality control measure, while others do not.

3.2 Audit firms have been changed from time-to-time for a number of different reasons: change in shareholding, increase in audit fees, where joint auditors have previously conducted the assignment performed jointly, auditor-client relationships breakdown, loss of capacity, etc.

3.3 As far as partner rotation is concerned, the practice has been varied. Amongst the "Big Four" the recent internal practice has been for partner rotation to take place every 5 to 7 years, although the practice has not always been adhered to by all the firms.

3.4 The King Report (2002, p139) tasked the audit committee to consider the rotation policy adopted by the auditors, and ascertain whether there is any need to recommend that the audit partner or senior staff be replaced because of their extent of time they have performed the audit engagement.

4. Deliberations

4.1 It has been argued that to improve auditor independence, auditor rotation should take place.

4.2 The global practice has been for auditors to report to the entity's shareholders, independent of their clients, with objectivity being brought into their reporting.

4.3 The auditors involved in certain recent corporate failures have been criticised and accused of having been too close to their clients; had firm rotation taken place periodically, the financial disaster that occurred might have been averted.

4.4 It has long been argued that firm rotation unfairly protects the audit firms' interests. Firm rotation cannot be done in isolation – it affects all firms, and if it is implemented, it would affect the interests of investors and other stakeholders and benefit the profession in the long-term.

4.5 It has been noted that there are limited high level specialist auditing resources in South Africa (SAICA, 2003, p5). For effective rotation to take place, there have to be sufficient firms with the requisite skills in place. In certain industries (such as banking, insurance, mining, etc.) the availability of specialist audit skills is scarce, affected by the emigration and move into industry and commerce of key audit personnel.

4.6 The time that it takes a team to familiarise itself and acquire the detailed knowledge with a complex client also militates against firm rotation.

4.7 The entity's audit committee should understand the independent auditor's staffing, and be satisfied that engagement team collectively possesses the competence and experience to perform an acceptable and high-quality audit.

4.8 Through the enhanced role of the audit committee (discussed in Term of Reference 5), in relation to its oversight of the entity – auditor relationship, and the manner in which audit firms maintain audit quality, the comfort is obtained on the audit firm's effectiveness, efficiency and independence.

4.9 To be globally competitive, and in keeping with international developments, South Africa needs to ensure that audit partner rotation takes place.

The audit committee should, on an annual basis, review the relationship between the auditor and executive management to ensure that an appropriate balance exists. The relationship should not be so close as to put at risk the auditor's independence and objectivity, and yet, at the same time, should be such that management and auditors can work together in an environment of constructive challenge.

4.10 The audit committee has the responsibility for appointment, compensation, and oversight of the company's audit firm. In that capacity, the audit committee has the responsibility for evaluating and determining that the audit engagement team has the competence necessary to conduct the audit engagement.

4.11 It is our view that <u>enforced firm rotation</u> can exacerbate the problem rather than offer an acceptable solution. Extensive international research has not provided a convincing case of the benefits, pointing out that it does lead to a reduction in audit quality (SDA Universita Bocconi, 2002).

4.12 The Panel believes that partner rotation should be a requirement for listed companies and public interest enterprises and the audit committee needs to ensure that it does take place.

TERM OF REFERENCE 4

A system of accountability between an auditor and their clients that addresses the issue of fees and the relationship between an auditor and directors and the board of a client entity.

1. Background

1.1 The issue being examined here is the independence of the auditors, the approval of their fees and their relationship with the management of the audit client.

1.2 For financial markets to operate effectively, the audit process that is integral to the confidence therein must be observable. Every public enterprise must be audited annually by a firm of independent accountants. Over the past few years, corporate collapses and crises such as Enron and WorldCom have focused attention on the integrity of the audit process and its oversight.

1.3 The appointment, removal, resignation, rights, duties and remuneration of the auditors is currently regulated by different forms of legislation, including the Companies Act, as amended (sections 270 to 281), as well as other applicable legislation (Banks Act, Public Finance Management Act, etc) in South Africa.

1.4 In most entities, the external auditors are still selected by executive management, despite the statutory right, of shareholders, improved corporate governance and the vital and expanded role of the audit committees. It is apparent that apart from an acceptable practical working relationship with executive management (Smith (SA) 2003, p2), the audit fees, non-audit (additional) services and continued appointment of the auditors are all effectively decided by executive management. It is not uncommon for management to influence the choice of auditors and shareholders to tacitly accept the recommendations. This gives rise to an inherent conflict between the regulatory nature of the audit function and the financial pressures emanating from the business of selling audit services. There is also ongoing pressure on auditors to curtail the increase in their fees.

1.5 To promote independence, certain 'persons' are disqualified from appointment as auditor, such as a director, officer or employee of the company or of any company performing secretarial work for the company (Company's Act, 1973, s275). They need to be completely independent, both directly and indirectly, of control by the company, through its directors or otherwise.

1.6 The role of audit committees has come under the spotlight, with many new duties and responsibilities being imposed upon them. As will be revealed later, several leading nations have required the audit committee to become responsible for the appointment, compensation and oversight of the work of the independent auditors, and for the auditors to report directly to the audit committee. The audit committee of a public interest enterprise is required to pre-approve all the services, as well as the fees, whether for audit or non-audit services, that are provided to the entity by the independent auditors.

1.7 It is generally accepted that the board of directors of a listed entity have little practical ability to manage or directly supervise every aspect of the entity's business and affairs. Operational control is largely in hands of senior executive management.

1.8 An annual audit enables the external auditor to provide an opinion on the fairness of the presentation of the annual financial statements in terms of Generally Accepted Accounting Practice (GAAP). Annual audits are required in terms of statute and sound corporate governance.

1.9 The causes of corporate failure are many and varied. The King Report on Corporate Governance (2002, p134) states that

> Directors or officers may have by their acts of commission or omission, contributed to a company's failure and should be held liable for any such conduct. Damages against auditors for company failures are becoming a matter of concern. Directors and auditors should be held liable for damages in proportion to their contribution to the failure.

1.10 To meet their responsibilities, the audit committee of a public interest enterprise must engage in active, independent and informed oversight of the entity's external auditors, internal auditors and management on their reporting.

1.11 Also, the objectivity and independence of the auditors needs to be maintained, as well as their observance of the highest standards of professional and business ethics.

1.12 A developing practice of the boards of public interest entities is to entrust the specific responsibilities of the audit committee, and setting these out in the audit committee charter. As far as this issue is concerned, the audit committee is required to consider the scope and results of the external audit and the cost effectiveness of the auditors by:

- understanding the scope of audit and reviewing the audit fees;
- facilitating discussion of audit findings;
- helping to resolve any differences of view between management and the independent auditors;
- reviewing the risks and, where relevant, safeguards relating to the independence and objectivity of the auditors;
- reviewing the nature and extent of any other services provided by the auditors, together with the fees for such services; and
- making recommendations in respect of the appointment of auditors (The Auditing Practices Board, 2002, p8).

2. Global Trends

2.1 There has been a global trend to expand the role and responsibilities of the audit committee. The 2003 Smith Report in the UK and the Sarbanes-Oxley Act of 2002 has expanded the responsibilities of audit committees. The 2001 Ramsay report in Australia has also made far-reaching recommendations, as has the European Commission, Canada, and South Africa.

2.2 Additional reporting obligations imposed on independent auditors by the SEC in the USA, require that they communicate to the audit committee:

- All critical accounting policies and practices used by the entity in preparing its financial statements;
- All alternative accounting and disclosure treatments of material financial information within Generally Accepted Accounting Principles (GAAP) that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm;

- Other material written communications between the accounting firm and management of the entity.

2.3 It is instructive to note that the United Kingdom's Smith Report on Audit Committees Combined Code of Guidance (2003, p4) states in paragraph 1.9:

> In particular, the management is under an obligation to ensure the audit committee is kept properly informed, and should take the initiative in supplying information rather than waiting to be asked. The board should make it clear to all directors and staff that they must cooperate with the audit committee and provide it with any information it requires. In addition, executive board members will have regard to their common law duty to provide all directors, including those on the audit committee, with all the information they need to discharge their responsibilities of the company.

2.4 Existing international professional auditing standards provide for certain matters to be communicated by the external auditors in relation to the audit.

These matters cover, inter alia,

- Methods used to account for significant unusual transactions;
- Effects of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus;
- Processes used by management in formulating particular sensitive accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates;
- Material audit adjustments proposed and immaterial adjustments not recorded by management;
- Auditor's judgements about the quality of the company's accounting principles;
- Disagreements with management over the application of accounting principles, the basis for management's accounting estimates, and the disclosures in the financial statements.

2.5 Globally, the trends have been towards a properly constituted independent audit committee having the primary responsibility for recommending the appointment, re-appointment or removal of the auditors to shareholders, as well as their remuneration and scope of the audit. The audit committee shall also monitor and report on auditor independence, as well as play a key role in determining and approving non-audit services.

2.6 It is also becoming a requirement that where a change in external auditors is proposed by management, the reasons for the change needs to be communicated to the audit committee by both the auditors and executive management. In the case of listed companies, the details for the change should be separately presented by the executive directors and the auditors.

2.7 The U.K. and U.S.A see an independent and effective audit committee as an appropriate mechanism to address the relationship between executive management and the external auditors. These countries' legislation is being amended to make it obligatory for companies and other public interest entities to have properly constituted audit committees.

2.8 A new requirement coming to the fore is for the external auditors to communicate certain specified matters related to the conduct of the audit, including an annual declaration of their independence, to the audit committee.

3. South Africa

3.1 Both the South African Institute of Chartered Accountants and the Public Accountants' and Auditors' Board have each issued a Code of Professional Conduct which provides specific guidelines as to matters which the independent auditor should take into account as affecting his/her independence in connection with his/her appointment or continuation in office. The matters include the existence of a personal financial interest in the company, participation in the making of policy decisions with regard to the conduct of the company's affairs, the existence of a family relationship with its shareholders or directors and the degree of importance to the auditor's practice of the particular client (Henochsberg, 2003, p522).

3.2 The Auditing Standards Committee of The South African Institute of Chartered Accountants has issued South African Auditing Standard SAAS 210 Terms of Audit Engagements, which recommends, on appointment, that the independent auditor should issue an engagement letter. This letter normally establishes the scope of the work (both audit and non audit), to be undertaken, the basis upon which the independent auditors' fees and other matters of mutual interest are to be determined, specifying the contractual obligations of both parties. The independent auditors carry out their statutory duties and report on the annual financial statements in terms of ss300 and 301 of the Companies Act.

3.3 The independent auditor reports whether the annual financial statements which are laid before the annual general meeting in terms of S286 (1), "fairly present" the financial position of the company and the results of its operations in the manner required by the Companies Act.

3.4 In terms of SAAS 730, Communications of Audit Matters with those charged with Governance, issued by The South African Institute of Chartered Accountants, the auditor should communicate audit matters of governance interest arising from the audit of financial statements with those charged on such matters of an entity. The auditor would ordinarily communicate on matters such as the approach to and scope of the audit, the choice or changes in accounting policies that could have a material effect on the financial statements, the identification of significant risks and their potential effect on the financial statements, material uncertainties that may jeopardise the company's ability to continue as a going concern, differences of opinion with management that could have a significant effect on the annual financial statements or the auditor's opinion, and other matters that warrant the attention of those charged with the governance of the company.

3.5 It is incumbent on the board of directors and management to take appropriate, timeous and decisive action to satisfy the auditors that their concems have been comprehensively addressed.

3.6 The auditor's remuneration is determined by agreement with the company (Company's Act, s283 (1)). In the annual financial statements, there shall be separate disclosure of the following:

- remuneration for the audit;
- remuneration for other specified services; and
- auditor's expenses and payments in respect of the audit and any other matter (Company's Act, s283 (2)).

3.7 The common practice has been for the auditors and management to discuss, annually in advance of the audit, the scope of the audit and the services to be performed, and to agree a budget in respect of the expense for auditor's remuneration.

3.8 The present Companies Act does not prescribe the requirement for an audit committee. However, several other pieces of legislation require audit committees (Banks Act, Public Finance Management Act, etc.). The JSE Securities Exchange SA requires a listed company to have an audit committee, and it needs to comply with the recommendations of the King Report on Corporate Governance.

3.9 The King Report (2002, p141) tasked the audit committee with the following recommendations, in relation to the independent auditors, with which the Panel concurs:

- review the scope and results of the external audit and its cost effectiveness;
- examine their independence and objectivity;
- examine the nature and extent of supply of non-audit services, ensuring value for money is received, and objectivity preserved;
- prepare a recommendation to the board for the appointment of the external auditors.

4. Deliberations

4.1 It is submitted that the audit committee will undertake on an annual basis an assessment of the independence and effectiveness of the external auditors which will also cover its competence, skills base, technical capacity, ethical practices, conflict of interest, fees, internal control, peer review and quality control procedures.

4.2 In relation to audit fees, the Panel found that on a comparative basis the audit committee needs to ascertain from the external auditors, whether or not the extent of the work performed and the scope of the audit was adequate to enable them to provide the required level of comfort and assurance, and that the fees were adequate to meet the scope of the audit. The overriding objective of the audit committee is to ensure that the level of assurance is appropriate and that the issue of costs is a subsidiary consideration.

4.3 The Panel's comprehensive view on this matter appears under Term of Reference 4 in Section B of this report.

TERM OF REFERENCE 5

An appropriate set of liabilities and disciplinary procedures for auditors that fail to properly report on the true financial health of an entity.

