

more significant. Notwithstanding, an audit firm could implement effective safeguards against such a threat by, *inter alia*, ensuring that –

- “the tax services are provided by partners and staff who have no involvement in the audit of the financial statements;
- the tax services are reviewed by an independent tax partner, or other senior tax employee;
- external independent advice is obtained on the tax work;
- tax computations prepared by the audit team are reviewed by a partner or senior member of staff with appropriate expertise who is not a member of the audit team; or
- an audit partner not involved in the audit engagement reviews whether the tax work has been properly and effectively addressed in the context of the audit of the financial statements.
- the audit firm should not promote tax structures or products or undertake an engagement to provide tax advice to an audit client where the audit engagement partner has, or ought to have, reasonable doubt as to the appropriateness of the related accounting treatment involved, having regard to the requirement for financial statements to give a true and fair view in accordance with the relevant financial reporting framework.”¹³

The type of tax services which the Standard prohibits an audit firm providing to its audit clients entail –

- the promotion of tax structures or products where, in the opinion of the audit engagement partner of the firm, after such consultation as is appropriate, the effectiveness of the tax structure or product depends on an accounting treatment about which there is reasonable doubt as to its appropriateness¹⁴;
- the audit firm undertaking a management role in the audit client, unless the audit firm is working with ‘informed management’ and appropriate safeguards are applied.¹⁵

To summarise: an audit firm is entitled to provide tax advisory services to its audit client during an audit, provided the audit partner is satisfied that there are no material threats to auditor independence occasioned thereby and the audit firm has procedures in place to protect against actual or perceived threats to auditor independence.

From the foregoing, it is clear that international best practice is not to ban the provision of tax advisory services by auditors to their public interest company audit clients.

¹³ Supra. 22.

¹⁴ Supra. 23.

¹⁵ Supra. 24.

We are supportive of a balanced approach to the regulation of tax advisory services. Such regulation should not, however, be contained in the Act itself, but rather be dealt with in professional ethical rules to be published by the CAE.

Positive aspects of the provision of tax services to audit clients

There are numerous reasons why audit firms should provide tax services to audit clients. Reasons include, *inter alia*:

A Positive impact on audit quality¹⁶

Due to the complexity of tax law and financial accounting rules, particularly in relation to international trade, separate and specialist expertise is needed to have an understanding of financial accounting standards, on the one hand, and tax law and its related accounting rules, on the other. Tax specialists at audit firms have developed, through working with their audit colleagues, a considerable ability to understand the differences between financial accounting and tax accounting principles and ensure that these differences are properly accounted for in the financial statements. In examining the tax accounts of a large multinational organization, the audit teams place a great deal of reliance on the skills of the tax personnel in countries across the world in gaining the necessary audit assurances.

There is additional, empirical, evidence that supports the argument that audit quality is enhanced if the statutory auditor is able to provide tax services to the audit client. Audit quality is improved when there is a "spill over" of knowledge of a client's tax accounting to the audit. This occurs when the auditor has access to a tax professional who, in formulating his tax advice for the client, has acquired a deep understanding of the aspects of the business affecting the client's tax liability.

William Kinney and colleagues at the University of Texas and the University of Kansas produced a study¹⁷ that contains evidence that audit quality increases when the external auditor of a publicly traded firm provides tax services along with the audit. The study found that an inverse relationship exists between the amount of fees the firms paid the auditor for tax services and number of restatements among the sample of firms. In other words, the more fees the firms paid to the auditor for tax services, the less likely it would be that the firm would have to restate its financial results. This suggests that the more the auditor uses his own tax specialists for tax input or specialist services, the more reliable the financial statements will be.

A positive impact on tax service quality

Historically, audit clients have chosen their audit firms to perform tax services because their audit firm has a unique understanding of their company. By auditing a company's accounts, the accounting firm develops the deep understanding of the

¹⁶ Apart from SEC and PCOAB acceptance of this proposition referred to above, early research confirming this includes Palmore, Z-V. (1986) "The effect of non-audit services on the pricing of audit services", Working Paper, University of Melbourne, and Simunic, D.T. (1984) "Auditing, consulting and auditor independence, *Journal of Accounting Research*, 22 (Autumn): 679-702.

¹⁷ Kinney, W.R; Palmore, Z; Scholtz, S. Auditor Independence, non-Audit Services, and Restatements: Was the US Government Right? *Journal of Accounting Research*. Vol 42. 3 June 2004 (USA).

client's business and its accounting methods and policies that is critical to fulfilling the company's tax responsibilities. The cycle of planning a transaction, properly reporting the transaction in a company's tax return and then explaining the transaction to tax authorities often takes place over many years. For larger public companies, as well as mid-cap or smaller public companies, the audit firm has the most thorough understanding of the company's accounting records, accounting methods, and business operations of any provider of tax services. That knowledge base is invaluable to the audit client in the normal cycle of tax planning, compliance and tax audit assistance, because the more historic knowledge a service provider has of an audit client's business, the higher the quality of tax advice the client receives and the higher quality of tax returns it files.

The overall cost of tax services is reduced

As already noted above, the cost savings derived from a more integrated provision of services is good for business and therefore good for shareholders. A client does not need to pay additional costs for multiple professional service firms as the tax practitioner can leverage from the knowledge the auditor has gained in conducting the audit rather than replicating that work. Likewise, the auditor can consult with the tax practitioner when auditing the client's tax position on the financial statements.

Integrating tax services with audit services provides low-cost solutions to companies. Since providing both tax services and audit services results in lower costs, these services are more accessible to small and medium-sized companies that ordinarily could not afford engaging an auditor and tax practitioner separately. Also, large multinational organisations often need tax advice that requires the bringing together of professionals from a number of different jurisdictions. The large accounting firms already have extensive international networks and their associated tax practices are better able to provide a cost-effective and coordinated cross-border service.

Other fundamental concerns relating to section 275A, if it were to be retained – Impact

In the event that the legislature passes section 275A into law in its present form, we submit that there will be several adverse unintended consequences that will arise as a result. These include:

If the section only deals with the designated auditor

Section 275A may result in tax partner rotation, similar to audit partner rotation, to the detriment of smaller auditing firms. If reference in section 275A to "auditor" is a reference to the audit partner of the firm, it will work to the detriment of smaller audit firms that do not have multiple partners and be detrimental to the future viability of such firms. It is noteworthy in this context that most black owned audit firms are relatively small and therefore section 275A may have an adverse effect on transformation and development of the black auditing profession. (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)

otherwise might have in the ordinary course of dealing with its audit firm.¹⁸

- Audit firms have a vested interest in their audit relationships with clients. Currently, and certainly after the introduction of balanced regulations relating to non-audit services, it is unlikely that an audit firm will try and sell its audit clients bad tax advice. To do so would certainly have adverse consequences on the auditor/client relationship. Independent tax advisors have no such vested interest, however. Section 275A, in its current form is unlikely to increase tax compliance.
- Multinational companies, many of whom seek tax advisory services from their auditors with whom they have an existing relationship and trust, will see significant investment into South Africa.
auditors providing tax advisory services to their public interest company audit
in light of the foregoing, our recommendations are summarised below.

¹⁸ Ramsay, I (2001) "Independence of Australian Company Auditors" : Report to the Minister of Financial Services and Regulation; Melbourne Australia. 65.

- 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.



Grant Gelink