THE LEGAL REGULATION OF THE EXTERNAL COMPANY AUDITOR IN POST-ENRON SOUTH AFRICA

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DECLARATION

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SUMMARY

The worldwide increase of corporate failures on the scale of Enron and WorldCom has sparked a renewed international trend of corporate governance review. With the external company auditor blamed at least in part for many corporate failures, corporate governance reform also necessitates a review of the statutory regulation of the company auditor. In particular, the lack of auditor independence when auditing clients has been under the legislator's spotlight. The problems associated with unregulated or poorly regulated auditors are well illustrated by the activities of auditing giant Arthur Andersen.

In the US, the Sarbanes-Oxley Act has been promulgated in reaction to corporate failures, imposing many new legislative restrictions on the auditor. The UK has a more tempered, self-regulatory approach. South Africa, following international trends with its recently promulgated Auditing Profession Act and Corporate Laws Amendment Act, has also greatly increased the regulation of auditor independence.

The question is now whether these new restrictions in the wake of corporate failures have been the right approach with which to prevent future failures and to provide adequate protection to shareholders. Although the general legislative increase in auditor awareness is welcomed, the efficacy of several provisions in South African legislation can be questioned.

Widespread reform has taken place in the appointment and remuneration of the auditor, which now has to be independently determined by the audit committee. In particular, South Africa's new regulation of non-audit services, and the lack of refined regulation on compulsory auditor rotation as well as the cross-employment of auditors by clients, needs a critical discussion.

It is submitted that the discretion of a well-regulated audit committee, combined with increased disclosure and transparency, should be enough to regulate most of the key aspects of auditor independence. Care should be taken to not overlegislate in haste to reform. South Africa needs a flexible and customised approach in this regard.

OPSOMMING

Die wêreldwye toename in korporatiewe skandale op die skaal van Enron en WorldCom het aanleiding gegee tot die internasionale hersiening van korporatiewe bestuur. Met die identifisering van die eksterne maatskappyouditeur as `n bydraende faktor tot korporatiewe mislukkings, het die hersiening van ouditregulering as deel van effektiewe korporatiewe bestuur, prioriteit geniet. Die probleme verbonde aan `n ongereguleerde of net swak gereguleerde ouditindustrie word goed geïllustreer deur die aktiwiteite van die gewese ouditreus, Arthur Andersen.

In die VSA, is die Sarbanes-Oxley wet in reaksie tot korporatiewe skandale gepromulgeer, wat onder meer streng nuwe statutêre beperkings op die maatskappyouditeur in werking gestel het. Die VK het `n meer gematigde, self-regulerende benadering tot ouditregulering. Suid-Afrika, in die voetspore van die internasionale tendense, het onlangs beide die *Auditing Profession Act* en die Wysigingswet op Korporatiewe Wette gepromulgeer wat die ouditeur nou strenger reguleer.

Die vraag is nou of hierdie nuwe beperkings die beste metode is om toekomstige korporatiewe mislukkings mee te voorkom en die aandeelhouers se belange mee te beskerm. Alhoewel die wetgewer se erkenning van die belangrikheid van die effektiewe regulering van die ouditeur verwelkom word, kan die effektiwiteit van verskeie van die nuwe wetsvoorskrifte bevraagteken word.

Belangrike hervorming het veral plaasgevind met betrekking tot die aanstelling en vergoeding van die ouditeur, wat nou onafhanklik deur die ouditkomitee vasgestel moet word. Spesifieke areas wat `n kritiese bespreking regverdig, sluit Suid-Afrika se nuwe regulering van nie-oudit dienste deur die ouditeur in, asook die gebrek aan regulering van verpligte ouditeur rotasie en die klient se indiensneming van sy ouditeur.