1. Background

1.1 The issue being examined here is the liability of and the imposition of appropriate sanctions on independent auditors who issue misleading or false audit reports.

1.2 There is a division of responsibility between management and the independent auditor. The critical distinction is

- The responsibility for preparing the financial statements and the contents of the statements lies with management.

- The independent auditor is responsible for auditing the financial statements and expressing an opinion on their fairness (Companies Act, as amended, s286 and s300).

Audit failure and consequent auditor liability has been subject to extensive debate around the world.

1.3 Auditors need to be held to account and be responsible for the quality of their work. Where users have suffered financial loss caused by reliance on negligently audited financial statements, they have civil law remedies against the auditors.

1.4 The primary responsibility for presenting the entity's financial position and financial statements lies with its directors; they have access to all operational, management and financial information and need to ensure that it is properly accounted for in the financial statements.

1.5 The independent auditors examine the financial statements, and provide their opinion after assuring themselves that the said financial statements meet the required statutory requirements and professional standards. In performing their duties, the auditors must act with skill, care and caution which reasonably competent, careful and cautious auditors would use.

2. Global Trends

2.1 The auditors' breach of duties leading to liability arise from one or more of the following causes:

- irregular or misleading audit opinion;
- non or late disclosure of fraud or irregularities;
- breach of other duties, such as disclosure of events compromising the solvency of the entity, duty of confidentiality, etc.

Table 3 below sets out whether the independent auditor is bound by more than his/her fault (duty of care) in the various countries surveyed.

It is noted that even when an unrestricted audit is carried out, in compliance with all professional and technical standards, the auditor may still fail to detect misrepresentations in accuracies or the existence of fraud; in such a case, the statutory auditor will not be liable.

A survey of audit liability rules was undertaken on a global basis. The table below sets out the survey of audit liability rules: in all countries surveyed, a duty of care by the auditor is necessary; where audit failure results, the strict liability borne by the auditor is subject to various statutory practices in different countries. Table 3 also highlights the countries in which general and specific rules are in place, addressing audit liability.

Table 3 : Survey of Audit Liability Rules

Country	Duty of Care	Strict Liability	General Rules	Specific Rules
Austria	Yes	No	Yes	Yes
Belgium	Yes	No	Yes	Yes
Denmark	Yes	No	Yes	No
Finland	Yes	No	Yes	Yes
France	Yes	Yes	Yes	Yes

Germany	Yes	No	Yes	Yes
Greece	Yes	No	Yes	Yes
Ireland	Yes	No	No	No
Italy	Yes	Yes	Yes	Yes
Luxembourg	Yes	Yes	No	No
The Netherlands	Yes	Yes	No	No
Portugal	Yes	Yes	Yes	Yes
Spain	Yes	Yes	Yes	Yes
Sweden	Yes	No	Yes	Yes
United Kingdom	Yes	No	No	No

Source : School of Accountancy, Wits University, 2003, p 40

2.2 Many countries have enshrined in their law proportional liability for audit or corporate failure.

2.3 In Australia, the Ramsay Report, (2001, pp 85 to 89) examined the disciplinary procedures and wide-ranging recommendations made by the Audit Review Working Party, and recommended that the ASIC Act or the Corporations Act, as may be appropriate, recognise and facilitate disciplinary proceedings against those identified.

2.4 A number of initiatives were carried out in the United Kingdom, and recommendations have been made (this is covered in Term of Reference 1 earlier in Section C of this report).

2.5 The Sarbanes-Oxley Act of 2002 describes in detail the investigation and disciplinary procedures, corporate responsibility for financial reports, improper influence on the conduct of audits and officer and director bans and penalties applicable to the United States of America.

2.6 Section 303 of the Sarbanes-Oxley Act of 2002 directs the SEC to adopt rules that make it unlawful for any officer or director, or anyone acting under their direction to fraudulently influence, coerce, manipulate or mislead any independent public or certified accountant engaged in the performance of an audit of a company's financial statements for the purpose of rendering them materially misleading.

3. South Africa

3.1 The PAAB and the DAPB takes the unprofessional conduct of members extremely seriously, with expulsion being the ultimate penalty. SAICA (2003, p7) states that …[t]he purpose of this is to protect the status of the profession and to ensure the financial integrity of financial statements that have been audited."

3.2 Our legislation and practice stated that the sanctions available to punish errant auditors should be comprehensive and effective, catering for the range and seriousness of the offences committed, with appropriate penalties. Subject to the comments contained in 3.3 to 3.5 hereunder, the civil and criminal justice processes necessary to deal with the civil and criminal liability of auditors are considered adequate.

3.3 A range of remedies are available to the regulatory bodies (SAICA and PAAB), including:

- expulsion from membership (permanent), without recourse to rejoin;
- temporary suspension to practise;

- formal reprimands;
- warnings, and
- fines.

3.4 Publicity is also given in the media of the failure of the auditor and the audit firm.

3.5 Criticism has been levelled in the past against the PAAB for the lack of speed of resolution of disciplinary procedures and for the sanctions (fines or penalties) imposed on practitioners. The PAAB currently has disciplinary rules to investigate errant auditors.

3.6 Criticism in the past has also been levelled at the differential treatment accorded to the different parties who may be at fault as well as the extent of the penalty imposed on them. It is important for equal treatment to be accorded to all guilty parties, and this is seen as being carried out.

3.7 The current powers of the PAAB appear to be inadequate to investigate and to discipline its members.

3.8 Several sections of the PAA Act govern the auditor's liability under existing legislation (PAAB, 2003); it also has the powers of investigation (s23), punishment and publication thereof in the media (s13 (h)).

3.9 The respective boards of the PAAB and SAICA agreed to appoint a joint disciplinary task team ("Myburgh Task Team", 2002) to debate nine issues presented to them by these boards, and make recommendations on how the problems identified in the issues paper could be addressed. The issues contained in the brief were as follows:

- The ability to obtain and subpoena evidence and witnesses, both by a statutory body and a voluntary association.
- How the needs of both SAICA and the PAAB can be met without double trials.
- Credibility of the process in the eyes of both the public and the members.
- Acceptability of "plea-bargaining" as a mechanism for improving the efficiency of the process.
- Optimum level of resources needed to be able to conduct the process effectively and the level of expenditure needed to sustain the process.
- The appropriateness of sentences imposed by both bodies in the light of current society norms.
- The composition of committees taking into account the availability of volunteers and the trend towards longer and more complex hearings.
- The increasing difficulty of proving cases and the adequacy of evidence.
- How the processes can be accelerated.

The joint disciplinary task team considered the disciplinary processes of various other jurisdictions and suggested recommendations to be incorporated into future legislation regarding the accountancy profession. Their recommendations were divided into two groups: those that were short-term and which can be effected without a change to any legislation, and those that are medium to long-term which would, in some instances, require changes to legislation.

3.10 The Myburgh Task Team also made a number of proposals in relation to the disciplinary processes. To be credible and maintain public confidence, the disciplinary process needs to meet with the following principles:

- It should be quick;
- It must be efficient in order to avoid duplication of efforts;
- It must be cost effective; and
- The process must be fair to all concerned (2002, pp2-3).

3.11 The King Report on Corporate Governance (2002, p44) states that:

> Directors and auditors should only be held liable for damages on a basis proportional to their contribution to the failure. Consideration should be given to amending the Apportionment of Damages Act (No. 34 of 1956) accordingly.

3.12 The Panel agrees with the policy recommendations of the World Bank (ROSC, 2002, p16) that business ethics should be taught as a separate subject in undergraduate commerce programmes. In addition, the professional examinations of SAICA and the PAAB, as well as other professional accounting bodies, should test candidate's knowledge about practical aspects of professional ethics (Ibid).

4. Deliberations

The Panel has analysed the issue and provided its opinion and recommendations under Term of Reference 5 in Section B of this report.

TERM OF REFERENCE 6

An appropriate set of liabilities and disciplinary procedures for executive management of entities that fail to properly disclose the true financial health of an entity to the auditors.

1. Background

1.1 The issue being examined here is the sanctions to be applied to the executive management (including directors) who mislead the independent auditors.

1.2 The following general principles should be kept in mind in considering this aspect.

The directors of a limited company are in law its "directing mind or minds" (*Levy v Central Mining & Investment Corporation 1955 (1) SA 141 (A) at 149150; Newborne v Senolid (Great Britain) Ltd [1954] 1 QB 45 (CA) at 51)*.

1.2.1 The directors' authority is derived from the company's articles of association and the Companies Act.

1.2.2 While at common law a director is not personally liable for the wrongful act of the company unless he himself perpetrated such conduct or procured the perpetration thereof, various provisions in the *Companies Act No 61 of 1973* and the *Public Finance Management Act*, No. 1 of 1999, inter alia, clearly impose personal liability, both civil and criminal, on the director for acts of financial misconduct and breach of fiduciary duty respectively (*Hamman v South West Africa People's Organisation 1991 (1) SA 127 (SWA) at 143-144; section 83 of the PFMA: section 248, inter alia, of the Companies Act).*

1.2.3 If a director fails to exhibit in the performance of his duties that degree of skill and care which in the circumstances may reasonably be expected from a person of his knowledge and experience, he is liable to the company for any damage it may suffer in consequence of such failure *(In re City Equitable Fire Insurance Co Ltd [1925] 1 Ch 407 (CA0 at 427-429; Fisheries Development Corporation of SA Ltd v Jorgensen 1980 (4) SA 156 (W) at 165-166).*

1.2.4 The Companies Act, as well as common law, provides for the sanctioning of directors and management who have been found guilty of wilful misconduct, fraud or deception.

2. Global Trends

2.1 The general practice is for each country, without exception, to have specific legislation to address the issue. There is general agreement that appropriate sanctions are applied, after due process is followed.

2.2 It is instructive to note the severe penalties that have been introduced with the Sarbanes-Oxley Act of 2002 in the United States of America for securities, corporate and criminal fraud as well as alteration of documents.

2.3 Similar forms of penalties are in operation elsewhere, especially in the USA, UK, etc.

3. South Africa

3.1 As is the case with Term of Reference 5, this is a legal matter which is extensively covered in various Acts, supported by extensive case law. The Companies Act, as amended, addresses the matter in s250 (Falsification of books and records) and s251 (False statement by directors and other for fraudulent conduct of business).

3.2 This matter is not explored further here as the Companies Act, as amended, is subject to review in terms of the Corporate La w Review Project

3.3 The King Report on Corporate Governance (2002, pp169 – 170) makes a number of recommendations on the sanctions to be applied to delinquent directors, which the Panel supports.

3.4 Changes in legislation also need to be made to implement the recommendations made by the Myburgh Task Team to SAICA and PAAB to speed up the disciplinary process against errant executive management who are members of these bodies, or their successor bodies.

3.5 The delinquent directors' register in terms of the Companies Act (section 421) needs to be updated, and all board appointments in future need to be made by reference to this register.

3.6 The responsibility for the preparation of an entity's financial statements lies with corporate management, and not with the auditors. Where they are found to report dishonestly, they need to be dealt with appropriately.

3.7 Where directors, including executive management, have contributed to the entity's failure, they should be liable for their conduct leading to the entity's demise.

3.8 Regulators need to be empowered to censure directors found wanting in their conduct of their fiduciary duties.

4. Deliberations

4.1 This issue has been considered in two contexts:

4.1.1 liability of executive management for financial statements that failed to fairly present;

4.1.2 liability of executive management regarding misrepresentations (including omissions) by executive management to the auditor.

and is detailed in Section B, Term of Reference 6 of this report.

TERM OF REFERENCE 7

The usefulness and appropriateness of accounting standards and disclosure rules and the feasibility of implementing a system of 'current disclosures'.

1. Background

1.1 This term of reference is being addressed by separating it into two components:

(a) the usefulness and appropriateness of accounting standards; and

(b) the feasibility of implementing a system of 'current disclosures'.

The usefulness and appropriateness of accounting standards is reviewed in detail while the feasibility of implementing a system of 'current disclosures' is addressed at a high level, many of the issues being tentative and in various stages of experimentation and development at this stage.

1.2 The availability of reliable and timely information, prepared in terms of globally accepted accounting standards and disclosure rules, is fundamental for effective investment decision making.

1.3 In considering the usefulness and appropriateness of accounting standards in general, the Panel have not undertaken a consideration of any specific areas of concern within the individual statements of Generally Accepted Accounting Practice ("GAAP").

1.4 South Africa has been harmonising its accounting practices with those of the International Accounting Standards Board ("IASB"). In 1993, the Accounting Practices Board ("APB"), in consultation with the Accounting Practices Committee ("APC") of the South African Institute of Chartered Accountants, embarked on what is known locally and globally as the Harmonisation Process. Prior to 1993, South Africa had published, written and regulated its own accounting standards. As South Africa opened its doors to the world economy, it became necessary to harmonise South African standards with international standards. South African Statements of GAAP are now largely identical in content to the International Financial Reporting Standards ("IFRS") of the IASB.

1.5 The current practice in South Africa is for proposed statements of GAAP to be widely circulated for comment in the form of exposure drafts. The APC develops the exposure draft, circulates it for comment, allowing comment periods to vary from three to six months, depending on the complexity (including technical and applicability aspects) of the issues being exposed. After receiving feedback from commentators, and incorporating these into the exposure draft, the APB issues a Statement of GAAP.

