Deloitte.

Private Bag X6
Gallo Manor 2052
South Africa

Deloitte & Touche
Registered Auditors
Reputation and Risk
Building 8
Deloitte Place
The Woodlands
Woodlands Drive
Woodmead Sandton
Docex 10 Johannesburg

Tel: +27 (0)11 806 5000
Fax: +27 (0)11 806 6138
www.deloitte.com

24 May 2006

By email: Marcelle Williams [mawilliams@parliament.gov.za]

By Fax: 021 403 8204

Att: Marcelle Williams
Portfolio Committee Trade and Industry
c/o The Secretary of Parliament
Parliament
Republic of South Africa
P O Box 15
Cape Town
8000

Dear Sir

COMMENT ON THE COMPANIES AMENDMENT BILL

We are pleased to submit our comment on the proposed amendments to the Companies Act published on 21 April 2006.

Our comments have been made in order of priority based on those matters we believe require the most urgent attention.

We wish to place on record our thanks to the staff at the Department of Trade and Industry for the diligence applied in responding to our previous comment letter. The majority of our comment has been dealt with.

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A full list of partners and directors is available on request

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1. The proposed section 275A provisions

We disagree with the addressing of other services provided by an auditor to a company in the Companies Act ("the Act"), whether a public interest or a limited interest company.

We respectfully submit that the purpose of the Companies Act 61 of 1973, as amended, is to consolidate the law relating to companies, rather than to regulate the auditing profession. The Auditing Professions Act 26 of 2005 (the "APA") has been promulgated to do this.

We believe that the Code of Ethics of the International Federation of Accountants provides an appropriate basis for regulating the Independence of Auditors from their audit clients.

Further, we believe that the Committee for Auditor Ethics (the "CAE") established under the APA is the appropriate body to issue specific regulations on the independence of auditors and to regulate which non-audit services an auditor may render to its public interest company audit clients.

We are concerned that section 275A is sought to be codified with undue haste. Section 275A, in its current form and for the first time referring to "tax advisory services", was introduced on 12 May 2006 and is sought to be implemented by 14 June 2006, a very short period indeed. This is unlike other jurisdictions such as the United States of America, where it took a lengthy period to finalise provisions dealing with auditor independence.

The changes brought about to the current version of section 275A as regards "tax advisory services" is largely as a result of a submission made by the South African Revenue Service ("SARS"). The SARS submission was based on a report by the Permanent Sub-committee on Investigations of the Committee on Homeland Security and Government Affairs of the US Senate on The Role of Professional Firms in the US Tax Shelter Industry. This report dealt specifically with aggressive tax schemes.

We believe that the SARS submission had insufficient probative value to justify exclusion of tax advisory services in its entirety from the realm of services which an auditor is able to provide to its public interest company audit clients and, with respect, should not have been followed. The reasons for our view are set out in full in Annexure A to this submission.

We agree that the provision of tax advisory services by auditors that relate to the marketing or opine in favour of aggressive tax position should be prohibited.

However, with regard to the proposed specific services prohibited, we disagree with the inclusion of Tax Advisory Services in the Act. This is in conflict with the service restrictions, inter alia, in the United States of America and the United Kingdom. We recommend that the prohibition on Internal Audit services and Tax Advisory Services be removed from the Act and that the CAE set guidelines on the constraints to be applied

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when an auditor provides Internal Audit services or Tax Advisory Services to an audit client.

We wish to point out certain fundamental concerns relating to the language of subsection 275A:

- The meaning of the word "auditor". It is not clear whether the legislature is referring to the designated auditor (i.e. the individual referred to in section 273(5)) or the audit firm generally. The head note refers to "certain non-audit services not open to current **designated auditor** of public interest company". On the other hand, the reference in the body of the subsection is to "(A)n **auditor** appointed to a public interest company". Further in the body of the subsection is the reference to "...to the extent that these would be subject to **its own** auditing,..." (emphasis added).
- The term "tax advisory services" is undefined and extremely broad.
- The words "...to the extent that these would be subject to its own auditing,..." is extremely wide and could potentially relate to all tax advisory services provided by an auditor to a public interest company. We respectfully submit, by the inclusion of these words, the legislature could not have intended that all tax services be prohibited, and clarity is required in this regard.