Dit word aangevoer dat die diskresie van `n goed gereguleerde ouditkomitee, gekombineer met toenemende openbaarmaking en deursigtigheid deur beide die komitee en ouditeur, voldoende is om die meeste sleutelaspekte van ouditeur-onafhanklikheid te verseker. Wetgewende hervorming moet met omsigtigheid benader word. Haastige wetgewing kan maklik tot oorregulering lei. Suid-Afrika benodig `n unieke en aanpasbare benaring in hierdie verband.

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LIST OF TERMS AND ABBREVIATIONS

AGM	annual general meeting
AICPA	American Institute of Certified Public Accountants
ASB	Auditing Standards Board
CA(SA)	Chartered Accountant, South Africa
CEO	chief executive officer
CGAA	Co-ordinating Group on Audit and Accountancy
CIPRO	Companies and Intellectual Property Registration Office
CPA	Certified Public Accountant
DTI	Department of Trade and Industry
FASB	Financial Accounting Services Board
FRC	Financial Reporting Council (UK)
FRIP	Financial Reporting Investigatory Panel (SA)
FSRC	Financial Standards Reporting Council (SA)
GAAP	Generally Accepted Accounting Principles
GDP	gross domestic product
IAS	International Accounting Standards
ICAEW	Institute of Chartered Accountants in England and Wales
IFRS	International Financial Reporting Standards
IODSA	Institute of Directors in Southern Africa
IPO	initial public offering
IRBA	Independent Regulatory Board for Auditors
IRRC	Investor Responsibility Research Centre
ISA	International Standards on Auditing
ISB	Independence Standards Board

JSE	Johannesburg Securities Exchange (South Africa)
KING I	King Report on Corporate Governance in South Africa 1994
KING II	King Report on Corporate Governance in South Africa 2002
LSE	London Stock Exchange
NYSE	New York Stock Exchange
OFT	Office of Fair Trading
PCAOB	Public Company Accounting Oversight Board
POB	Public Oversight Board
RSA	Republic of South Africa
SEC	Securities and Exchange Commission
SOA	Sarbanes-Oxley Act of 2002
SPE	special purpose entity
SRO	self-regulatory organisation
SRP	Securities Regulation Panel
USA	United States of America
UK	United Kingdom
$	US Dollar

CHAPTER 1

INTRODUCTION

1 1 THE IMPORTANCE OF CORPORATE GOVERNANCE

The increased separation between the ownership and management of companies and the vast scope of corporate mismanagement over recent years, has given rise to an increasing need for the development of an efficient system of rules that does not leave the power of corporate management unchecked.

Corporate governance can be simply defined as "the system by which companies are directed and controlled".[1] Although the term "corporate governance" has only been popularised from the 1990's, the concept and practice is as old as companies itself.[2] However, the traditional corporate governance rules have proved ineffective in limiting or preventing corporate malfeasance in the modern company. With the prevalence of multinational companies, increased listings on stock exchanges and with the revenue of the largest global firms comfortably exceeding the GDP of smaller first world countries,[3] the need for updated corporate governance regulation that keeps track with the rapid growth and modernisation of companies, is clearly essential. This incredible growth of companies has led James Wolfensohn, previously president of the World Bank, to note that "[t]he proper governance of companies will become as crucial to the world economy as the proper governing of countries".[4] It is thus imperative that corporate governance regulation evolves with the companies it aims to regulate.

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[1] Cadbury Committee *Report of the committee on the financial aspects of corporate governance* (1992) par 2.5 ("Cadbury Report") <http://www.ecgi.org/codes/code.php?code_id=132>.
[2] Mongalo *Corporate law & corporate governance* (2003) 185.
[3] For example, the revenue of the largest oil company in the world, ExxonMobil, was reported as $377.6 billion in 2006. The GDP of Switzerland was $377.2 billion in 2006. Norway, Austria, Denmark, Portugal and Ireland all had smaller GDP's than Switzerland. Although the comparability of company revenue with countries' GDP is often criticized, this information is still valuable to convey a general idea of how pervasive the power and economic influence of a global company truly is. Hargreaves "Exxon posts biggest annual profit ever" *CNN* (2007-02-01) <http://money.cnn.com/2007/02/01/news/companies/exxon/index.htm>; International Monetary Fund <http://www.answers.com/topic/list-of-countries-by-gdp-nominal>.
[4] King Report on corporate governance 2002 ("King II") par 7.2.