1.6 To enforce compliance with Statements of GAAP, SAICA and the JSE Securities Exchange SA (JSE) constituted the GAAP Monitoring Panel (GMP) in September 2002 "…to investigate complaints and advise the JSE in relation to compliance by issuers with GAAP or IFRS, the JSE's required accounting practices (in terms of the Listings Requirements) and the accounting practices required by the Act. If, after receiving advice from the GMP, the JSE is satisfied that an issuer has not complied with any of the above, the JSE will be able, in its sole discretion:

- to censure such issuer in accordance with the provisions contained in Section 1 of the Listings Requirements; and
- instruct such issuer to publish or reissue any information the JSE deems appropriate.

1.7 In addition, the JSE will refer any such non-compliance to SAICA, PAAB or any other professional or relevant Body" (The JSE Listings Requirements, 2003, p8-18) for it to take further action.

(a) The appropriateness and usefulness of accounting standards

1.8 The United States Securities and Exchange Commission ("SEC") in their Concepts Release (2000) dealing with International Accounting Standards, defines accounting standards as "…a comprehensive set of neutral principles that require consistent, comparable, relevant and reliable information that is useful for investors, lenders and creditors, and others who make capital allocation decisions". Accounting standards identify the generally accepted accounting practice that underpins the initial and subsequent recognition, measurement and disclosure of economic events.

1.9 High quality accounting standards are essential to the efficient functioning of a market economy because decisions about the allocation of capital rely heavily on credible and understandable financial information. Accounting standards achieve this by formally enforcing desirable accounting practices. The success of the capital markets is founded on investor confidence that is dependent on the credible accounting standards (Levitt, 1998, pp79-82).

1.10 Criticism has been levelled at the existing system of financial accounting standards; some of the more significant criticisms are:

- The increasing complexity of accounting standards has resulted in significant difficulties in interpreting standards and applying them in practice.
- The standards are based on "generally accepted" accounting practice, and therefore emerge from a political process that creates inconsistencies as a result of the search for a consensus.
- ACCA note that while IFRS are evolving to meet needs and changes in the economic environment (e.g. standards for financial instruments and share option schemes), there are, however, still important gaps - for example, an absence of standards on extractive industries, insurance, etc. (ACCA, 2003, p39).

1.11 This criticism of current standards and their appropriateness is far from being exhaustive; however, it is important to note that none of the criticisms suggest that the accounting standards are not useful; they are more in the nature of calls for refinements and improvements to the current standards.

2. Global Trends

2.1 The IASB and the United States Financial Accounting Standards Board ("FASB") have acknowledged that convergence of IFRS and US GAAP is a primary objective of both Boards and agreed a plan in September 2002 to work towards that goal. Progress is being made in reducing key differences between the two sets of standards. A formal liaison relationship, monitoring relationships for major projects, and the undertaking of joint projects, have all contributed to this reduction. It seems that the U.S. authorities' commitment to the IASB's new structure is so complete as to indicate that US GAAP and the IFRS will inevitably converge (Damant, 2000, p97).

2.2 The SEC state that globalisation and the emergence of the "Global Economy" means that standards are seen as a necessary means of ensuring uniform reporting across all the world's major securities markets, which in turn contributes to inter-market efficiency. The efficiency of capital allocation by investors would be reduced without consistent, comparable, relevant and reliable information regarding the financial condition and operating performance of

potential investments. The efficiency of cross-border capital flows is therefore facilitated by uniform accounting standards (SEC, 2000).

2.3 The normal due process of the IASB includes issuing for comment an exposure draft of any new or revised standard. The period allowed for comments on a standard would normally be at least three months. The comments submitted would be published, considered by the Board and a standard issued only after that process. The standard would include an explanation of the key decisions taken in developing the standard, and a basis for the conclusions.

3. South Africa

3.1 If South African companies are to compete for capital in the international markets, it is essential that their financial reporting is compliant with internationally accepted accounting standards, such as those promulgated by IASB.

3.2 SAICA, although emphasising the importance of IFRS, believes that that there are weaknesses in international standards. Nevertheless, it supports the recommendation that the local standard-setting body should only make amendments to the international standards in exceptional cases, where considered absolutely necessary, to meet unique domestic circumstances.

3.3 Other commentators observed that the current approach has the advantage of local standards being "…set by a body (the IASB) which is both independent of the local profession, and also highly authoritative. Nevertheless, this does carry the risk that the Standards may be drafted from a first-world perspective, which will not necessarily meet the needs of the South African environment" (Everingham & Watson, 2003, p1-7).

3.4 SAICA contends that experience has shown that preparers of financial statements will only comply with accounting standards if they are obliged to do so in terms of legislation. In this regard, the Companies Act is currently not entirely clear as to what set of standards companies need to apply when preparing their financial statements. As a result, it is possible for South African companies to prepare financial statements without complying with Statements of GAAP. In the USA, Canada, UK, Australia and New Zealand, there is legal backing for their accounting standards.

3.5 As far as small and medium enterprises (SMEs) are concerned, Ernst and Young (2003, pp4-5) support the principle of allowing non-public companies to prepare financial statements in accordance with an alternate authoritative basis of accounting. With international standards being aimed at entities operating in the financial markets, compliance with these standards can be a burden for those not operating in these markets.

3.6 These sentiments were echoed in the submission to the Panel by Grant Thornton Kessel Feinstein (2003, p6), who contend that compliance with IFRS should be a minimum requirement for public interest entities. Limited Purpose Financial Reporting Standards ("LPFRS") should be set for owner-managed businesses.

3.7 According to SAICA (2003, p12), in a young and developing economy like South Africa, attention should be paid to the role and importance of small and medium-sized enterprises. It is often very burdensome to force SMEs to comply with accounting standards of an international calibre. In terms of the current legislation, as set out in the Companies Act, no distinction is made between multinational or listed companies and SMEs. SAICA believes that the matter is appropriately dealt with in the draft Financial Reporting Bill and strongly supports that these proposals should be implemented as soon as possible in order to provide SMEs with some form of relief.

4. Deliberations

4.1 The Panel submits that accounting standards are essential for the proper functioning of a modern economy. It further believes that South African accounting standards should continue to be based on IFRS.

4.2 The Panel considers that there is an urgent need for legal backing to be introduced for accounting standards. The Financial Reporting Bill provides for such legal backing, requires standards to be based on international standards and introduces less onerous requirements for small enterprises. Standards should not be embodied in legislation such as the Companies Act as it will be necessary to effect changes quickly.

(b) The feasibility of implementing a system of 'current disclosures'

5. Background

5.1 The International Organization of Securities Commissions ("IOSCO') states that ongoing or current disclosure includes generally all current, continuous and periodic disclosures, other than those disclosed at IPO dates (reference to be inserted). The report states that "…continuous disclosure refers to the disclosure regimes of certain jurisdictions in which information is provided under a general principle of materiality, without reference to a specific timeframe" (IOSCO, 2002(a), p3).

5.2 The Panel has considered the following as issues raised by the possible implementation of a system of 'current disclosures':

- The duration between an entity's year-end and the release of its financial statements;
- More frequent periodic reporting, i.e. how many times an entity reports per annum;
- The extent of assurance provided on such periodic reports;
- Immediate disclosure of material events or continuous disclosure;
- Real time or online reporting of the complete financial statements (online reporting);
- Providing additional non-financial disclosure in the annual financial statements.

5.2.1 The duration between an entity's year-end and the date of release of its financial statements.

5.2.1.1 "If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the economic decision-making needs of users" (AC000, Framework for the and Preparation and Presentation of Financial Statements).

5.2.1.2 A survey of the international statutory time requirements for the publication of the annual reports is presented in Table 4 below.

Table 4 : International Reporting Periods

Country	Duration between year end and release of financial results
South Africa	6 months in terms of the JSE Listing Requirements to publish the audited annual report Approx. 8 months 1 week (21 days before 9 months) in terms of the Companies Act to publis h the audited annual report
Australia	3 months
Austria	5 months
Belgium	6 months
Canada	140 – 170 days
Germany	5 months
Japan	3 months
Sweden	6 months
United Kingdom	6 months
United States	3 months (2 months) * * The SEC in September 2002 reduced the reporting deadline from 90 to 60 days for the annual financial statements of certain companies e.g. those with a public float of over $75 million. This amendment will be phased in over a three-year period.

Source : School of Accountancy, Wits University, 2003, p48 (adapted)

5.2.1.3 The United States has recently reduced the maximum delay in the publication of financial statements of certain large listed companies to 60 days after the financial year-end. This is significantly less than the current time required in South Africa.

5.2.1.4 The SEC believes that shortening the filing timeframes for annual reports will have beneficial consequences for investors and capital markets, including more rapid dissemination of information (School of Accountancy, Wits University, 2003); an increase in the relevance of disclosures to investors' decisions, which may lead to the greater use and scrutiny of companies' disclosures by investors (Wood & Maron, 2002).

5.2.1.5 It is noteworthy that one of the reasons why the SEC reduced its reporting deadline is that hundreds of public companies were issuing press releases (albeit not necessarily providing all required information) to announce quarterly and annual results well before they file their reports with the SEC. This proves that it is viable to reduce the reporting deadline (SEC, 2002).

5.2.1.6 It is also instructive to note that a number of public companies, accountants, securities lawyers and other interested parties in the USA have expressed serious reservations with the shortened reporting timeframes (School of Accountancy, Wits University, 2003). Despite the technological advancements over the past few decades, at least some of the companies subject to the new requirements, including those with widely dispersed and international operations, may find it difficult to meet the accelerated filing deadlines and may incur significantly increased costs in attempting to do so (Ibid).

5.2.1.7 Furthermore, the filing date change comes at a time when companies' financial disclosures are receiving increasing scrutiny from investors and

regulators and when the SEC itself is asking for enhanced disclosure (Ibid). The challenge is that there would be less time for accounting staff and management to compile and review the financial information and prepare the related disclosure, for the auditors to complete their audits and reviews that serve as vital checks on the accuracy and completeness of the financial information. In addition, there would be less time for in-house and outside counsel to review the disclosure and provide detailed input, and for already heavily burdened audit committees to review the information and disclosure with the auditors and management. Rather than assisting the new focus on improved disclosure, the accelerated filing deadlines could result in disclosures that are in fact less accurate, complete and meaningful (Ibid).

5.2.1.8 While the Panel notes that the advantages in reducing the reporting deadline include:

- more timely and relevant data;
- more rapid dissemination of information; and
- an increase in the relevance of disclosures to investors' decisions, which may lead to the greater use and scrutiny of companies' disclosures by investors, it is concerned with the impact that the disadvantages of reducing the reporting deadline may have on reporting entities, which include:
- companies, including those with widely dispersed and international operations, may find it difficult to meet shorter filing deadlines;
- significant cost increases;
- enhanced disclosure requirements call for a longer reporting duration;
- less time for audit committees, auditors and clients to review the financial information; and
- shorter filing deadlines could result in disclosures that are less accurate, complete and meaningful .

5.2.1.9 The Companies Act, Section 302(1), requires that the annual financial report must be presented to members 21 days before the AGM which has to take place within 9 months of the financial year-end. Public companies are however required to publish and mail provisional *non-audited* financial statements within 3 months of their year-end, if they have not yet produced their audited financial statements. Provisional financial statements do not have to be audited and are in summary form.

5.2.1.10 The JSE Securities Exchange SA Listing Requirements, Section 3.23(1), requires listed companies to produce the annual financial report 6 months after year end, failing which the shares will be suspended at the end of the seventh month. The JSE Listing Requirements, however, require provisional reviewed (not audited) financial statements if annual financial reports are not produced within 3 months.

5.2.2 Interim reporting

5.2.2.1 Interim financial reports are defined as a financial report containing either a complete set of financial statements or a condensed set of financial statements for a reporting period shorter than a whole financial year (AC 127 : Interim Financial Reporting).

5.2.2.2 Currently, GAAP Statement AC 127 and the Companies Act regulate the reporting requirements of interim financial statements.

5.2.2.3 The Companies Act requires every public company to prepare an interim report, which has to be sent to every member and debenture-holder, which fairly presents the business and operations of the company (Section 303).

5.2.2.4 As far as the minimum content of interim reports are concerned, South Africa's AC127, being based on IFRS, will in future be effectively harmonised with those of the European Union, Australia and New Zealand. Canada's interim reporting standard has also been substantially harmonised with IFRS.

5.2.2.5 The main issue in interim reporting relates to increasing the frequency of reporting, if made mandatory for all public interest entities, and therefore the timeliness of information. Quarterly reporting would result in more timely, and therefore, relevant information (School of Accountancy, Wits University, 2003).

5.2.2.6 Quarterly reporting is, however, accompanied by certain disadvantages, such as

- Seasonality severely affects quarterly reports, therefore impairing usefulness;
- The costs of having to provide additional quarterly information and having it audited are onerous;
- Quarterly reporting would mean that South Africa would be at odds with predominant international practice, which requires semi-annual reporting; and
- Quarterly reporting causes managers to focus on short-term results and therefore neglects those activities whose worth would be greater over a longer time (School of Accountancy, Wits University, 2003).

5.2.3 Requirements for review of interim financial information

5.2.3.1 Section 3.23(b) of the JSE Listing Requirements requires unaudited interim reports to be reviewed if the auditor's opinion on the company's latest annual financial statements is modified. There are no further requirements currently for a review or an audit in South Africa.

