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7 August 2008

Mr Ben Martins
Chairperson
Portfolio Committee on Trade and Industry
Parliament of South Africa

For attention : Committee Secretary, Ms Marcelle Williams
mawilliams@parliament.gov.za

Dear Mr Martins

SUBMISSION ON THE COMPANIES BILL, 2008

We thank the Portfolio Committee on Trade and Industry for the opportunity to contribute to the development of legislation governing companies in South Africa.

We would like to express our support for the overall objectives and principles as set out in the Companies Bill, 2008. Also, we congratulate the Department of Trade and Industry on a job well done in terms of the quality and cohesion of the Bill.

Other than the areas of comment raised in our submission, we support the Companies Bill, 2008.

We have included in our comment matters of principle, those aspects where there may be unintended consequences, and matters where clarification is required on certain sections of the Companies Bill, 2008 which would help in ensuring consistent application of the final legislation.

We are committed to contributing to the development of legislation regulating companies and welcome the opportunity to offer further assistance should this be called on. Kindly contact Dr Johan Erasmus on 011 806 6292 if clarity is required on any of our comments or if we are able to assist in any way.

We would appreciate the opportunity to make an oral presentation at the public hearings scheduled for 11-14 August 2008.

Yours faithfully

G C Tweedy
Audit Risk Leader
Deloitte & Touche

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1. Limitation of audit requirement

Deloitte would like to express its support for the exemption in section 30 of certain companies to have their annual financial statements audited. This seems to be in line with international best practice, and we believe that given the risk to stakeholders (including shareholders), it is appropriate and desirable for the Bill to provide for an alternative form of verification of financial statements. Although this provision might have an impact on the auditing profession, we believe that the Companies Bill is not an appropriate vehicle to regulate comprehensive auditing requirements of the various classes of juristic persons, which Deloitte believes, ought rather to be contained in auditing specific legislation.

Deloitte would like to express its support for the exemption in section 30 of certain companies to have their annual financial statements audited.

2. Clarification of accountability and transparency requirements for private companies

Section 84 clearly states that the provisions of Chapter 3 (which require and regulate the appointment of a company secretary, an audit committee and an auditor) apply only to :

- public companies;
- state owned enterprises; and
- private companies, limited liability companies and non profit companies *only to the extent* that this requirement is included in the company's Memorandum of Incorporation.

However, section 30(10) determines that the Minister may require different categories of private companies to have their respective annual financial statements audited.

The question arises as to what the position is with regard to the applicability of Chapter 3 in the case where a private company did not include the requirements of Chapter 3 in its Memorandum of Incorporation, but falls within one of the categories of companies required by the Minister to have its annual financial statements audited.

It is proposed that the legislature clarifies the application of Chapter 3 by providing a clear indication that all companies that are required in terms of this

Bill to have audited financial statements should comply with the requirements of sections 90 to 93 (appointment of auditor) and section 94 (appointment of an audit committee).

It is proposed that section 84 be amended by the inclusion of a new subsection as follows :

84. (1)(d) every private company that is required to have its annual financial statements audited in terms of section 30(10).

It is proposed that section 90(1) be amended as follows :

90. (1) Upon its incorporation, and each year at its annual general meeting, a public company [or], state-owned enterprise or private company that is required to have its annual financial statements audited in terms of section 30(10) must appoint an auditor.

It is proposed that section 94(2) be amended as follows :

94. (2) At each annual general meeting, a public company or state-owned enterprise, or private company that is required to have its annual financial statements audited in terms of section 30(10), or other company that has voluntarily determined to have an audit committee as contemplated in section 34(2), must elect an audit committee comprising at least three members, unless

(a) the company is a subsidiary of another company that has an audit committee; and
(b) the audit committee of that other company will perform the functions required under this section on behalf of that subsidiary company.

3. Commencement of the Act

In order for the Companies Act to be implemented effectively, and for companies to be able to comply with all relevant provisions, it is necessary to publish all regulations prior to the commencement of the Act.

This is especially true in the case of the regulations pertaining to the financial reporting standards, as well as the regulations published in terms of section 30(10) in terms of which the Minister may require certain categories of private companies to have their annual financial statements audited. Where private companies have to comply with the said requirement, they will only be aware of

the fact that they have to appoint an auditor to audit their annual financial statements after the publication of the regulations, which will only be published after the commencement of the Act.