We understand, from discussions that have taken place, that SARS intended their proposal to only relate to the "nominated auditor", now "designated auditor". Even on this basis we believe that section 275A is inappropriate and particularly the insertion of the words "tax advisory services".

We submit that there will be several serious, but unintended negative consequences should section 275A be adopted in its present form. These include:

If the provisions are intended to relate in their present form to the designated auditor, section 275A may result in tax partner rotation to the detriment of smaller firms. Larger firms, with numerous partners can more easily develop internal controls to ensure independence, whereas smaller firms do not have the partner numbers to do this. As a result, smaller auditing firms will suffer more under this interpretation of section 275A. (It may be possible for certain clients to change their articles so that they qualify as a "limited interest company", but this may not always be possible)

- If the provisions could be interpreted as relating to the audit firm
  - A risk that audit committees become prone to exercising excessive and unnecessary caution in dealings with their auditors, with negative consequences for audit quality.
  - Audit firms have a vested interest in their audit client relationships and are less likely to sell poor quality or aggressive tax advice which might damage the auditor/client relationship. Prohibiting auditors from providing tax advice to their audit clients may result in tax advice being taken from advisors who do not have a similar vested interest in providing high quality tax advice.

- Multinational companies will view section 275A as a further hindrance of doing business in South Africa, as it does not accord with international best practice and will result in them having to instruct new tax advisors whose outputs will be audited at additional audit cost.
- Audit firms increasingly need specialist tax advisors to provide crucial audit support. A prohibition against providing tax advisory services to audit clients will make it difficult for auditors to attract and retain such specialists resulting in reduced audit effectiveness.

We have set out our views on these issues in more detail in Annexure A to this submission.

With regard to the restriction on Internal Audit Services, while we accept that the provision of the full Internal Audit Function by the auditor may be inappropriate, we disagree with the inclusion of this activity in the Companies Act. Other jurisdictions have sought to limit the auditor's contribution to the provision of testing based on a scope of work agreed as set by management. As a consequence the definition of which Internal Audit activities an auditor should not provide is best left to the Committee for Auditor Ethics to define.

1. The Independence Requirements Proposed on Auditors (continued)

1.1 We recommend that section 275A be deleted in its entirety on the basis that the CAE will publish rules relating to audit independence and prohibited services as it is mandated to do under the APA.

1.2 If the restriction on Internal Audit services and Tax Advisory Services subject to own audit is not removed from the Companies Act, we recommend that these terms be defined as those services which the CAE and/or the IRBA list as services which an auditor is prohibited from providing to a public interest company and that the reference to "auditor" be changed to "designated auditor" and the word "its" be replaced with the words "his or her".

1.3 Failing either 1.1 or 1.2, we recommend that section 275A(1) be amended such that reference to "auditor" is changed to "designated auditor" and the word "its" be replaced with the words "his or her".

1.4 We recommend that the CAE be required to adopt globally consistent rules governing the independence of Registered Auditors, including financial interests and the service offerings of a Registered Auditors to an audit client.

1.5 We recommend that the Code of Ethics of the International Federation of Accountants in relation to Independence be adopted, until such time as the CAE has been formed and has issued its final requirements.

2. Audit Committees and Company Regulation

We agree with the recommendations on the formation of an audit committee made up of Independent Non-Executive Directors for Public Interest Companies, as defined.

In light of developments in the United States of America we recommend that some aspects of the Sarbanes-Oxley Act be considered in respect of Public Interest Companies, in particular:

- The provisions relating to Audit Committees, including the requirement to appoint a Publicly Identified Financial Expert to the Audit Committee.
- Certification of Financial Results by the Chief Executive Officer and Chief Financial Officer in their personal capacities, in addition to the collective authority of the Board of Directors.