5.2.3.2 It is noted that a review is very different in nature to an audit. The level of assurance expressed by an auditor in a review engagement is significantly lower than an audit. SAAS 910: Engagements to review Financial Statements states that review engagements provide only "negative assurance". "Negative assurance" indicates that nothing has come to an auditor's attention that causes him or her to believe that the financial statements are not fairly presented. Australian company law requires either

an audit or review. In the United States of America, the SEC requires a review of all quarterly reports. The requirement to review interim results is currently being considered in Britain.

5.2.3.3 Mandatory review of interim financial information has been criticised on the following grounds (School of Accountancy, Wits University, 2003):

- Review creates an expectation gap. Users of financial information may not know the difference between an audit and review and may therefore place too much reliance on the review. The additional costs required for a review may be a great burden on the company.

5.2.4 Immediate disclosure of material events

5.2.4.1 IOSCO (2002 (a), p4) contends that information about material events should be disclosed on an immediate basis.

5.2.4.2 In the USA, under the *prescription approach*, all public companies are required to file current immediate reports (on a document known as a Form 8-K) in the intervening period between periodic reports to disclose a specific list of events that are presumptively material. Japan has followed a similar approach.

5.2.4.3 In the European Union and in other jurisdictions, regulators require listed entities to disclose information, under the *general obligation approach*, comprising price sensitive information. The *general obligation approach* does not explicitly list every item that requires disclosure. Such information, if deemed material, would have to be disclosed immediately. Under this general obligation, delays may be allowed under certain circumstances.

5.2.4.4 In South Africa, immediate disclosure of material or price sensitive information for listed companies is required for example with the use of the Stock Exchange News Service ("SENS").

5.2.5 Online Reporting

5.2.5.1 There has been recent discussion on on-line and real-time reporting of financial statements, particularly in relation to companies listed on the JSE Securities Exchange South Africa. While the technology exists to do this, there are however, concerns over the integrity and accuracy of information produced.

5.2.5.2 An auditor's opinion and indeed those of the entity's management can only be formed some time after certain transactions take place. This is particularly important when considering accounting estimates relating to the value of work in progress, the saleability of stock and the recoverability of debts. Current disclosure may result in some volatility in values disclosed for all of these items which may not be in the interest of markets (ACCA, 2003, p41).The Panel submits that the feasibility of issuing real time reporting is considered low in South Africa. This is because of difficulties that would be faced in preparing such reports, particularly for subjective areas that are only determined periodically, as well as the issues such as expressing assurance on such numbers.

5.2.6 Providing additional non-financial disclosure in the annual financial statements

5.2.6.1 In terms of "current disclosures" of other information that might be useful to diverse stakeholders (such as employment equity, sustainability reporting etc.), KPMG (2003, pp37-38) submit that it is important for South African companies to share the information as required in King Report on Corporate Governance and by others.

5.2.6.2 The Panel, although recognising the importance of non-financial disclosure as a new and growing discipline of particular relevance to South Africa as a developing economy, does not consider it to be part of the scope of "current disclosures" and thus beyond the scope of Term of Reference 7.

6. Deliberations

6.1 South African legislation and the JSE listing requirements relating to the time in which audited financial reports are released are not within world norms. The Panel recommends that the South African reporting deadline should be amended to a limit no later than 4 months from the financial year-end.

6.2 The Panel does not support mandatory quarterly reporting for all public interest entities at this juncture. Where there are dual-listed companies, with their primary or secondary listing on the JSE, they may continue to do so, as required in terms of their international listing obligations.

6.3 The Panel does not support mandatory auditing of interim reports at present.

6.4 The Panel submits that the legislation be amended to require all public interest entities to disclose all material information, which is in the public or shareholders' interest, immediately.

6.5 The Panel does not support obligatory online reporting at this stage.

TERM OF REFERENCE 8

The feasibility and appropriateness of incorporating the regulation of internal audit, and audit committees and their relationship to external auditors in the legislative framework.

1. Background

1.1 This term of reference considers whether the law should require public interest enterprises to establish audit committees and internal audit arrangements and, if so, whether the law should regulate the relationships between the audit committee and internal audit function and the external auditor. These matters are addressed through the examination of three component parts:

a) Internal Audit;

b) Audit Committees; and

c) External auditors.

1.2 The issues involved are of a corporate governance nature and have been considered in most recent reviews of corporate governance practices, both locally and globally.

1.3 Internal audit is the process whereby an entity sets about ensuring that the risks to the achievement of its objectives are minimised or, at least, adequately managed. The process involves the adoption by an entity of a systematic and disciplined approach to the planning and evaluation of its risk management, control and governance processes (Institute of Internal Auditors, 2003).

1.4 The primary purpose of the audit committee is to carry out, on behalf of the board and ultimately shareholders, an objective and independent assessment of the company's accounting and control processes as managed by the executive directors. The committee will also aim to act as the primary channel of communication between the company's board and the external auditor.

1.5 The external auditors have a statutory responsibility to audit the financial statements of the enterprise. Specifically they are required to:

- audit the financial statements in accordance with the relevant legal and regulatory requirements and Generally Accepted Auditing Standards;
- review, in the case of a listed company, whether the corporate governance disclosure contained in the annual report reflects the entity's compliance with the provisions of the King Report on Corporate Governance (as well as any other supplementary, specific legislative requirements, such as the Banks Act, Long Term Insurance Act, etc); and
- read the other information contained in the annual report and consider whether it is consistent with the information contained in the annual financial statements (The Auditing Practices Board, 2002, p10).

(a) Internal Audit

1.6 The King Report requires entities covered by the Code to establish an effective internal audit function. The Public Finance and Management Act of 1999 also imposes specific responsibilities on public sector entities to put in place adequate internal audit arrangements.

1.7 While the audit of the entity's annual financial statements is a statutory requirement and is conducted by the external auditor, the way in which internal audit is carried out, if it is carried out at all, is currently a matter for the directors or controllers of an entity to decide. Internal audit may be (and most often is) conducted in-house by executive management with specialist internal audit skills. In some cases, an entity may decide that it is more efficient for its internal audit service to be outsourced. In other cases, the nature of an entity's operations might make it inappropriate for it to have an internal function at all.

1.8 Where the directors of an entity do not operate a formal internal audit process, it is still important that they apply other monitoring processes in order to assure themselves that their system of internal controls is functioning effectively. In such cases, the board will need to assess whether these processes provide sufficient and objective assurance. A third party may be contracted to perform some or all of the work concerned, although it will be noted that, under the Sarbanes-Oxley Act of 2002 in the United States of America, it is unlawful for a registered public accounting firm to perform both internal and external audit services for the same client

1.9 Where an entity does have a formal process of internal audit, the official in charge of the process should have a direct line of communication and reporting responsibility to the audit committee, again where one exists, and should report to it on any significant matter that should be brought to the committee's attention.

(b) Audit Committee

1.10 The formation of audit committees

1.10.1 The audit committee is a committee of the board which is assigned particular responsibilities, including safeguarding the integrity of the entity's accounting and audit processes. Where audit committees are regulated by law or best practice guidance, they are often given specific powers to, *inter alia*, nominate external auditors, to approve or recommend approval of auditors' fees and to meet with the external auditor independently of the main board and entity management.

1.11 The structure and composition of audit committees

1.11.1 Audit committees need to have a specific charter (terms of reference or mandate) and, in keeping with their function to safeguard the integrity of the audit process, should comprise members who are non-executive directors; it is often argued that the majority of the members of an audit committee should have sufficient financial literacy (King Report, 2002). Members should also preferably be independent. While most audit committees have played an effective role in advancing corporate governance in SA companies, there have been some examples where they have been singularly ineffective. Much depends on the calibre of the audit committee members, specifically the effectiveness of the audit committee chairman, and the ability of the audit committee to interact with the rest of the board of directors. To be really effective, the role of the audit committee must be clearly understood, it must have sufficient qualified members to ensure that the committee is able to make

rigorous appraisal of procedures and it must have a comprehensive understanding of the effect that the application of particular accounting principles have or may have on the financial affairs of the company (KPMG, 2003, p41).

1.12 Legal requirement for audit committees

The question of whether audit committees should be required by statute has received considerable recent attention, in the light of significant corporate failures. In Annex 3 to this report, we provide a review of the jurisdictions in which audit committees are required by legislation. The arguments in relation to legislation are set out below:

1.12.1 Arguments against legislation

1.12.1.1 The legal responsibility for the management of the entity rests solely with its directors. Any statutory responsibilities assigned to audit committees must not weaken the authority and effectiveness of an entity's board.

1.12.1.2 The Smith Report in the United Kingdom (2003) acknowledges that some of its recommendations for audit committees might be inappropriate for certain listed companies; thus, legislation on certain ideal situations could be undermined by practical constraints.

1.12.1.3 The Smith Report argues further that, with regard to the relationships between the audit committee and the board, the executive and non-executive directors respectively, the important feature of these relationships is a frank and open dialogue requiring attributes that cannot be legislated for.

1.12.1.4 Certain of the "Big 4" accounting firms do not advocate that audit committees have their relationship with external auditors regulated by legislation (Deloitte & Touche, 2003, p7). The South African Reserve Bank also considers that it is unnecessary to be prescriptive on the relationship between the audit committee and the external auditor.

1.12.2 Arguments for legislation

1.12.2.1 A requirement for listed companies to have an appropriately constituted audit committee would be a most effective way of enhancing the independence of auditors of such companies (Ramsay Report, 2001, p70).

1.12.2.2 A thread running through many of the commentaries post-Enron is that it is now necessary to strengthen the membership and role of audit committees (The Co-coordinating Group on Audit and Accounting Issues, Interim Report dated July 2002 to the UK Secretary of State for Trade and Industry).

(c) Audit committees in relation to external auditors

1.13 Company law prescribes that the appointment of external auditors is the responsibility of the shareholders. In practice, the shareholders of a listed company do little more than "rubber stamp" a recommendation which has been made by the company's executive management and board of directors.

1.14 Developing international practice suggests that the responsibility for the appointment and remuneration of independent external auditors should lie with the audit committee. A properly constituted audit committee will have the capacity to play a significant role in bolstering shareholders' confidence in the independence of its auditors. Auditors should be expected to engage in constructive dialogue with the audit committee over matters of uncertainty.

1.15 It is widely accepted that the audit committee should make recommendations to the board in relation to the appointment of the external auditor. The audit committee should also evaluate the effectiveness of the external auditors on an annual basis and perform the following functions:

1.15.1 Monitor the external auditor's performance, independence and objectivity in the conduct of its duties;

1.15.2 Develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm (KPMG, 2003, p16);

1.15.3 Publish an annual report on its findings and recommendations, specifically stating why it has not changed external auditors, and in the case of where external auditors have resigned during the year, outlining reasons for the resignation insofar as this is legally permissible.

1.16 The audit committee should require reports from the auditors on the critical accounting policies and practices of the company; alternative accounting treatments which have been discussed with management; and written communications such as management letters and unadjusted differences (USA Public Accounting Oversight Board, 2003). The audit committee should review whether the auditor has met the agreed audit plan and understand the reasons for any changes, including changes in perceived audit risks and the work undertaken by the external auditors to address those risks (The Smith Report, 2003).

2. Global Trends

2.1 There is a global move to enhance the role and independence of audit committees, whether by legislation or by codes of conduct.

(a) United States of America

2.2 The United States of America, through the Sarbanes-Oxley Corporate Fraud and Accountability Act of 2002 (SOA or Act), has mandated a number of requirements for U.S. publicly held corporations in relation to membership of audit committees, the roles of the internal audit function and the independent auditors (the details are provided in Annexes 4 and 5 to this Report in Section C).

2.3 Section 301 of the SOA directs the SEC to adopt rules that direct the national securities exchanges (which includes the NYSE and Nasdaq) to bring into effect certain listing

standards (similar, in part, to recent proposals by such exchanges) that impose the following requirements on audit committees' functions and role:

2.3.1 Independence

The audit committee must be composed entirely of independent directors. To be "independent" under the Act, the audit committee member may not accept any consulting, advisory or other compensatory fee from the company, except in his or her capacity as a board or board member, and may not be an "affiliated person" of the company.

2.3.2 Audit committee oversight of outside auditing firm

The audit committee must be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the company (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work and the accounting firm must report directly to the audit committee.

2.3.3 Authority to engage advisors

The audit committee must have the authority, and any funding it finds appropriate, to engage the independent counsel and other advisers as it determines necessary to carry out its duties.

2.3.4 Employee complaint procedures

Audit committees must establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, and for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.

2.4 Section 407 of the SOA directs the SEC to issue rules requiring disclosure in companies' periodic reports whether or not (and if not, why not) at least one member of the audit committee is a "financial expert" as the SEC defines such term.

2.5 The SOA directs the SEC to adopt rules to carry out the following regarding auditor independence. The SOA also prohibits the provision of non-audit services and requires the pre-approval of all permitted services (Sections 201 and 202 of SOA).

2.5.1 The SOA prohibits registered public accounting firms from providing to any issuer, "contemporaneously with the audit", any professional services (including internal audit) other than those provided in connection with an audit or review of the financial statements of the company.

2.5.2 Audit services and permitted non-audit services, including tax services, must be pre-approved by the audit committee. The Act provides a narrow waiver of the pre-approval requirement for permitted non-audit services in some circumstances.

2.5.3 Audit committee approval of any non-audit services must be disclosed in the company's periodic reports.

2.5.4 Audit committees may delegate to one or more independent committee members authority to grant pre-approvals of both audit and non-audit services, so long as the delegatee presents his or her decisions at each scheduled committee meeting.

