KPMG comments

Corporate Laws Amendment Bill

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Corporate Laws Amendment Bill - draft 1

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1 Introduction

KPMG welcomes the Corporate Laws Amendment Bill (the Bill). The process of reviewing the company and auditing legislation has been initiated globally and we welcome the corporate law review initiative within South Africa as an important step in keeping South Africa in line with global trends.

The Bill has many positive amendments, which we believe need to be actioned as a matter of urgency to bring South Africa into line with global trends. We appreciate the opportunity to comment on the Bill.

In general, KPMG South Africa supports the amendments in the Bill, but we take this opportunity to provide additional input on certain amendments.

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2 Specific comments on the Bill

2.1 Section 1: Definitions

We agree with the definition of Public Interest Company as defined in section 1(h).

As highlighted in our original submission to the Companies Amendment Bill, we believe it is important that any restrictions and requirements be applied only to listed and other public interest companies of reasonable size and not to all entities.

The one area of the definition that may create some interpretive issues is the term "public". It is unclear if the intention of the Bill is to regulate subsidiaries of foreign listed entities in South Africa as well, or if this definition will be restricted to companies whose shares are available to members of the South African public.

2.2 Section 269A: Audit committees for public interest companies

Section 269A(3) states that an "an audit committee must have at least two members and consist only of non-executive directors of the company who must act independently".

We agree that an audit committee must have at least two members, but it is not practical to require **all** members to be independent non-executive directors and in fact, it is unclear if this was the intention of this section. The limited number of experienced independent non-executive directors available in South Africa will force companies to reduce the number of members on the audit committee.

The intention of this requirement of strengthening corporate governance will not be achieved through having smaller audit committees and in fact audit committees of large companies should ideally consist of between 3-5 members.

The Bill does not provide any transitional arrangements with regards to the establishment of an audit committee and many companies will be in immediate non-compliance upon enactment of this legislation. This will result in directors and officers being guilty of an offence and may also result in the auditor reporting an irregularity in terms of section 45 of the Auditing Profession Act.

2.3 Section 270A: Functions and funding of audit committees

We support legislating the role of the audit committee and we agree that a properly constituted audit committee should be responsible for recommending to the board the appointment, reappointment and removal of the external auditor. We do not believe the board's responsibility for these matters should be wholly assumed by the audit committee.

Section 270A(e) requires the audit committee to pre-approve any proposed contract for the provision of non-audit services by the external auditor to the company. We agree with the

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restriction that this pre-approval may not be delegated to management and should be provided before the commencement of non-audit services.

We do, however believe that the Bill should allow the audit committee to delegate the pre-approval responsibility to certain members of the audit committee or in line with an agreed pre-approval policy, however all such engagements should be tabled at the following audit committee meeting for ratification.

2.4 Section 274A: Rotation of auditors

We agree that mandatory partner rotation should address the perceived relationship build-up between senior client staff and the audit firm.

It is unclear if the requirements of the transitional provision (section 53(3)) will be applied retrospectively or prospectively. The lack of appropriate punctuation in these provisions could result in varying interpretations of the transitional arrangements.

2.5 Section 275A: Certain non-audit services not open to current designated auditor of public interest company

Although the title of this section refers to the designated auditor only, section 275A(1) refers to "an auditor appointed" which implies both the individual responsible for the audit as well as the firm. This contradiction may result in differing interpretations and should be amended.

The Bill proposes to prohibit internal and tax advisory services by the registered auditor to public interest companies to the extent that these services will be subjected to the auditor's own audit procedures.

KPMG supports the global trends (both in the US and the EU) that prohibit the provision of services which would require the auditor subjecting the non-audit service to his/her own external audit procedures.

We do wish to point out that both internal audit services and tax advisory include a wide range of services and propose that if this course of regulation is to remain, the Bill should define those "tax advisory" and "internal audit" services it believes will be prohibited.

We believe that only a small portion of the tax advisory and internal audit services would need to be prohibited as:

- many of these services will not be subjected to the auditor's own audit procedures during the external audit; and
- many of these services will be performed as part of the external audit.

As part of providing assurance to audit clients, a large range of specialists has to be included on the audit of a modern, complex audit engagement. These expert services include (amongst

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others) forensics, internal audit services, information risk management, treasury, international advisory services, tax, actuarial, and environmental and sustainability skills. Many of these expert services provided by audit firms equip the auditor to perform the audit more effectively, as the auditor obtains an in-depth knowledge of the client's business and the skills involved are an integral part of the audit.

Whilst there is a case for again reviewing the nature of each service an auditor may provide and whether it is perceived as a conflict to his duties as an auditor, a "blanket" prohibition of any specific non-audit services to audit clients is ill founded and would actually harm audit quality by limiting the ability to recruit the range of skills required to complete a complex audit engagement.