We also recommend that the requirement of the Sarbanes-Oxley Legislation for management to certify to the appropriateness of the controls deployed under their supervision at a Public Interest Company, supported by annual attestation by the external auditors of this certification, be considered – in particular for the most significant Public Interest Companies – such as Registered Banks, Major Listed Entities, Entities Registered with the Financial Services Board and Entities of Such Significance as to require this.

3. Definition of a Public Interest Company

The definition of a Public Interest Company should be extended to include other Public Interest Entities, such as Medical Aids, Financial Advisors and Intermediaries, Pension and Provident Funds and other Large Entities – which we believe should be defined by the CAE, and amended from time to time.

Further, we believe all Public Entities and Entities governed by the Public Finance Management Act or the Municipal Finance Management Act should be included as Public Interest Companies.

While the Ministerial Review Panel recommended size measures of 200 Employees or Turnover in excess of R200 million or Assets in excess of R200 million, we believe that the potential impact and consequences of the size limit being set at that level are far-reaching. This is particularly the case when one considers the applicability of the recommendations to entities with assets or turnover over R200 million and/or 200 or more employees.

3. Definition of a Public Interest Company (continued)

The threshold proposed by the Ministerial Review Panel would mean that a vast number of entities, including owner-managed entities and subsidiaries of larger groups, will fall within the ambit of the recommendations. For those companies at the lower end of the scale, many of the recommendations will add significant cost to these businesses, together with practical obstacles.

A few examples of scenarios where the current thresholds may be costly without the requisite benefit, or may be impractical are:

- A single motor dealership owned by a small number of shareholders who manage the business may easily exceed the R200 million turnover by virtue of its type of operation; and
- An employee intensive industry, such as tourism or farming, may easily exceed 200 employees.

While we support the need to place regulation on public interest entities, we do not believe that such regulation should make the cost of small, medium and micro business unsustainable.

However, we agree with the view of the Ministerial Review Panel that some entities, while their shares or debt are not traded publicly, are still entities in the Public Interest by virtue of their relative size, impact on society or nature of business.

The firm therefore recommends that legislation or ministerial regulations should define the characteristics of entities that will be regarded as 'public interest entities' as suggested above. Further, the definition should originate in a form which governs entities which are not companies – for instance Medical Schemes, Pension Funds and the like.

The criteria decided should include aspects such as number of employees, dependent suppliers and size. With any size-based criteria applied should be sufficiently large to prevent over regulation of small and medium size businesses.

These changes would ensure that entities which may have a significant impact on matters of a Public Interest have appropriate level of corporate governance.

Finally, we welcome the amendment of the Bill to exclude wholly owned subsidiaries of Public Interest Companies from appointing their own audit committee where the audit committee of the Public Interest Company includes such subsidiaries in their activities.

4. Attendance of the auditor at annual general meeting

The requirement for the registered auditor to attend the annual general meeting of relevant entities has far reaching implications and could have significant unintended adverse consequences, increase the expectation gap and may confuse the public.

In particular, auditors may be asked questions in respect of the fair presentation of specific items included in the annual financial statements, or of their current opinion/whether they stand by their report.

An audit opinion is expressed only on the financial statements taken as a whole and not on any individual components thereof and is expressed at a specific date in relation to information available to the auditor at that date. Accordingly, many questions asked by shareholders will likely be answered by wording such as:

"We have reported on the financial statements as a whole as at the date of completing our fieldwork. Read the audit report. I cannot comment on any specific or individual items in the financial statements. I can confirm that we conducted our audit in accordance with requisite auditing standards."

This will likely be frustrating for shareholders and cause unnecessary complications.

Attendance by the auditor at the meeting may also result in directors not taking responsibility for their actions. The annual financial statements, and the contents thereof, are the responsibility of the directors and not of the auditors. We disagree with this recommendation in its entirety.

We recommend that:

4.1 The requirement for an auditor to attend the annual general meeting and be prepared to answer questions relating to the audit should be abandoned.