2.5.5 Audit committees will need to carefully determine the nature and scope of any non-audit service that is approved.

2.6 Section 204 of the Act requires registered public accounting firms to make timely reports to the audit committee of:

- all critical accounting policies and practices to be used;
- all alternative treatments of financial information within GAAP that have been discussed with management, ramifications of the use of such alternatives, and the treatment preferred by the accounting firm; and
- other material written communications between the accounting firm and management, such as any management letter or schedule of unadjusted differences.

(b) United Kingdom

2.7 Arising from the extensive review that has been conducted in the United Kingdom, a revised version of The Combined Code on Corporate Governance was released in July 2003. The Code provides comprehensive guidance to the audit committee and the auditors, its overriding principle being:

> The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors (Combined Code, 2003, p16).

2.8 In Annex 6 of Section C of this report, a high level summary of the UK's Combined Code is set out, dealing primarily with the membership and appointment as well as the role and purpose of the audit committee.

2.9 Under the Code, the company's internal audit activities should be monitored and reviewed for effectiveness by the audit committee. Similar to the position in South Africa (and the recommendations of the King Report), the audit committee should consider annually whether there is a need for an internal audit function where one currently does not exist and make a recommendation to the board. The reasons for the absence of such a function should be stated in the company's annual report.

2.10 In a far-reaching move, the U.K. has decided that "…the audit committee should have primary responsibility for making a recommendation on the appointment, re-appointment and removal of the external auditors…" (Combined Code, 2003, p17). In a somewhat unusual provision, the Code states that "[i]f the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position" (Ibid).

2.11 The need to safeguard auditor objectivity and independence is also addressed in the Code. The company's annual report should explain how this is maintained when the auditor provides non-audit services.

(c) Elsewhere in the world

2.12 The practice and extent of progress elsewhere in the world has varied. The Panel's research has not revealed any country calling for the statutory regulation of internal auditing.

2.13 Research undertaken to establish in which countries audit committees were established voluntarily, legislated or required in terms of regulated corporate governance appear in Annex 3 of Section C of this report. The Panel also examined those countries in which the relationship between the external auditors and the audit committee are regulated by legislation (details appear in Annex 4).

3. South Africa

3.1 The Draft Accountancy Profession Bill, 2001 does not address the issues considered in this section. Audit committees are not presently required to be established by the Companies Act. Under the revised JSE Securities Exchange SA listing requirements, all listed companies are obliged to have audit committees. Legislation, including the Public Finance Management Act, the Banks Act, Long Term Insurance Act, and the Short Term Insurance Act stipulate the requirement for the appointment of audit committees and external auditors, as well as for the establishment of an internal function (these matters are summarized in Annexes 7, 8 and 9 in Section C of this report).

3.2 In spite of the general move to enforcing audit committees for entities that are governed in terms of the regulations set out in 3.1 above, there remain categories of public interest entities that are not obliged to appoint audit committees. We set out in Annex 10 the King Committee recommendations on the audit committee, addressing the issues of the members of the audit committee and the role and function of the audit committee. The internal audit function forms part of the risk management system of the company.

3.3 The King Committee has examined and debated the need for audit committees. It concluded that the audit committee gives the board a means to monitor the effectiveness of its internal control system as well as reinforcing its internal audit function (2002, p137).

3.4 There is a widely held view that a well-structured audit committee that is functioning effectively can significantly enhance the independence of the external auditor (Van Esch & Kelly, 2002; and Ramsay Report, 2001).

4. Deliberations

4.1 The regulation of internal auditing, audit committees and their relationships to external auditors are matters that fall within the ambit of corporate governance.

4.2 The Panel believes that proper internal controls and risk management processes are essential for sound corporate governance within an entity, and the relationship among internal audit, external auditors and the audit committee needs to be managed in a dynamic manner.

4.3 The Panel supports the global approach taken to the composition and duties of the audit committee as reflected in the Annexes.

4.4 South African Auditing Standard SAAS 610: Considering the Work of Internal Audit, establishes standards and provides guidance to external auditors in considering the work of internal audit. The Panel supports the thrust of SAAS 610 which states that:

- The external auditor should consider the activities of internal audit and their effect, if any, on external audit procedures.
- The external auditor should obtain a sufficient understanding of internal audit activities to assist in planning the audit and developing an effective audit approach.

- During the course of planning the audit, the external auditor should perform a preliminary assessment of the internal audit function when it appears that internal audit is relevant to the external audit of the financial statements in specific audit areas.

- When the external auditor intends to use the specific work of internal audit, the external auditor should evaluate and test that work to confirm its adequacy for the auditor's purposes.

4.5 The internal audit profession has been subject to regulation for a number of years; it is regulated through International Standards and a Code of Ethics and competence is assured through a South African Qualifications Authority registered qualifications framework, other continued professional development initiatives, and the requirements for regular external quality assurance reviews (Institute of Internal Auditors, 2003, p1).

4.6 The Panel does not believe that it is either feasible or appropriate for a management activity such as internal auditing to be regulated by legislation. The scope and performance of the internal audit function should be reviewed and monitored by the audit committee.

4.7 The Panel supports the approach initially promoted by the King Report on Corporate Governance (1994) and subsequently legislated in the PFMA, Banks Act, Long Term and Short Term Insurance Acts, Medical Schemes Act, etc., for the law to require the establishment of statutory audit committees and to impose rules governing the composition of their membership. It notes that the revised listing requirements of the JSE Securities Exchange SA advance and give force to the recommendations of the revised King Report on Corporate Governance (2002).

4.8 The existence of an internal audit function or even of an audit committee is not necessarily appropriate for every entity. The Panel believes that audit committees are appropriate and necessary for public interest enterprises only. As far as SMEs and unlisted companies are concerned, it should be left to the directors to decide how to implement satisfactory controls and to safeguard the integrity of the audit process.

4.9 The role of the audit committee needs to be reviewed regularly by the board of directors, in order to strengthen the objectivity and independence of the external auditors. It needs to keep abreast of developments in other countries and adopt their best practice, as reflected in Annex 11 (which provides a summary of audit committee practices in different countries).

4.10 The corporate governance statement which must be included in the annual report should disclose, in detail, how the entity has addressed the issues of internal auditing, audit committees and their relationship with the external auditor.

TERM OF REFERENCE 9

The inter-relationships between the Accounting Professions Bill, the Financial Reporting Bill and the Companies Act, 1973.

1. Background

1.1 The quality of corporate financial reporting and independent audit has been seriously questioned in South Africa in the past few years, heightened by certain local corporate failures. A number of Commissions of Enquiry have been established to examine the reasons for the failures. Some have reported, such as the Regal Bank Commission, while others are continuing with their efforts. The Nel Commission into the affairs of Masterbond Group, a broad and expansive investigation, pointed to various weaknesses and concerns relating to the efficiency, objectivity and independence of auditors.

1.2 In examining the various issues that the Panel has been tasked to review, it has become apparent that the Companies Act, in particular, is in need of extensive revision. In order to ensure that holistic improvements to corporate governance flow from the implementation of a re-drafted Accounting Professions' Bill and the Financial Reporting Bill, the Minister of Finance anticipated that amendments to the Companies Act might be necessary. In addition, these three pieces of legislation need to be reviewed in the context of the Panel's overall recommendations to ensure consistency in terms of where certain groups of recommendations should be best housed. A summary of the Panel's recommendations in terms of legislative changes across all term of reference is provided in Annex 12, Section C of this report, for ease of reference.

1.3 The Draft Accountancy Profession Bill has been extensively debated over the past number of years, and the proposals that it has advanced has been subject to a detailed review in Section C : Term of Reference 1 of this publication. It addresses the issue of protecting public interest and takes into account global developments since the Enron debacle on accounting standards: it focuses on the monitoring and the enforcement thereof.

1.4 The World Bank, in their draft Report on the Observance of Standards and Codes (ROSC) (2002), stated:

> Immediate steps are needed for enactment of the Financial Reporting Bill, amendments to the Companies Act, and the Accountancy Profession Bill; and to ensure proper enforcement of established statutory requirements and standards.

It is not the Panel's intention to provide definitive answers to what are essentially legal drafting issues and questions. However, the Panel was of the opinion that some guidance was appropriate. The general approach is important to highlight because the legislative framework with regard to corporate governance has a direct impact on the integrity of South Africa's financial markets.

1.5 Although the issue of an appropriate legislative accounting and financial reporting framework has been under debate and discussion since the 1990's in South Africa, limited progress has been made, interrupted by the democratisation of the country and the two elections held in the 1990s. There is ongoing criticism, from both local and international commentators, that South Africa has "… a weak enabling environment for high-quality financial reporting" (World Bank, 2002, p1). There has been wide discussion and extensive consultation in formulating the current versions of the DAPB, the Financial Reporting Bill, as well as extensive proposed amendments to the

Companies Act to give effect to new and emerging developments in corporate governance, audit, financial reporting and accounting standard setting.

1.6 We have examined the DAPB in Section C : Term of Reference 1, and highlighted its limitations in its current form.

1.7 The Financial Reporting Bill focuses on monitoring and enforcement of accounting standards. In its current form, it provides for the

1.7.1 setting of financial reporting standards for the preparation and presentation of financial statements by designated entities;

1.7.2 the setting of general purpose financial reporting standards based on International Financial Reporting Standards;

1.7.3 the setting of limited purpose financial reporting standards;

1.7.4 the establishment and functions of the Financial Reporting Standards Council, the main function of which will be the developing and setting of financial reporting standards; and

1.7.5 supervision and enforcement by the Financial Services Board of compliance by designated entities with the financial reporting standards (Memorandum, 2002).

1.7.6 The introduction of administrative sanctions in the form of an independent tribunal administered by the FSB ("The Enforcement Committee")

1.8 The changes necessary to the Companies Act, 1973, as amended, to adapt to the provisions of the Financial Reporting Bill have been proposed in the draft Companies Amendment Bill of 2002. The Financial Reporting Bill does not provide for criminal sanctions for mis-reporting. When this Bill was drafted, the issue was considered and, as the intention is that it will be applied by various types of entities, not only companies, it was considered that criminal sanctions for incorrect reporting should be contained in the Companies Act, Pensions Fund Act, etc., as differing penalties may be appropriate.

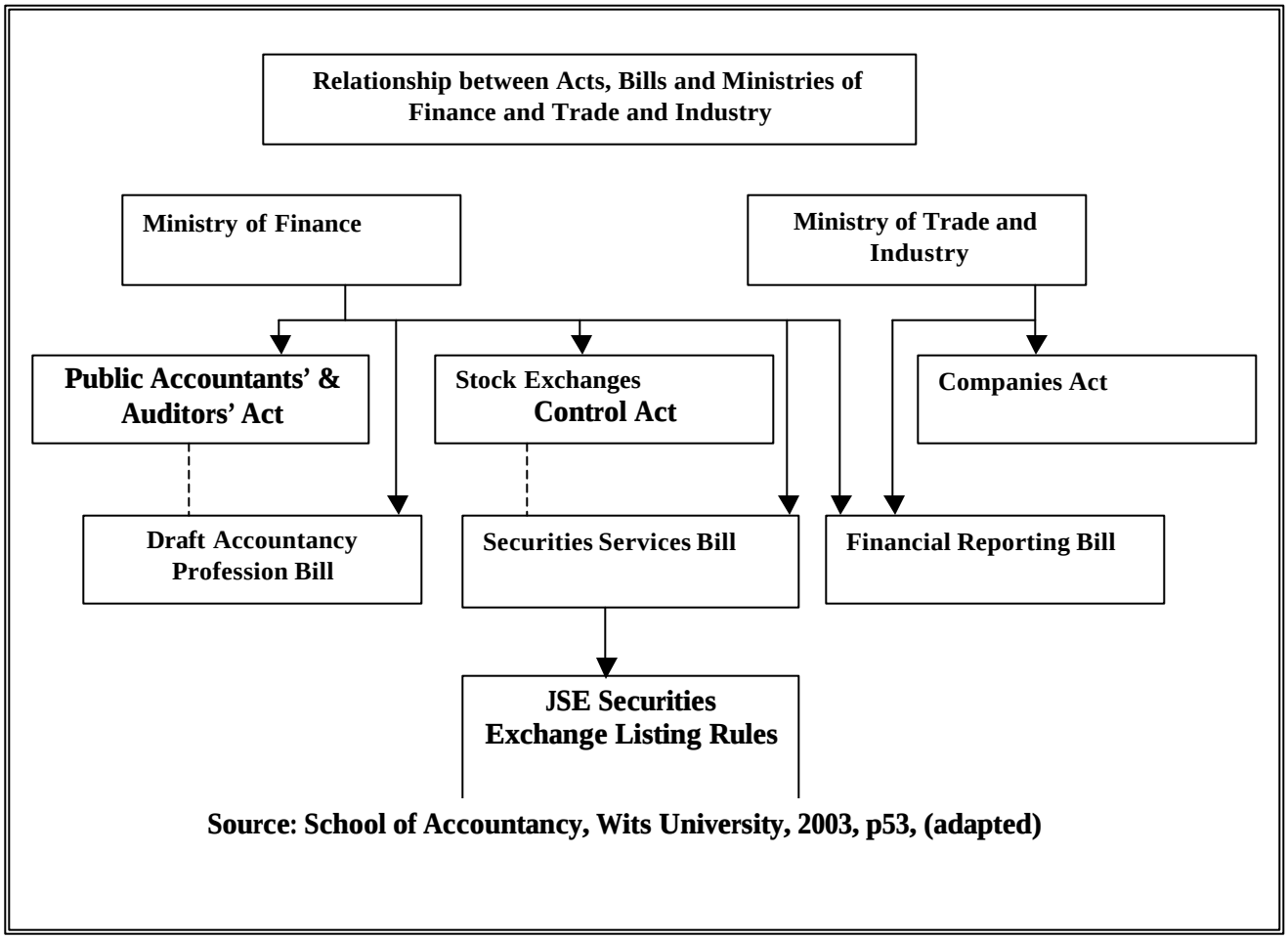
2. Global Trends

We have, in various parts of Section C of this report, detailed the approaches taken in various countries that have addressed the need for ensuring high-quality financial reporting, the legal backing of accounting standards and the quality of corporate audit. Each of the countries we have examined have their own regulatory structures and statutory and oversight bodies to address their own unique regulatory, legislative and professional arrangements. In proposing a structure for South Africa, we have attempted to recommend the "best-of-breeds" approach.