Modern corporate governance as known today can be described as follows:

> "Corporate governance is concerned with the enhancement or fortification of the rules and principles of company direction for the purpose of accommodating the modern environment within which companies operate and the imposition of stricter checks and balances to curb or alleviate malpractices or wrongdoings by those engaged in corporate decision-making."[5]

This modern emphasis on corporate governance has increased the regulation of the key role players in the company's governance structure. Recent reforms have focused on improving managerial accountability, with particular focus on non-executive directors and the remuneration and audit committees of the company board. The regulation of the auditor has recently received much regulatory attention because of the importance of the auditor's role in the reliability of companies' financial statements and thus indirectly on management and investor decision-making.[6] In particular, the auditor has frequently been cited as one of the main contributing parties to the failure of corporate governance. Several corporate failures all over the world from the 1990's and most famously, Enron, has clearly directed some of the blame for their failure to the ineffective regulation of the external company auditor. Attempts at reform of the auditor's role have been mainly aimed at the increased regulation of the company auditor, with particular focus on regulating auditor independence. It is thus within this framework of corporate governance that the statutory regulation of the auditor will be discussed.

As stated in the Cadbury report:

> "The annual audit is one of the cornerstones of corporate governance...the audit provides an external and objective check on the way in which financial statements have been prepared and presented, and it is an essential part of the checks and balances required. The question is not whether there should be an audit, but how to ensure its objectivity and effectiveness."[7]

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[5] Mongalo *Corporate law* 185.
[6] Mongalo *Corporate law* 180-182.
[7] Cadbury Report par 5.1.

1 2 THE EXTERNAL AUDITOR

1 2 1 DEVELOPMENT OF THE ROLE OF THE EXTERNAL AUDITOR

The word "auditor" is derived from the Latin *audire* which means "to hear".[8] The use of the term "auditor" as an independent verifier of financial affairs can be traced back as early as 1285,[9] although the concept dates back to ancient Egypt. Custom determined that slave masters periodically called their slaves to verify how the slave managed the portion of his master's wealth that was charged to his care. This would usually concern the scope of the work that slave has performed that day, in particular what has been bought and sold by the slave.[10] From this practice, a secondary meaning of the word *audire* has later developed to be known as "one who satisfies himself as to the truth of the accounting of another".[11]

As accounting and bookkeeping practices evolved, so did the auditing profession. Oral reports were quickly replaced by written reports, although these were initially complicated by the use of Roman numerals. After Luca Pacioli's double-entry bookkeeping system became popular and associations for accountants were founded across Europe from the late sixteenth century onwards,[12] the need for more formalised auditing practices arose to keep up with rapidly developing accounting methods.[13]

The industrial revolution heralded the birth of modern auditing as known today, when the increasing popularity of joint stock companies and the increasing separation between ownership and management demanded an independent and honest report to the shareholders on the state of affairs in the company they part-owned but had no control over. Over time, the company auditor became an invaluable agent for the shareholders of companies, as it still is today. Shareholders rely largely on the audited or verified reports of companies for reliable financial information on the state of affairs of their investment.

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[8] Puttick & van Esch *The principles and practice of auditing* 8 ed (2003) 1.
[9] King Edward I passed the first statute that required audits to take place in certain circumstances. Slave masters had to assign auditors to audit the records of slaves who keep up their master's accounts. Arrearages found by the auditor often lead to the imprisonment of those slaves. Puttick & van Esch *Auditing* 2.
[10] Jackson & Stent *Auditing notes for South African students* 6 ed (2007) 1/2 – 1/8.
[11] Puttick & van Esch *Auditing* 1.
[12] The first society for accountants, the *Collegio dei Raxonati* was founded in Venice in 1581. Puttick & van Esch *Auditing* 3.
[13] Puttick & van Esch *Auditing* 2-3.