In order to allow all companies (including the categories of private companies that will be required to have audited financial statements) sufficient time to prepare for the implementation of the Act and to appoint an audit committee and auditors, it is proposed that the Bill provides for a staggered implementation.

Although section 223 allows for a streamlined process for the publication of regulations pertaining to financial reporting standards, and paragraph 14 of Schedule 6 dealing with Transitional Arrangements allows for a shorter public comment period when initial regulations are promulgated, it is submitted that all relevant regulations should preferably be published prior to the commencement of the Act.

It is proposed that the provisions of the Bill be implemented in a staggered manner, similar to the approach followed in the Consumer Protection Bill. In terms of this approach all regulatory agencies will be established one year after the President has assented to the Act. The remainder of the Act will only become effective eighteen months after the President signed the Act and it has been promulgated in the Government Gazette. This approach allows for the :

- regulatory agencies (Companies and Intellectual Property Commission, Companies Ombud, Takeover Regulation Panel and Financial Reporting Standards Council) to be established and prepare for the implementation of the Act; and
- Minister to ensure that all required regulations are published during the six month period after the initial effective date.

In terms of the proposed approach the following provisions will commence one year after the President has assented to the Act :

- enabling provisions of the Bill (Chapter 1);
- provisions dealing with the establishment of all regulatory agencies (Chapter 8); and
- provisions enabling the publication of regulations.

The remainder of the Bill will then become effective six months later.

It is proposed that section 225 be redrafted as follows : 225. (1) This Act is called the Companies Act, 2008. (2) Chapters 1 and 8 of this Act, section 223 and any other provision authorising the Minister to make regulations take effect on the date that is one year after the date on which this Act was signed by the President. (3) Any provision of this Act not contemplated in subsection (2) takes effect on the date that is 18 months after the date on which this Act was signed by the President.

4. Limitation of auditor's liability

At present the limitation of liability of auditors is regulated in terms of the Auditing Professions Act, 2005 and the Companies Act, 1973. The Auditing Professions Act deals only with a limitation of liability with regard to fraudulent or negligent actions, and to instances where third parties relied on an auditor's report or opinion and suffered economic loss as a result. However, the Companies Bill, 2008 does not provide for matters pertaining to liability, limited liability or indemnification of auditors.

International experience has shown that as companies have become larger and their activities global, and as society has become more litigious, auditors have faced an increasing number of claims, including many that, if they were successful, would be beyond their financial resources.

This position is exacerbated if other parties (such as directors or other advisers) who are held responsible for the losses suffered by the company are unable to meet any award made against them. In those circumstances, under the principle of 'joint and several' liability, the auditors could be required to meet the full amount of the damages awarded in favour of the company, not just the amount for which they were held to be directly responsible.

This situation raises the concern that :

- one of the big auditing firms might exit the market for provision of audit services, which would seriously threaten the effective functioning of the South African capital markets, and adversely affect many listed and other companies through disruption of the market for audit services;
- without a means of limiting auditor liability, audit fees might increase to cover the risks arising from increasing exposure to claims or firms would not be willing to accept appointments as auditors of higher risk entities; and

- the pre-existing arrangements for liability and the increase in litigation against auditors may contribute to an environment which encouraged auditors to adopt a defensive, risk-averse approach to auditing.

In view of the concerns raised above, it is proposed that provision is made in the Bill for limitation of auditor liability similar to the construct of 'liability limitation agreements' as employed in the UK Companies Act, 2006 (section 532 to 538, effective since 6 April 2008). As the Bill proposes measures to deal with the appointment of Auditors, and deals specifically with matters pertaining to the independence of auditors, it is submitted that it is appropriate for this Bill to also deal with matters pertaining to the liability of auditors.

For the reasons set out above, it is proposed that consideration be given to the construct of 'liability limitation agreements' as employed in the UK Companies Act, 2006 (section 532 to 538, effective since 6 April 2008).