3. South Africa

3.1 In examining the structure of the inter-relationship between the Draft Accountancy Profession Bill, the Financial Reporting Bill and the Companies Act, 1973, one observes the regulation overlap between the current Ministry of Finance and of Trade and Industry. This is depicted in Figure 5 below.

Figure 5 : Relationship between the various Acts, Bills and Ministries of Finance and of Trade and Industry



3.2 The Minister of Finance, as the responsible Minister for the Financial Services Board, oversees investor protection aspects of securities exchanges and listed companies while the "Minister of Trade and Industry has the task of ensuring the corporate and other entity structures and governance" (School of Accountancy, Wits University, 2003, p53).

3.3 The Panel believes that currently a disjuncture exists between the jurisdictions of the Minister of Finance and the Minister of Trade and Industry that impacts negatively on the effectiveness of the legislative framework to ensure adequate adherence to accepted principles and practices of good corporate governance.

3.4 A new and improved accounting standard-setting arrangement will be introduced when the Financial Reporting Bill and the Amendments to the Companies Act are passed. The Financial Reporting Standards Council will be recognised through the Amendment to the Companies Act as the authorised body to set and monitor compliance with accounting standards for all companies registered under the Companies Act. Three new committees will be constituted in terms of the new Financial Reporting Act to fulfil the responsibilities of the Financial Reporting Standards Council:

- Financial Reporting Standards Development Committee, which will be responsible for the development of accounting standards for *general purpose financial statements;*

- Small Enterprises Financial Reporting Committee, which will assume responsibility for identifying and developing another comprehensive basis of accounting for private companies for *limited purpose financial statements;* and

- Committees that would be responsible for monitoring compliance with established accounting standards and for taking appropriate enforcement actions against violators on the basis of recommendations from the *Compliance Committee* (World Bank, 2003, p9).

3.5 Statement of South African Auditing Standards SAAS 1005: The Special Considerations in the audit of small entities states that "… its purpose is to assist auditors, and the development of good practice, by providing additional guidance on the application of the basic principles of essential procedures contained in the statements of SAAS in the audit of small entities".

The inter-relationship between the Accountancy Profession Bill, the Financial Reporting Bill and the Companies Act, 1973 cannot be considered without also considering their inter-relationship with the Public Accountants' and Auditors' Act, the Securities Services Bill and JSE Securities Exchange Listing requirements.

3.6 In view of the extent of the proposed Companies Act amendments, consideration should be given to the promulgation of a separate act as an interim arrangement dealing with these issues. Such an Act should fall within the jurisdiction of the Minister of Finance. Appropriate criminal sanctions should be included for mis-reporting. In due course, when the Companies Act is revised, the two acts can be consolidated.

4. Deliberations

4.1 To be globally competitive, the legal backing of accounting standards should no longer be in doubt, with amendments being made to the Companies Act and the enactment of the Financial Reporting Bill.

4.2 This report proposes extensive amendments to the Companies Act, 1973 (refer Annex 12). The Department of Trade and Industry are in the process of undertaking a review of current corporate law and have indicated that this will take up to five years to complete. Whilst a number of proposed amendments, such as the requirement to report in terms of international accounting standards and the introduction and structure of audit committees, have been prescribed in the JSE Listings Rules, this will only apply to listed companies and not other "public interest enterprises". Furthermore, sanctions that can be applied in terms of the JSE rules are limited to administrative fines or, in serious cases, delisting.

4.3 The Panel supports the views of the World Bank (2002, p14) which holds that high quality financial reporting depends on a combination of appropriate accounting and auditing standards and the proper enforcement thereof. A successful enforcement regime is dependent on three important links:

(a) the preparers of financial statements need to comply with established standards;

(b) the auditors need to be seen to be acting independently to assure financial statements are prepared in compliance with established standards and they fairly present the enterprises' financial conditions; and

(c) all regulators (self-regulatory organisations and statutory regulatory bodies), need to establish proper arrangements for efficient monitoring of compliance/non-compliance, and be seen to be taking effective actions against all those responsible for violating standards, rules and regulations.

SECTION C

ANNEXES

ANNEX 1 : THE PROHIBITED NON-AUDIT SERVICES UNDER THE SEC'S NEW RULES

THE PROHIBITED NON-AUDIT SERVICES UNDER THE SEC'S NEW RULES		
1.	**Bookkeeping**	The rule prohibits maintaining or preparing the audit client's accounting records, and preparing the client's financial statements or the source data underlying the financial statements. Although not a significant change from the 2000 rules, the new rule does eliminate exceptions for foreign bookkeeping and temporary and emergency situations.
2.	**Financial Information Systems Design and Implementation**	The rule prohibits operating or supervising the operation of an audit client's information system or managing the audit client's local area network. It also prohibits designing or implementing a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the audit client's financial statements or other financial information systems taken as a whole. The SEC's rule release clarifies that the rule is not intended to preclude the accountant from making recommendations on internal control matters to management or other service providers in conjunction with the design and installation of a system by another service provider.
3.	**Appraisal or Valuation, Fairness Opinion, or Contribution-in-kind Reports**	The rule generally prohibits these services; although the SEC continues to permit valuations for non-financial reporting purposes, including transfer-pricing studies, cost segregation studies, and other tax-only valuations. The SEC's rule release notes that some commentators believed that a strict application of these rules related to contribution-in-kind reports might create conflicts in certain foreign jurisdictions where such reports must be prepared by the company's auditors. The SEC indicates that it is sensitive to these issues and that it will work with other regulatory agencies to resolve them. As under the 2000 rules, it is accepted that there is not an independence concern where a contribution-in-kind report is issued as a result of an internal reorganisation (typically as a result of a reorganisation to achieve tax efficiencies) involving transfers solely among wholly owned subsidiaries (i.e. where there is no effect on an outside minority interest or where there is no outside interest).
4.	**Actuarial Services**	The rule prohibits services involving the determination of amounts recorded in the financial statements and related accounts. The rule eliminates the provision in the 2000 rules that allowed accountants to perform actuarial valuations for pension, other post-employment benefits, or similar liabilities. The rule permits assisting a client in understanding the methods, models, assumptions, and inputs used in computing an amount. Also, although not explicitly stated, consistent with the rule on appraisal or valuation services, actuarial services for non-financial reporting purposes, including actuarial work solely for tax purposes, are not prohibited by the rule.

ANNEX 1 : THE PROHIBITED NON-AUDIT SERVICES UNDER THE SEC'S NEW RULES (continued)

5.	**Internal Audit Outsourcing**	The rule prohibits any internal audit service that has been outsourced by an audit client that relates to the audit client's internal accounting controls, financial systems, or financial statements. The 2000 rules allowed such services for up to 40% of the total internal audit activities (measured in hours). The rule does allow operational auditing and non-recurring evaluations of discrete items or other programs, provided they are not in substance outsourcing.
6.	**Management Functions**	The rule prohibits acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client. This basic rule regarding management functions does not represent any significant change from the 2000 rules. The 2000 rules did explicitly permit services in connection with design and implementation of internal accounting controls and risk management controls. The current rule, however, clarifies that the auditor may not take responsibility for the design and/or implementation of internal accounting or risk management controls. The release indicates the "design and implementation of these controls involves decision-making and, therefore, is different from recommending improvements" in such controls. The rule release makes clear, however, that engagements to make recommendations regarding improvements in internal accounting and risk management controls are permissible.
7.	**Human Resources**	Although titled "Human Resources", the rule solely prohibits executive recruiting services and does not represent a significant change from the 2000 rules.
8.	**Broker-Dealer**	The rule prohibits: acting as a broker-dealer (registered or unregistered), promoter, or underwriter on behalf of an audit client; making investment decisions on behalf of the audit client or otherwise having discretionary authority over an audit client's investments; executing a transaction to buy or sell an audit client's investment; or having custody of assets of the audit client, such as taking temporary possession of securities purchased by the audit client. The release states that the only change from the 2000 rules is the explicit coverage of persons who perform broker-dealer services but have not complied with SEC broker-dealer registration requirements.
9.	**Legal Services**	The rule prohibits providing a service to an audit client that, under the circumstances in which the service is provided, could be provided only by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided. The release states that the SEC does not intend to prohibit tax services in countries where such services must be provided by lawyers, and will also allow exceptions for other legal services that would not be considered to be "legal services" in the US.
10.	**Expert Services**	The rule prohibits expert services such as providing expert testimony or opinions where the purpose of the engagement is to advocate the client's position in an adversarial proceeding or where the accountant is part of the "team" that "has been assembled to advance or defend the client's interests" in an adversarial proceeding. The rule release states that the auditor may be engaged by the audit committed or its legal counsel to perform internal investigations or other "fact finding engagements" and may provide factual testimony on "Positions taken or conclusions reached during the performance of any service". The release also makes clear that this prohibition on expert services does not restrict tax services.

Source : Ernst & Young (USA), 2003, pp2-3

ANNEX 2 : REVIEW OF INTERNATIONAL PRACTICE ON PARTNER AND FIRM ROTATION

1. United States of America

- Rotation of lead engagement partner and the review partner every 5 years, instead of mandatory firm rotation
- Section 207 of Sarbanes-Oxley Act of 2002 requires study of mandatory audit firm rotation of registered public accounting firms and submit the findings within one year

2. United Kingdom

- Rotate engagement partners for 5 years instead of firm rotation
- Rotate other key audit partners on subsidiaries etc. for 7 years

3. Australia

- Partner rotation in listed companies every 7 years and two years cooling off period for partner subsequently joining the audit client

4. EU and Canada

- Rotation of partner regularly (generally five years)

5. Italy

- Audit firm rotation every 9 years for 20 listed companies
- It had an impact on threat to audit quality and independence from competition point of view, and partner migration to new audit firm engaged to perform audit

6. Brazil

- Firm rotation every three years

7. India

- Compulsory audit partner rotation and 50% of the Audit team.

8. Spain

- Had firm rotation, but abandoned the practice in 1995

9. Greece

- Firm rotation every 3 years

ANNEX 3 : A COMPARATIVE COUNTRY ANALYSIS OF THE LEGISLATION ON AUDIT COMMITTEES

The table below summarises the countries in which audit committees have been legislated upon or regulated by codes of conduct.

	EU	USA	Ireland	France	Canada	Australia	Singapore	RSA	UK
Legislated Audit Committee		Sarbanes-Oxley Act of 2002 applicable to listed entities	Companies (Audit and Accountants) Amendment Bill 2002 - applicable to public limited companies, or groups headed by plcs, Unlisted or listed or large private companies		Required by the Canada Business Corporation Act - applicable to securities issued by public	Proposed legislation to apply to top 500 listed companies: CLERP 9		Public Finance Management Act, Short Term/ Long Term Insurance Acts, Banks Act Medical Schemes Act	CGAA recommended introducing a requirement for audit committees into company law
Regulated corporate governance		New York Stock Exchange	Irish Stock Exchange		Toronto Securities Exchange	Australian Stock Exchange	Singapore Exchange Securities	JSE and King II Report Recommendations	London Stock Exchange
Established voluntarily	High Level Group Of Co Law Experts recommend regulatory requirements in company law			Moving towards legislating on Corporate Governance principles					

Source : Additional research provided in response to further requests. Author: A Oosthuizen, 14th May 2003, Wits School of Accountancy

ANNEX 4 : SHOULD THE RELATIONSHIP BETWEEN THE EXTERNAL AUDITOR AND AUDIT COMMITTEE BE REGULATED BY LEGISLATION?

The table below examines countries where audit committees are legislated. It shows that where such legislation exists, the relationship between the external audit and audit committee is legislated.

Country	USA	Ireland	Canada
Legislation	Sarbanes-Oxley Act of 2002	Companies Audit and Accounting Amendment Bill 2002	Canada Business Corporations Act as amended (2001)
Areas where relationship between the external auditor and audit committee governed (extracted from Smith Report, United Kingdom)	• The audit committee of a listed company has the responsibility for the compensation, appointment, and oversight of any accounting firm employed to perform audit services. • Subject to de minimis limits, the audit committee must pre-approve non-audit services, • The accounting firm must report to the audit committee all "critical accounting policies and practices to be used…all alternative treatments of financial information within [GAAP] that have been discussed with management …ramifications of the use of such alternative disclosures and treatments, and the treatment preferred" by the firm.	• Have a majority of non-executive directors, who cannot be employees of the company or the Chairman of the Board. • Have written term of reference covering: monitoring the performance and quality of the work of the auditors, auditor appointment, the provision of non-audit services by the audit firm and ensuring there is a suitably resourced internal system.	• Relationship with and expectation of the external auditors, including the establishment of the independence of the external auditor. • External auditor is ultimately accountable to the board and audit committee as representatives of the shareholders.