To manage this situation, and all other instances of the auditor providing non-audit services, as is envisaged by the King II report on corporate governance, we recommend that legislation should establish a robust principles-based process applied by the audit committee that can deal with independence issues as they arise in order to keep in line with global trends. This would necessarily mean not specifying individual service prohibitions within the Bill.

2.6 Section 275: Accounting assistance

This section refers to the term 'private' company. We believe that this is an oversight, and that the reference to 'private' in this section should be replaced with the term 'limited interest company' throughout.

2.7 Section 285A: General requirements for financial statements

We agree with the requirement that all public interest companies must comply with financial reporting standards.

Section 285A(2)(a) allows limited interest companies to comply with only the accounting framework of financial reporting standards.

The International Standards on Auditing require the auditor to evaluate the measurement, recognition, presentation and disclosure of an entity's financial statements in terms of a 'recognised framework'. In the absence of a framework, the auditor is unable to express an unqualified opinion. The recognised framework must allow for consistent evaluation by different parties and result in a similar opinion on the financial statements.

Although the "accounting framework" of the financial reporting standards is a "recognised framework", it does not include any presentation and disclosure criteria. Although the Companies Act will allow such departures, the auditor will be unable to express an unmodified opinion on those financial statements.

These 'standard' modifications will negatively impact on the public perception of the company and could in fact deter the user's attention from other significant modifications such as going concern problems. Modified opinions will result in increasing difficulty for limited purpose companies to obtain funding from banks and other financial institutions.

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2.8 Section 290: Group financial statements

Section 290 allows the directors of limited purpose companies not to consolidate financial statements if certain criteria are met. This is a departure from International Financial Reporting Standards and will result in two sets of rules for exactly the same transaction. Subsection 2 requires disclosure of an inappropriate application of the Financial Reporting Standards however this departure will still result in a modified external audit opinion.

Should this requirement remain, we believe that this decision should be taken through majority consent of the shareholders and not solely by the directors. The financial report is a vehicle to report the financial results of the company to the shareholders and as such the shareholders should be afforded the right to elect the manner in which the information is conveyed.

Although section 290 allows for a legal departure from IFRS, this form of presentation and disclosure does not constitute a suitable framework. The auditor will be unable to express an unqualified opinion on the financial statements in this situation.

We suggest that this departure from IFRS be defined in the limited interest accounting standards framework, once completed.

2.9 Section 300A: Attendance of auditor

This section requires the auditor to respond according to his/her knowledge and ability to any question which is relevant to the audit. Such requirement may result in sensitive information being disclosed at an annual general meeting and, in fact, may be beyond the scope of the Promotion of Access to Information Act or the auditor's duty of confidentiality. We suggest the Bill should address some form of protection to the company, its directors and its auditors in such situations.

2.10 Section 440U: Approval and publication of standards

Section 440(U)(2) requires the Minister of Trade and Industry to approve the financial reporting standards. We believe that an additional approval layer should be not be built into an already long and resource intensive process.

We believe that the composition and mandate of the Financial Reporting Council will afford such a body with the necessary skills and experience to assess and comment on all new and revised IFRS. If the process of approval and publication of standards as set out in the Bill is followed, it will be unnecessary to include the additional approval by the Minister or publishing the financial reporting standards in the Government Gazette.

The accounting standards are updated and issued very frequently. In 2004 alone 18 IFRS's were revised and 6 new IFRS's were issued. This exposure and approval process will be expanded to include the GRAP standards and the limited purpose financial reporting standards which will increase the approval and publication rate exponentially.

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Legal backing of standards will also result in the auditor having to report a "Reportable Irregularity" to the IRBA under section 45 of the Auditing Profession Act, 2005 in instances where clients have issued incomplete or non-compliant financial statements.

In addition, there is currently a conflict between the requirements for listed entities to report in terms of International Financial Reporting Standards, whereas the Bill requires these entities to report those standards issued by the Financial Reporting Council. This is a concern as the FRC cannot issue IFRS.

2.11 Schedule 4

The majority of the disclosures required in terms of schedule 4 are already required in terms of IFRS or SA GAAP. A risk of duplicating the contents of financial reporting standards is that as such standards change, the Companies Act will require amendment. If it is not amended, this will result in inconsistencies between the requirements of the financial reporting standards (which have legal backing in terms of the proposed Bill) and the contents of the specific sections of the Act.

We acknowledge that there will be some items that remain part of the disclosure required by the Companies Act, for example, disclosure relating to the directors report and share premium, as these are not specifically dealt with in IFRS, and are particular to the requirements of the South African Companies Act.

If the intention behind keeping the detailed requirements with Schedule 4 is to require these disclosures for Limited Interest Companies, we would recommend that these requirements rather be incorporated into the Financial Reporting Standards that are to be developed by the Financial Reporting Council.

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