The principles of the liability limitation agreements are as follows :

- a liability limitation agreement is an agreement that purports to limit the amount of a liability owed to a company by its auditor in respect of any negligence, default, breach of duty or breach of trust occurring in the course of the audit of accounts, for which the auditor may be responsible in relation to the company;
- a liability limitation agreement cannot cover more than one financial year;
- a liability limitation agreement must be approved by a resolution of the company's shareholders;
- any arrangement to limit liability will not be effective except to the extent that it is 'fair and reasonable' in the particular circumstances. This is the key principle in the UK legislation, and it means that the court can override any contractual limits agreed between the company and the auditors if it considers that they are less than 'fair and reasonable'. The court may reach this conclusion notwithstanding the fact that the agreement had been approved by the company's shareholders. In these circumstances the agreement does not become null and void - instead the liability is amended to a level set by the court;
- although the question of what is a 'fair and reasonable' limit on the auditor's liability will ultimately be for the court to decide in each individual case, the legislation sets out a number of factors that should be taken into consideration :
  - the auditor's responsibilities (which include provisions relating to the statutory audit and the duties and rights of auditors);

- the nature and purpose of the auditor's contractual obligations to the company; and
- the professional standards expected of the auditor;

However the legislation also states that no account is to be taken of :

- matters arising after the loss or damage in question has been incurred; or
- matters (whenever they arise) affecting the possibility of recovering compensation from other persons liable in respect of the same loss or damage.

▪ where an agreement is in place, the legislation does not restrict the manner in which liability can be limited. This means that, in principle, the contractual limits could be set in a number of different ways, for example :

  - a limit based on the auditor's proportionate share of the responsibility for any loss. Under this approach, the company would agree that if there is someone other than the auditor who is also liable to the company for, or who has caused or contributed to, all or part of the same loss, the auditor's liability would be limited to the extent to which the auditor was responsible for that loss. The company would not be able to look to the auditor for any loss attributable to the acts of any other party (which could include a director, officer or employee of the company, irrespective of whether they had acted negligently, in breach of trust or dishonestly);
  - purely by reference to the 'fair and reasonable' test;
  - a cap on liability, expressed either as a monetary amount or calculated on the basis of an agreed formula; or
  - a combination of some or all of the above.

5. Financial reporting standards

Section 29 determines that if a company provides any financial statements to any persons of any reason, those statements must satisfy the 'financial reporting standards'. It further states (in subsection (5)) that the financial reporting standards, as prescribed in regulations, must be consistent with the International Financial Reporting Standards (IFRS) of the International Accounting Standards Board. In other words, this section requires any financial statements prepared by any company *for any reason* to comply with International Financial Reporting Standards. Accordingly, even those companies that are not required in terms of the Bill to prepare financial statements (such as personal liability companies and certain private companies) will have to apply IFRS if they prepare financial statements.

The requirements of IFRS with regard to recognition, measurement and disclosure are complex and require advanced accounting skills to apply (this applies particularly to fair value measurement and recording). It is extremely unlikely that the overwhelming majority of owners of personal liability companies and some private companies (who will be unsophisticated in accounting) will be able to comply with this. Furthermore, it will expose them to unnecessary expense with little or no benefit.

There seems little logic in allowing such companies to keep their accounting records on a basis other than IFRS, such as purely historical cost accounting, but then requiring them to apply IFRS should they elect to prepare financial statements that will be neither audited nor reviewed. It will be preferable to allow such companies to comply with accounting policies appropriate to their business as is permitted by section 58 of the Close Corporations Act.

It is proposed that financial reporting standards consistent with the International Financial Reporting Standards *only* be required in the case of companies that are required to have audited financial statements in terms of the Bill, i.e. public companies, state owned enterprises, and those categories of private companies as determined by the Minister in terms of section 30(10).

It is proposed that financial reporting standards that conform to generally accepted accounting practices be required for any company that prepares financial statements that are not required to be audited in terms of section 30.

It is proposed that section 29(5) be amended as follows :

29. (5) Any regulations contemplated in subsection (4)

(a) must promote sound and consistent accounting practices;

(b) may establish different financial reporting standards applicable to

(i) profit and non-profit companies;

(ii) different categories of profit companies.

(c) in the case of financial reporting standards that apply to public companies, state owned enterprises and those categories of private companies as contemplated in section 30(10), must be consistent with the International Financial Reporting Standards of the International Accounting Standards Board or its successor body; and

(d) in the case of financial reporting standards that apply to companies other than those companies contemplated in subsection (b), must be in conformity with generally accepted accounting practices.