Source: Additional research provided in response to further requests. Author: A Oosthuizen, 14th May 2003, Wits School of Accountancy

ANNEX 5 : UNITED STATES OF AMERICA :SUMMARY OF THE SARBANES -OXLEY CORPORATE FRAUD AND ACCOUNTABILITY ACT OF 2002 : AUDIT COMMITTEES

A. Introduction

The Sarbanes-Oxley Corporate Fraud and Accountability Act of 2002 (SOA) legislates on areas relating to audit committees and is applicable to publicly held companies from 26 January 2003.

B. Composition

- There must be an audit committee consisting solely of independent outside directors.

- Independence requires that those directors must not accept any consulting, advisory or other compensatory fee from the company, except for their board fee, subject to an exemption, if granted, by the SEC.

C. The role and function of the audit committee

- The audit committee is directly responsible for the appointment (subject to shareholder approval), compensation and oversight of the registered public accounting firm, including the resolution of disagreements between management and the auditor regarding financial reporting. The auditors are now required to report directly to the audit committee.

- Audit committees are now required to adopt written procedures to receive and address complaints regarding accounting, internal controls and auditing issues, including procedures to maintain the confidentiality of the whistle blower.

- The audit committee will also be empowered to employ independent legal counsel and other advisers. The company must appropriately fund these functions of the audit committee. This would result in the independent directors having assistance from a legal counsel who is truly independent of management. This independent counsel should disclose all actual or potential conflicts of interest and furnish an undertaking to the audit committee to provide it with any potential conflicts of interest as they arise. The use of truly independent counsel is also a factor looked upon favourably by the courts and may help to shield independent directors who are members of the audit committee as well as management.

- Therefore, members of the audit committee, with their own independent counsel, are in an even better position to ask the hard questions and obtain disinterested legal advice. If the audit committee does not include a financial expert, this fact must be disclosed.

D. Disclosure

- Companies that use any of the proposed exemptions, other than the multiple-listing exemption, have to disclose that fact and their assessment of whether and (if so) how it would materially adversely affect the audit committee's performance in relation to its obligations under the proposed rule. The disclosure would appear in proxy filings and, at least by reference, in annual report filings. All issuers, including non-listed issuers, would have to disclose in their proxy reports whether their audit committee members are independent. If the entire board is acting as an issuer's audit committee, the independence information would have to be disclosed for all members of the board. Listed companies would use the definition of independence from the applicable listing standards.

- Non-listed companies would make the disclosure by choosing a definition from any adopted by a national securities exchange or association and approved by the Commission and identifying which definition was used.

ANNEX 6 : UNITED KINGDOM: SUMMARY OF EXCERPTS FROM THE COMBINED CODE – IN THE SMITH REPORT : AUDIT COMMITTEES

A. Membership and appointment

- Audit committees should include at least three members, who should all be independent non-executive directors.
- The chairman of the company should not be an audit committee member.
- Appointments to the audit committee should be made by the board on the recommendation of the nomination committee (where there is one), in consultation with the audit committee chairman.
- Appointments should be for a period of up to three years, extendable by no more than two additional three-year periods, so long as members continue to be independent.
- No one other than the audit committee's chairman and members is entitled to be present at a meeting of the audit committee.
- The audit committee should be provided with sufficient resources to undertake its duties. At least one member of the audit committee should have significant, recent and relevant financial experience, for example as an auditor or a finance director of a listed company.
- The board should provide written term of reference for the audit committee.
- The audit committee should review the significant financial reporting issues and judgements made in connection with the preparation of the company's financial statements, interim reports, preliminary announcements and related formal statements. The audit committee should also review the clarity and completeness of disclosures in the financial statements.

B. The role and purpose of the audit committee

The audit committee is required:

- to monitor the integrity of the financial statements of the company;
- to review the company's internal financial control system and unless addressed by a separate risk committee or by the board itself, risk management systems;
- to monitor and review the effectiveness of the company's internal audit function;
- to make recommendations to the board in relation to the appointment of the external auditor and to approve the remuneration and terms of engagement of the external auditor following appointment by the shareholders in general meeting. This recommendation should be made to the board, and then to shareholders for their approval in general meeting;
- to develop and implement policy on the engagement of the external auditor to supply non-audit services. Where the audit committee's monitoring and review activities reveal cause for concern or scope for improvement, it should make recommendations to the board on action needed to address the issue or to make improvements;
- to review, with the external auditors, the findings of their work. The directors' report should contain a separate section that describes the role and responsibilities of the audit committee and the actions taken by the audit committee to discharge those responsibilities; and
- the chairman of the audit committee should be present at the AGM to answer questions, through the chairman of the board, on the report on the audit committee's activities and matters within the scope of audit committee's responsibilities.

ANNEX 7 : EXCERPTS OF CURRENT SOUTH AFRICAN LEGISLATION – SECTION 64

A. Section 64 of the Banks Act: Audit Committee

1) Subject to the provisions of subsections (3) and (4), the board of directors of a bank shall appoint at least three of its members to form an audit committee.

2) The functions of the audit committee shall be to-

a) assist the board of directors in its evaluation of the adequacy and efficiency of the internal control systems, accounting practices, information systems and auditing processes applied within that bank in the day-to-day management of its business;

b) facilitate and promote communication, regarding the matters referred to in paragraph (a) or any other related matter, between the board of directors and the executive officers of, the auditor appointed under section 61 or 62 for, and the employee charged with the internal auditing of the transactions of, the bank; and

c) introduce such measures as in the committee's opinion may serve to enhance the credibility and objectivity of financial statements and reports prepared with reference to the affairs of the bank.

*d) perform such further functions as may be prescribed.**

3) All of the members of the audit committee may be, and the majority of such members, including the chairman of the audit committee, shall be, persons who are not employees of the bank nor of any of its subsidiaries, its controlling company or any subsidiary of its controlling company: Provided that the chairman of the board of directors of the bank shall not be appointed as a member of the audit committee.

4) *All of the members of the audit committee may be, and the majority of such members, including the chairperson of the audit committee, shall be, persons who are not employees of the bank nor of any of its subsidiaries, its controlling company or any subsidiary of its controlling company: Provided that the chairperson of the board of directors of the bank shall not be appointed as a member of the audit committee.**

*Text in italics is proposed amendments contained in the Banks Amendment Bill, 2003, which have not yet been passed.

Source: Banks Act, No 94 of 1990, as amended.

ANNEX 8 : EXCERPTS OF CURRENT SOUTH AFRICAN LEGISLATION – SECTION 23

B. Section 23 of the Long term Insurance Act : Audit Committee

The board of directors of a long-term insurer shall appoint an audit committee of at least three members of whom at least two shall be members of that board.

The majority of the members, including the chairperson of the audit committee, shall be persons who are not employees of the long-term insurer.

The functions of an audit committee shall, inter alia, be-

1) to assist the board of directors in its evaluation of the adequacy and efficiency of the internal control systems, accounting practices, information systems and auditing and actuarial valuation processes applied by the long-term insurer in the day-to-day management of its business;

2) to facilitate and promote communication and liaison concerning the matters referred to in paragraph (a) or a related matter, between the board of directors and the managing executive, auditor, statutory actuary and internal audit staff of the long-term insurer;

3) to recommend the introduction of measures which the committee believes may enhance the credibility and objectivity of financial statements and reports concerning the business of the long-term insurer; and

4) to advise on a matter referred to the committee by the board of directors.

If the appointment of an audit committee is, in a particular case, inappropriate or impractical or would serve no useful purpose, the Registrar may, subject to such conditions as the Registrar may determine, exempt the long-term insurer concerned from the requirements of subsection (1).

Source: Long Term Insurance Act, No 52 of 1998, as amended.

ANNEX 9 : EXCERPTS OF CURRENT SOUTH AFRICAN LEGISLATION – SECTION 22

C. Short Term Insurance Act, 1998, Section 22 : Audit Committee

1) The board of directors of a short-term insurer shall appoint an audit committee of at least three members of whom at least two shall be members of that board.

2) The majority of the members, including the chairperson of the audit committee, shall be persons who are not employees of the short-term insurer.

3) The functions of an audit committee shall, inter alia, be-

   (a) to assist the board of directors in its evaluation of the adequacy and efficiency of the internal control systems, accounting practices, information systems and auditing processes applied by the short-term insurer in the day-to-day management of its business;

   (b) to facilitate and promote communication and liaison concerning the matters referred to in paragraph (b)or a related matter, between the board of directors and the managing executive, auditor and internal audit staff of the short-term insurer;

   (c) to recommend the introduction of measures which the committee believes may enhance the credibility and objectivity of financial statements and reports concerning the business of the short-term insurer; and

   (d) to advise on a matter referred to the committee by the board of directors.

4) If the appointment of an audit committee is, in a particular case, inappropriate or impractical or would serve no useful purpose, the Registrar may, subject to such conditions as the Registrar may determine, exempt the short-term insurer concerned from the requirements of subsection 1.

Source: Short Term Insurance Act No 53 of 1998, as amended.

ANNEX 10 : KING COMMITTEE RECOMMENDATIONS ON AUDIT COMMITTEE

A. Members of the Audit Committee

- The board should appoint an audit committee that has a majority of independent non-executive directors.
- The majority of the members of the audit committee should be financially literate.
- The chairperson should be an independent non-executive director and not the chairperson of the board.
- The chairperson should have the requisite business, financial and leadership skills and should be a good communicator.
- The size of the audit committee is not specified.

B. The Role and Function of the Audit Committee

- The appointment of the audit committee gives the board a means to monitor an effective internal control system. In addition, the audit committee reinforces both the internal control system and the internal audit function.
- The audit committee should have written term of reference dealing adequately with its membership, authority and duties.
- The term of reference of the audit committee should be confirmed by the board and reviewed every year. Companies should disclose in their annual report whether or not the audit committee has adopted formal term of reference and, if so, whether or not the committee has satisfied its responsibilities for the year, in compliance with its term of reference.
- The audit committee should–
  - Review the functioning of the internal control system;
  - Review the functioning of the internal audit department;
  - Review the risk areas of the company's operations to be covered in the scope of the external and internal audits;
  - Review the reliability and accuracy of the financial information provided to management and other users of financial information;
  - Review whether the company should continue to use the services of the current internal and external auditors;
  - Review any accounting or auditing concerns identified as a result of the internal or external audits;
  - Review the company's compliance with legal and regulatory provisions, its articles of association, code of conduct, by-laws and the rules established by the board;
  - Encourage communication between members of the board, senior executive management, the internal audit department and the external auditors;
  - Confirm the internal audit department's charter and internal audit plan;
  - Develop a direct, strong and candid relationship with the external auditors;

ANNEX 10 : KING COMMITTEE RECOMMENDATIONS ON AUDIT COMMITTEE (continued)

- Review the scope and results of the external audit, its cost effectiveness and the independence and objectivity of the external auditors (and in so doing should review the nature and extent of any non-audit services provided to the company by the external auditors);
- Place the minutes of its meetings before the board at the next board meeting;
- Consider the rotation policy of the external auditors and whether there is a need to change the audit partner or senior staff engaged in the audit;
- Draw up a recommendation to the board for the appointment and removal of the external auditors;
- Investigate any matters within its term of reference and safeguard all information supplied to it.