4.2 If the requirement is to be retained, that the proposal be the subject of further research and consultation prior to being adopted.

4.3 If the requirement for the auditor to attend the annual general meeting is retained, there should be clear guidance issued by the Committee for Auditor Standards regarding the role of the auditor at the annual general meeting. This guidance should outline the type of question that an auditor can realistically be expected to answer and a framework for the process of answering such questions.

4.4 In addition, if attendance at the annual general meeting becomes a requirement, legal protection should be provided for the auditor against assuming a duty of care beyond that which is applicable to an audit in the auditor's answering any questions. For example, a question at an annual general meeting may cover specific elements of the financial statements or individual assets or liabilities.

5. Strict penalties on individuals who mislead or frustrate the audit process

The Companies Act should establish an offence capable of civil and criminal sanction on parties who mislead an auditor in his or her inquiries or who fail to make timely disclosure of any relevant matter to the auditor.

Further, the Company's act should establish an onus on persons in management and governance of parties subject to audit to make proactive disclosure to the auditor of matters which are material to the audit.

Such provisions are contained in section 303 and sections 801-807 of the Sarbanes-Oxley Act and are a sensible step in providing appropriate legal sanction on parties who deliberately mislead, conceal or fail to disclose information to the auditor.

We recommend that:

5.1 The Companies Act establish a legal onus on persons in management and those charged with the governance of audited entities to make proactive disclosure to the entity's auditor of matters material to the audit.

5.2 The Companies Act, or other suitable legislation, provide for civil sanctions on individuals and entities misleading an auditor be provided for in legislation.

5.4 Appropriate criminal sanction on persons and parties misleading an auditor be provided for in legislation.

6. Financial Reporting Standards, setting, monitoring and enforcement

The statutory endorsement of Financial Reporting Standards is welcomed.

We do believe that the investigation process should be amended to allow the company more time than 7-days to respond. In a large public interest entity the notice period for a board meeting alone may be 21-days.

Further, one would expect the audit committee to consider the matter and make a recommendation to the board of directors. In the new context, the audit committee may wish to submit its own response to the panel.

Therefore, we recommend the company be given a period of at least two months to formulate a response to any request by the Financial Reporting Standards Investigation Panel.

Our experience of the JSE Limited's GAAP Monitoring Panel leads us to conclude that a hearing and interactive process is more constructive in evaluating the treatment by a company of an item in the financial statements – and this should be allowed for.

6. Financial Reporting Standards, setting, monitoring and enforcement (continued)

Further, we believe that the Panel should be obliged to notify the auditors of the investigation and the results of the investigation.

There should be some mechanism to protect directors, company officials and auditors from unjustified or unwarranted actions or victimisation by the Panel or any of its members.

We believe that the Companies Act should make it an offence for the officers of the company and the audit committee, capable of civil and criminal prosecution, to deliberately mislead or fail to fully disclose information which they have and knew, or ought reasonably to have known, should be considered in the preparation of the financial statements.

We recommend that:

6.1 The company and the audit committee be given a period of at least two months to formulate a response to any request by the Financial Reporting Standards Investigation Panel.

6.2 The Panel should be obliged to notify the auditors of the investigation and to allow the auditors opportunity to comment after the company has responded.

6.3 The Auditor should be notified of the results of that investigation.

6.4 The Panel should be required as its first task to publish guidance on what is meant by non-compliance with Financial Reporting Standards which might prejudice users. Such guidance should identify who "users" are; and provide benchmarks for the assessment of whether a matter is prejudicial to such users.

Closing remarks:

Further to our comment, we support the other areas of change proposed. In particular, we believe the amendments to section 38 of the Act to be a welcome move.

We remain committed to providing comment and support to the process of forming legislation that promotes public trust and an enabling environment that provides appropriate public confidence to users of financial information through the establishment and enforcement of Financial Reporting Standards, the activities of Audit Committees and a robust audit profession.

Should you wish us to contribute to specific aspects of redrafting with regard to the legislation, please contact Phillip Austin on (011) 806 5815 to facilitate this.