6. Rotation of auditors

It is proposed that the mandatory rotation of the audit partner should apply only to companies that are required by the Companies Act or other legislation to appoint an auditor.

Personal liability companies or private companies that voluntarily elect to have an auditor should not be required to have auditor rotation as this will often be impracticable. In most cases, the relationship of an auditor to such companies is one primarily of bookkeeper, financial advisor and consultant with the audit playing a small role. There are a number of towns in South Africa where there are only one or two registered auditors and the requirements of this section may make it impossible for personal liability and certain private companies to appoint an auditor should they so wish. In addition, not requiring these companies to appoint an auditor indicates that the legislators consider that there is little if any protection required to be provided to stakeholders of such companies by way of an audit - having an auditor with a long association with such companies should pose no additional risk.

It is proposed that the rotation of auditor requirements only be applicable to companies that are *required* to have their financial statements audited in terms of the Bill, i.e. public companies, state owned enterprises, and those categories of private companies as determined by the Minister in terms of section 30(10).

It is proposed that a new subsection (1) be included in section 92 as follows :

92. (1) This section applies only to public companies, state owned enterprises, and those categories of private companies as determined by the Minister in terms of section 30(10).

7. Audit Committee

We would like to support the requirements for persons to be appointed as members of the audit committee as set out in section 94(4). It is to be welcomed that all members of the committee should be directors. Also the requirements provide for sufficient independence to ensure that the committee can carry out the prescribed functions as envisaged in the Bill. The requirement to have three members (rather than only two as per the Corporate Laws Amendment Act) is also in line with corporate governance best practice.

It is, however, proposed that the limitation on membership of this committee be extended to *all* full-time employees of the company, and not only to executive employees, as it may affect the independence of the committee should any ex-employee be allowed to serve as a member.

> It is proposed that section 94(4)(b)(ii) be amended as follows :
>
> 94. (4)(b)(ii) a prescribed officer, or full-time [executive] employee, of the company or another related or inter-related company, or have been such an officer or employee at any time during the previous three financial years;

With regard to the functions of the audit committee, Deloitte would like to support the functions as enumerated in section 94(7)(a) to (h). Although we support the fact that the board may assign any additional function to the committee (including, but not limited to matters related to oversight of risk management, internal controls, and governance), we do not agree with the proposed additional function as set out in section 94(7)(i), as the development and implementation of policies and plans should be a management function. The audit committee should at most be responsible for *oversight* of the development and implementation of the said policies and plans

> It is proposed that section 94(7)(i) be amended as follows :
>
> 94. (7)(i) to perform other functions determined by the board, <u>which may include oversight of</u> the development and implementation of a policy and plan for a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes within the company.

8. Definition of 'related or inter-related persons, and control'

The definition of 'related and inter-related persons, and control' is to be welcomed. However, the Bill proposes that two individuals are to be regarded as related if they are separated by no more that three degrees of natural or adopted consanguinity or affinity. It is submitted that this may result in too wide a definition and that it may lead to unintended consequences - especially if one considers the potential effect of the definition of inter-related persons (see below in relation to the definition of a 'group of companies').

Further, it is not clear what is meant by three degrees of 'affinity'.

It is submitted that, for the purposes of the Bill, relatedness be limited to immediate family (natural or adopted) and brothers or sisters, as this will avoid unintended consequences.

It is proposed that the reference to 'affinity' be either defined or removed, and that the definition of related persons be limited to two degrees of natural or adopted consanguinity.

It is submitted that section 2(1)(a)(ii) be amended to read : 2. (1)(a)(ii) are separated by no more than [three] <u>two</u> degrees of natural or adopted consanguinity [or affinity].

9. Definition of a 'group of companies'

The Bill defines a 'group of companies' as two or more companies that are related or inter-related. In order to interpret this definition, one has to rely on the definition for 'related and inter-related persons, and control'. In terms of this definition, two or more companies are related (and therefore form a group) where they are controlled by a single person or related persons, even though they might have no other common interest.

This wide definition of a 'group of companies' may complicate the interpretation and application of the provisions of the Bill. For example, the solvency and liquidity test requires directors of a company that is a member of a group to consider the consolidated assets and liabilities of the group when applying the test. This may be difficult where there is no formal relationship between the respective companies.