Source: The King Report on Corporate Governance for South Africa, (2002), Institute of Directors in Southern Africa, Johannesburg, March

ANNEX 11 : SUMMARY OF AUDIT COMMITTEE PRACTICES IN DIFFERENT COUNTRIES

	EU	USA	Ireland	France	Canada	Australia	Singapore	RSA	UK
Membership									
Independent board members/non-executives		·	·	· **2/3**	·	·	**majority**	**majority**	·
At least one financial expert/ financial literate person		·			·	·	·	·	·
Duties									
Selecting / terminating contract of the auditor	·	·	·	·		·			
Recommend the board on appointment/ removal of auditor								·	·
Monitoring independence of the auditor	·	·	·	·	·	·	·	·	·
Monitoring auditor effectiveness						·	·	·	·
Monitoring /approval of non-audit services	·	·				·	·	·	
Being given sufficient time to carry out duties				·					
Reviewing accounting policies	·	·							·
Monitoring internal audit	·	·	·	·	·	·		·	·
Reviewing risk management and internal controls	·	·		·	·	·	·	·	·

ANNEX 11 : SUMMARY OF AUDIT COMMITTEE PRACTICES IN DIFFERENT COUNTRIES (continued)

	EU	USA	Ireland	France	Canada	Australia	Singapore	RSA	UK
Having authority to engage independent advisors		·		·				·	
Assessing information	·							·	
Being provided with appropriate funding from company		·					·	·	·
Receiving report from / discuss with auditors on critical accounting policies, alternative treatment, key matters and management letters	·	·	·	·	·			·	·
Establishing procedures for the receipt, retention and treatment of complaints received by company re accounting, internal controls and auditing.		·							
Receiving a report from CFO re risks and off balance sheet commitments				·					
Having a charter / term of reference		·	·	·	·	·	·	·	·
Reporting to the shareholders		·	·	·					
Reporting to the board			·	·		·		·	
Having oversight of integrity of financial statements		·	·	·	·	·		·	
Holding regular joint and separate meetings	·	·	·	·	·		·		·
Receiving induction training on appointment to committee				·				·	
Reviewing consolidation				·					
Ensure compliance with legal and regulatory provisions								·	
Subject to regular evaluation / monitoring by board to ensure duties are effectively carried out								·	

Source: Adopted from the appendix to the FRC's Combined Guidance Code on audit committees (2003) and adjusted to include a comparison of the South African King Report (2002) and Singapore's Corporate Governance Code (2001), Prepared by Wits University, School of Accountancy, 2003, Accounting Research Report No. 2

ANNEX 12 : RECOMMENDATIONS FOR LEGISLATIVE CHANGES

Recommendation Reference		Recommended for inclusion in:
TOR 1	Regulation of auditors – all aspects set out under TOR 1	Auditors' Act (New)
TOR 2	No regulation recommended	
TOR 3	Regulation of requirement to rotate audit personnel	Companies Act or other relevant legislation for entities other than companies
TOR 4 **4.13** **4.15 – 4.19**	Regulations surrounding Audit Committees, requirements of the audit committee and discharging of its obligations	Companies Act or other relevant legislation for entities other than companies
4.20	Auditor to attend AGM	Companies Act or other relevant legislation for entities other than companies
4.21	Regulations surrounding appointment of external auditors, duties and liability	
TOR 5 **5.5**	Statutory offence for auditors that knowingly mis-report	Auditors' Act (New) or Companies Act or other relevant legislation
5.6 – 5.16	Disciplinary procedures for auditors	Auditors' Act (New)
TOR **6.2**	Onus on auditor to report false representations or material non disclosure by management	Auditors' Act (New)
6.3	Statutory penalties on management for false or non-disclosure of material information to their auditors	Companies Act or other relevant legislation
6.4 – 6.7	Statutory offence for all parties who are knowingly a party to the presentation of financial statements that fail to fairly present	Companies Act or other relevant legislation
TOR 7	Legislative structure for setting of accounting standards and compliance therewith	Financial Reporting Bill and amendments to Companies Act and other relevant legislation requiring compliance therewith. (Note: the JSE listings requirements achieve this for listed companies but this does not achieve the required standard of monitoring and enforcement and does not cover other relevant enterprises.)
TOR 8	No regulation recommended	
TOR 9	No regulation recommended	

ANNEX 12 : RECOMMENDATIONS FOR LEGISLATIVE CHANGES (continued)

Recommendation Reference		Recommended for inclusion in:
Other Matters		
10.1 - 10.12	Examination process and access to the profession	Auditors' Act and subordinate rules thereunder
10.13 – 10.18	Statutory protection of term "chartered accountant"	Chartered Accountants Designation Act
10.19 – 10.21	Material Irregularities	Auditors' Act
10.22 – 10.25	Multi-disciplinary practices	Auditors' Act
10.26	Powers and duties of auditors' regulatory body	Auditors' Act
10.27 – 10.29	Registration of auditors and protection of name	Auditors' Act

Section D

MEMBERS OF THE MINISTERIAL PANEL

Len Konar

- Chairperson of the Ministerial Accounting Review Panel
- Chartered Accountant (South Africa)
- MAS (Illinois, USA); D Com
- Consultant in Corporate Governance, Risk Management, Internal Audit and Technical Accounting and Auditing Issues at Fisher Hoffman PKF (Jhb) Inc.
- Formerly Head of Investments and Internal Audit at the Independent Development Trust
- Former Professor and Head of the Department of Accountancy, University of Durban-Westville
- Non-executive directorships: South African Reserve Bank, Old Mutual South Africa, JD Group Ltd, Kumba Resources Limited, Unitrans Limited, Macsteel Holdings (Pty) Limited and Steinhoff International Holdings Limited
- Fellow Member of the Institute of Directors of Southern Africa
- Patron of the Institute of Internal Auditors, South Africa
- Member of the King Committee on Corporate Governance
- Member of the Association for the Advancement of Black Accountants in Southern Africa
- Member of the Accounting Standards Board
- Trustee of the Chartered Accountants' Eden Trust
- Member of the Securities Regulation Panel

Steven Levitt

- Secretary to the Ministerial Accounting Review Panel
- Chartered Accountant (South Africa)
- Executive directorships: IIC International Inc. BVI, O2 Capital (Pty) Ltd
- Non-executive directorships: Macsteel Holdings (Pty) Ltd, Macsteel Service Centres SA (Pty) Ltd, Nosmas Investment Holdings BV, African Bank Investments Limited, African Bank Limited, Amalgamated Appliance Holdings Limited

Harvey Elliot Wainer

- Chartered Accountant (South Africa)
- Chairman of the GAAP Monitoring Panel of the JSE Securities Exchange
- Member of the Auditing Standards Board
- Visiting Professor in the Faculty of Commerce, University of the Witwatersrand
- Former Chief Executive and Managing Partner of Fisher Hoffman Sithole
- Past member of the Accounting Practices Committee of the South African Institute of Chartered Accountants
- Former member of the Accounting Issues Task Force
- Past director of PPS Insurance Company Ltd. Chairman of PPS Audit Committee

Samantha Jane Anderson

- Director: Financial Markets – National Treasury of South Africa
- Teaching Assistant: "Government, the Economy and Public Policy" – Cornell University
- Research on the regulatory implications of demutualisation – JSE Securities Exchange South Africa
- Teaching Assistant: "Calculus" – Cornell University
- Research to Portfolio Committee on Finance – National Parliament of South Africa
- Research Assistant – Local Government Finance – Institute for Multi Party Democracy
- Research Assistant – University of Natal

Robert James Gourlay Barrow

- Chartered Accountant (South Africa)
- Deputy Executive Officer – Financial Services Board
- Chairman of the Insider Trading Directorate
- Former Director: Surveillance – JSE Securities Exchange South Africa
- Former member of the South African Institute of Chartered Accountants: Accounting Practices Committee
- Former Partner: Coopers and Lybrand

Simon Burdett

- BA
- Diploma in International Taxation
- Accredited Public Relations Practitioner
- Head of Corporate Development of the Association of Chartered Accountants – Southern Africa
- Communications Manager – Eastern, Central and Southern Africa
- Board member – Eastern Central and Southern African Federation of Accountants
- Member of the Steering Committee for the Global Reporting Initiative in South Africa

Hercules Phillipus Dwinger

- Advocate of the High Court of South Africa
- Director: Legal Services of the Companies and Intellectual Property Registration Office
- Former Secretary to the Standing Advisory Committee on Company Law
- Former Senior Legal Officer – Department of Trade and Industry: Registrar of Companies
- Former Parliamentary Legal officer – Department of Co-operation and Development
- Former Magistrate and State Prosecutor

Dilip Garach

- Chartered Accountant (South Africa)
- Bcom; Bcom Hons; Mcom – University of Durban – Westville
- Dip.A.P.P.; CFP
- Head of Tax, School of Accountancy, University of Durban - Westville
- Served on the South African Revenue Services Advisory Board
- Member of the Income Tax Special Court
- Member of the Audit Committee of South African Revenue Service

Christopher CM Malan

- LLB – University of Cape Town
- LLM in Commercial Law – University of Cape Town
- Post Graduate Diploma in Tax Law – University of Cape Town
- Chief Director – Financial Regulation: National Treasury
- Former member of the Policy Board for Financial Services and Regulation
- Member of the Standing Committee for the Revision of the Banks Act, 1990
- Treasury member on the Exchange Control Technical Committee
- Treasury Representative on the Money Laundering Advisory Council
- Treasury Representative to the Financial Action Task Force

Futhi Mtoba

- Chartered Accountant (South Africa)
- Higher Diploma in Banking Law (RAU)
- BA (Econ) (Hons) - University of South Africa
- Partner: Deloitte and Touche
- Board member of the South African Institute of Chartered Accountants
- Board member of the Public Investment Commissioners
- National President of the Association for the Advancement of Black Accountants of Southern Africa
- Board member of the Money Laundering Advisory Council

- Board member of the Financial Markets Advisory Board
- Trustee of the WDB Trust

Vassi Naidoo

- Chartered Accountant (South Africa)
- Chief Executive: Deloitte and Touche
- Trustee of the National School of Accounting
- Trustee of the Chartered Accountants' Eden Trust
- Fellow Member of the Institute of Directors in Southern Africa
- Member of the Association for the Advancement of Black Accountants of Southern Africa
- Trustee of the Colleges of Medicine
- Member of the Council of the University of the Witwatersrand
- Member of the SA Foundation

Madoda Petros

- Chartered Accountant (South Africa)
- Advanced Tax Certificate – University of South Africa
- Head: On-site Supervision – South African Reserve Bank
- Member of the Metrorail Audit Committee
- Member of the Association for the Advancement of Black Accountants of Southern Africa

Wessel Pretorius

- Diploma in State Finance, Accounting, Auditing and Business Engineering
- B Admin (Public Administration, Accounting and Auditing)
- Executive Manager – Officer of the Auditor-General

Tryphosa Mmarona Ramano

- Chartered Accountant (South Africa)
- Executive Development Leadership Program – Harvard University
- Head of Asset Management – National Treasury
- Formerly Portfolio Manager and Head of the Institute of Investment Excellence – Rand Merchant Bank Asset Management
- Board member of Sasria
- Board member of Insider Trading Directorate
- Board member of Kaya FM

Ignatius Sehoole

- Chartered Accountant (South Africa)
- Executive President – The South African Institute of Chartered Accountants
- Board member – The International Federation of Accountants
- Committee member – The Audit Committee of the International Federation of Accountants
- Committee member – The Regulatory Monitoring Group of the International Federation of Accountants
- Committee member – The Developing Nations' Committee of the International Federation of Accountants
- Board member – Eastern Central and Southern African Federation of Accountants
- Committee member – The Executive Committee of the Eastern Central and Southern African Federation of Accountants
- Member of the King Committee on Corporate Governance
- Commissioner – The Public Investment Commissioners
- Committee member – Audit Committee of the Public Investment Commissioners
- Committee member – Higher Education Quality Committee (HEQC) of the Council on Higher Education
- Committee Chairman – Audit Committee for the National Treasury
- Board member – Development Bank of Southern Africa
- Committee member – Audit and Finance Committee of the Development Bank of Southern Africa
- Board member – Pareto Limited
- Committee member – Audit Committee of Pareto Limited

- Committee member – Accounting Standards Board
- Trustee member – Thuthuka Project

George Williams

- Chartered Accountant (South Africa)
- Masters in Business Administration, majoring in Banking and Finance – University of Nebraska, USA
- Member of the Financial Management Association– USA
- Member of the association of MBA Executives of the United States
- Council member of the South African Accounting Association
- Member of the Transkei Public Accountants' and Auditors' Board
- Member of the Association for the Advancement of Black Accountants of Southern Africa
- Member of the Southern Africa Institute for Management Scientists
- Member of the South African Public Accountants' and Auditors' Board and its Education Committee

Tania Inga Wimberley

- Chartered Accountant (South Africa)
- Employed by the Listings Division of the JSE Securities Exchange South Africa
- Member of the South African Institute of Chartered Accountants: Accounting Practices Board
- Member of the South African Institute of Chartered Accountants: Accounting Practices Committee

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SUBMISSIONS FROM THE PUBLIC

Professional Bodies

Institute of Commercial & Financial Accountants of Southern Africa	16th May 2003
JSE Securities Exchange South Africa	21st February 2003
Public Accountants' & Auditors' Board	17th February 2003
The Association of Chartered Certified Accountants	21st February 2003
The Banking Council, South Africa	20th February 2003
The Chartered Institute of Management Accountants	18th February 2003
The Institute of Administration & Commerce	21st February 2003
The Institute of Internal Auditors South Africa	21st February 2003
The Institute of Municipal Finance Officers	17th February 2003
The South African Institute of Chartered Accountants	20th February 2003
The Western Cape Trainee Account Forum	21st February 2003

Companies

Burmeister & Co (Pty) Ltd	23rd January 2003
Macsteel Service Centres SA	4th February 2003
Northam Platinum Limited	21st February 2003
Standard Bank Group	21st February 2003

Audit Firms

Deloitte & Touche	23rd February 2003
Ernst & Young	20th February 2003
Fisher Hoffman PKF (Jhb) Inc.	21st February 2003
G C Cloete & Associates	21st February 2003
Grant Thornton Kessel Feinstein	20th February 2003
J Perkel & Company	21st February 2003
KPMG Inc.	12th February 2003
SAB & T Inc	21st February 2003
SizweNtsaluba VSP	21st February 2003

Private Individuals

Bosomworth, Mr R	31st January 2003
Crawford, P	31st January 2003
Day, Mr K	8th February 2003
Gloeck, D & de Jager H	5th February 2003
Hattingh, J	February 2003
Kolia, G	22nd January 2003
Manenzhe, G M	February 2003
Molema, Mr D T	February 2003
Opperman, Mr W	February 2003
Payne, N	21st February 2003
Scheepers, Mr J F J	21st February 2003
Schroder, R	21st February 2003
Smith, Mr P	14th March 2003
van der Merwe, N	4th March 2003
Wolstenholme, Mr D	21st February 2003

Other

Cape Society Discussion Group	21st February / 14th March 2003
South African Reserve Bank	25th February 2003