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REPRESENTATION BY ERNST & YOUNG CHARTERED ACCOUNTANTS

IN RELATION TO THE PROPOSED SECTION 275A OF THE COMPANIES ACT

Introduction

Ernst & Young fully appreciate that certain historical events, primarily outside of South Africa, have given rise to the concern that the auditor of a company may experience an independence conflict when rendering services, other than audit services, for consideration to that company. In the context of tax advisory services these generally comprise the provision of what are referred to as "tax based products" which commonly relate to the acquisition of finance or of assets for commercial purposes, in a particularly "tax efficient" manner. Other less contentious tax services rendered may, however, also be perceived to result in some independence conflict.

The conflict of independence referred to lies in the perception that an auditor may be less stringent in his evaluation for audit purposes, of advice given or tax based products delivered, by members of his own firm. More simply put, an auditor should not audit his own work. It is this concern that has given rise to the prohibition contained in the proposed section 275A.

We have been given to understand, after this document was drafted, that the intention of SARS in motivating the proposed legislation was not in fact to necessarily prohibit an auditing firm from performing tax advisory work for its client, as opposed to prohibiting the individual audit partner from performing such work. This restricted prohibition would naturally be far more acceptable to Ernst & Young and, we suspect, to the profession as a whole. However, for the sake of completeness and to avoid any misunderstanding of our position, we nonetheless make the following submission.

Executive summary

The auditing profession in South Africa has for many years imposed its own restrictions upon the non-audit work that an auditor may perform for his audit client. In particular, an auditor may not perform book-keeping or accounting services for his audit client. However, for good reason, tax advisory services do not fall within that prohibition. The same is true in the USA, where SEC[1] registrant audit clients may have tax advisory work performed for them by their auditor.

Tax advice takes many and different forms and can be requested in relation to tax compliance processes and to the tax consequences of specific events. Most business transactions (events) have tax consequences and many of these "tax significant events" trigger provisions of the tax law in respect of which genuine differences of opinion arise as to their proper application, between professional advisors and SARS, and between professional advisors themselves. These differences of opinion may materially affect the proper amount of tax to be paid by the taxpayer concerned. Taxpayers accordingly request advice in relation to the tax consequences of most transactions of significant value, contemporaneously with entering into them, in case the tax law concerned may be uncertain in its effect[2]. Because of their familiarity with the

[1] Securities and exchange commission. SEC registrants are essentially the equivalent of companies listed on the JSE in South Africa.

[2] The significance of such an enquiry is well illustrated by the simplified facts of a particular matter which was resolved some years ago in the Income Tax Court. Simply, a Governmental body had entered into a contract with a private organisation (company A) to perform certain infrastructural work. Company A was unable to complete the work and transferred the contract to company B (an unrelated party). The original contract price was (say) R100 and company B paid R50 to company A to acquire the contract. Company B then spent a further R30 in completing the work. Company B's book profit was therefore 100 – 50 – 30 = 20 and this was the profit contained in company B's

1. The giving of advice on the taxation consequences of proposed commercial transactions (this is the most common form of tax advisory service and is generally, per item of advice, of relatively low cost).

2 The review, for purposes of ascertaining that full compliance has taken place, of the annual or provisional tax returns prepared by the audit client in respect of his annual or other periodic liabilities.

3. The preparation of the returns mentioned in 1 above, on behalf of the client, where the client's own internal resources are not adequate to the task.

4. A combination of 2 and 3. In the case of 2, 3 and 4, a thorough knowedge of the taxpayer's business is desirable in order properly to challenge the make-up of the return and its various components and the interpretational positions taken by the client therein.

5. The identification for the client of areas in which his tax administration or business processes are deficient, in that they may lead to a greater or lesser amount than the "proper amount of tax" being paid to SARS, with consequential disadvantage to shareholders or employees or the company itself and/or the fisc. Here again, knowledge of the business is valuable although possibly less so than in 1 to 4.

6. The presentation to the client of materials which explain the meaning, application and impact of new taxes, or new provisions in existing taxes, in the context of the client's business. We note that for this purpose, an understanding of the client's business is important for the tax advisor to place the new provisions in context, so that their implications are properly understood and applied and so that the fisc achieves the result intended by the legislation. It is not always appreciated that the volume of new legislation each year is such that even specialist tax personnel within business organisations have difficulty in reading, analysing and properly applying existing and new law. They accordingly rely heavily upon professional advisors who have experience of the client's particular circumstances and operations, as well as those of the industry in which the client operates in general, in order to ensure that the tax laws are properly applied.

7. The provision of assistance to a client who finds himself in dispute with SARS as to the meaning or application of a particular provision of the law, to pursue that dispute in accordance with the administrative provisions of the Act.

We believe it is evident that in all the advisory functions referred to above, the tax advisor must have knowledge of the facts and circumstances in which the law concerned is applied. The great advantage possessed by the tax staff of a company's auditor, is that they are familiar, as a consequence of their audit work in prior periods, with the general factual background against which the provisions of the law must be applied and (generally) do not have to be "instructed" by the client as to those facts, as would be the case with another tax advisor who does not possess the same familiarity. Furthermore, experience shows that familiarity with a taxpayer's affairs in general, frequently enables an advisor to raise issues of fact and context which the taxpayer himself would not necessarily consider relevant. A greater cost effectiveness as well as better quality of advice can therefore result from an advisor's familiarity with his client's affairs in general.

The audit function and tax advisory services

As a general statement, approximately 29% (or just less than one-third) of most companies' profits are paid to SARS over a period (although there are peaks and valleys which result from specific provisions in the tax code and which are intended to have that result). The plain truth is that the "tax charge" contained

Conclusion and proposal

It is submitted that a clear case has been made that there exists a significant cost and audit-process advantage to a company, of its auditor being allowed to provide tax advisory services in relation to tax significant events. To legislate otherwise, would increase the cost of doing business and create a significant danger of qualified audit reports being issued in situations where tax advisory consultation with the taxpayer's own auditors would have avoided the problem arising.

As a general statement, tax advisory services given in relation to normal commercial transactions, business processes or legislative change are unlikely to generate revenues significant enough to raise any concern that an auditor would give anything other than a properly considered audit report.

On the other hand, it is quite clear that in certain instances there is merit in more than one advisor providing an opinion upon a tax significant event. This is particularly so, where the value of the tax consequences of the transaction concerned, might lead to an audit qualification.

The conjunction of audit responsibility and advisory revenues which might give rise to a perceived independence conflict, is most likely to occur in relation to those tax based product transactions which SARS itself perceives as high risk and high value. A provision exists in the Income Tax Act – section 76A – which provides for certain proposed transactions to be "reportable" to SARS and it is suggested that these specified transactions can be used as the cornerstone of a provision acceptable both to auditors and to Government. It is therefore proposed that in place of the suggested section 275A, a provision be considered for inclusion in the Companies Act which requires any reportable transaction as defined in section 76A of the Income Tax Act to be advised upon by a person other than the company's auditor. This would not amount to a prohibition on the auditor also giving such advice which, as we have explained, is critical to avoid potentially unpleasant consequences at the time the audit takes place.

Alternatively, or in addition to the above proposal, it could be made a requirement that an auditor should obtain pre-approval for the rendering of tax advisory services to his client, from that client's audit committee. This process is in place in the United States as a response to the US Senate report on the Role of Professional firms in the US tax shelter industry, and other US initiatives.

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statement, is not known to the audit client. Accordingly, it is impossible, without compromising the audit process itself, to identify prior to the audit, those events which will have "material" tax consequences.