It is proposed that a 'group of companies' be defined only in terms of the relationship between a holding company and its subsidiaries.

In the alternative, where a 'group of companies' is defined also in terms of the relationship between natural persons that are able to control a company, that the relationship between those individuals be limited to:

- marriage or a relationship similar to marriage; or
- no more than two degrees of natural or adopted consanguinity.

10. Business rescue

Deloitte welcomes the inclusion of Chapter 6 dealing with business rescue. The provisions of Chapter 6 will undoubtedly contribute significantly to assist and salvage failing companies.

Deloitte would like to express support for the:

- introduction of the concept of 'financial distress';
  The requirement for a company to be financially distressed, rather than an act of insolvency (as was required in an earlier draft of the Bill), to commence business rescue proceedings is welcomed. This will ensure that companies in financial difficulty have sufficient opportunity to address the relevant issues to avoid insolvency and possible liquidation.
- measures to ensure oversight of the profession of business rescue supervisors; and
- measures to protect all stakeholders, including employees.

11. Criteria to require audited financial statements

The Bill proposes specific criteria to be used by the Companies and Intellectual Property Commission when it has to determine whether certain companies should be required to have annual financial statements.

In terms of section 30(2) the Commission may require certain exempted companies to prepare annual financial statements if the preparation of annual financial statements by that company appears to be necessary to protect the interests of any holders of the company's securities or it is in the public interest, having regard to the economic or social significance of the company as indicated by :

- its annual turnover;
- the size of its workforce; or
- the nature and extent of its activities.

Section 30(10) authorises the Minister to determine specific categories of companies that should have their annual financial statements audited. The section is, however, silent on the criteria to be used by the Minister when this determination is made. It is therefore proposed that criteria similar to the criteria in section 30(2) be applied in section 30(10).

It is proposed that section 30(10) be amended to provide for specific criteria to be employed when the Minister determines the categories of private companies that should have their annual financial statements audited.

It is proposed that a new subsection 30(10)(c) be included as follows :

30. (10)(c) When making a determination in terms of subsection (10)(a), the Minister must consider

(i) the need to protect the interests of any holders of the private company's securities, or

(ii) the public interest, having regard to the economic or social significance of the company as indicated by :

(aa) its annual turnover;

(bb) the size of its workforce; or

(cc) the nature and extent of its activities.

12. Application of the takeover regulations to private companies

In terms of section 118(1)(c) the takeover regulations will only apply to a private company where 10% or more of the securities held in that company have been transferred in the last 24 months or where the company's Memorandum of Incorporation expressly provides that the takeover regulations would apply.

It should, however, be noted that this provision might not have the required effect in that :

- there are some very large private companies that do not often trade their securities. When its securities are then traded, the takeover regulations may not be applicable (as the requirement for 10% or more of the securities held in that company to have been transferred in the last 24 months have not

been met), and as such minority security holders may have very little recourse, other than the normal recourse to the court; and

- it is expected that not many private companies will amend their Memorandum of Incorporation to provide for the application of the takeover regulations.

It is proposed that the takeover regulations should apply to all private companies where the company's Memorandum of Incorporation expressly provides that the takeover regulations would apply, or where the private company has 10 or more security holders and the transaction size of a fundamental transaction exceeds R10m.

13. Dissenting shareholders' appraisal rights

Section 164 provides for the appraisal rights of dissenting shareholders. This section determines that where a company resolves to alter the preferences, rights, limitations or other terms of any class of its shares, or enters into a fundamental transaction, dissenting shareholders may demand that the company pay the shareholder the fair value for all of the shares of the company held by that person if the shareholder followed the correct procedure.

It should, however, be noted that the payment of fair value in cash to the dissenting shareholders may have certain unintended consequences :

- the appraisal rights may be abused by shareholders to receive cash instead of shares in a share-for-share transaction;
- it may lead to the unequal treatment of shareholders in that dissenting shareholders may receive more compensation for their shares than those shareholders that opt to support the share-for-share transaction; or
- where a company is cash strapped, minority security holders following their rights in terms of section 164 may force the company to borrow funds to comply with this provision to the detriment of the company. It is also not clear whether the solvency and liquidity test requirements set out in section 4 would enable a cash-strapped company to counter such an abuse by the minority.