The external audit function of a company has evolved with time as well:

> "Auditing began as a management tool to detect employee fraud. This was corporate management's greatest need through the beginning of the twentieth century. At this early juncture, there was no concept of auditor independence. Auditors sat on corporate boards and did not have a united professional society or status as a profession. There was no disciplinary oversight authority governing how auditors conducted themselves. They were not public accountants. The financial statements they prepared for their clients did not have to comply with any meaningful standards."[14]

Today, it is a statutory requirement in most jurisdictions that all companies have to appoint an auditor.[15] The auditing industry has developed into a sophisticated global network of auditing firms, with auditors providing a wide range of both audit and non-audit services.[16]

The main function of the external company auditor ("auditor")[17] is to "express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework."[18] This (main) audit function is often termed the "assurance" function.[19] It should be noted that the external auditor may also perform a variety

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[14] Weiss & Berney "Restoring investor trust in auditing standards and accounting principles" 2004 *Harvard Journal of Legislation* <http://www.law.harvard.edu/students/orgs/jol/vol41_1/weiss.pdf>.
[15] See, for example, s 270 of the Companies Act; ss 485, 489 of the UK Companies Act 2006.
[16] *Cf* n 63.
[17] It should be noted that, although the term "auditor" will be used throughout this thesis, the terms "auditor" and "accountant" are often used interchangeably. However, the functions of accounting and auditing should not be confused. Where accounting can be defined as the *processing* of financial data, auditing is the objective, critical *evaluation* of that data. Because auditors obviously have to understand these data before they will be able to evaluate it, auditors are first and foremost trained as accountants. Porter, Simon & Hatherly *Principles of external auditing* (1996) 7.
[18] SAICA *Handbook Vol 2 Auditing* (2006) 66. Other types of auditing do occur in the company environment. These include operational, forensic, internal and management auditing. However, these audit activities differ vastly from the legislative duty of the external auditor towards the company's financial statements, and are thus expressly excluded from the scope of this thesis. It is also important to distinguish the internal auditor from the external auditor. Where the external auditor provides assurance to external parties, the internal auditor provides assurance to internal parties, usually management. Internal auditors, virtually unregulated by statute, can be either employees or an outsourced company. The nature and frequency of the internal audit will vary according to the needs of management. Most often, management will seek assurance from an internal auditor that systems within the company are functioning properly. This may or may not be the financial reporting system, and can vary from the company's internal control system to, for example, the implementation of health regulations. External auditors will often rely on the reports of internal auditors in assessing the financial statements. Porter et al *External auditing* 6; Puttick & van Esch *Auditing* 31-34; Wixley & Everingham *What you must know about corporate governance* (2002) 105.
[19] Puttick & van Esch *Auditing* 23.

of other, non-audit (or non-assurance) functions, such as the drafting of financial statements, tax services, and general advisory functions.[20]

Porter et al provides the following definition of an auditor:

> "Auditors are essentially intermediaries between the management of an entity and external parties interested in the entity. They have a duty to form and express an opinion as to whether or not the entity's financial statements (which are prepared by management for shareholders and other parties outside the organisation) present a true and fair view of the entity's financial position and performance. If the users of the financial statements are to believe and rely on the auditor's opinion, it is essential that the auditor is, and is seen to be, independent of the entity, its management and any other interested party."[21]

With the auditor as a key role player in corporate affairs, the development of corporate governance has also been visible in the development of audit regulation over recent years. Independence, in particular, is an essential characteristic of an auditor, and has been referred to as "the cornerstone of auditing"[22] Regulating auditor independence has therefore become one of the priorities of recent corporate governance regulation.[23]

Although early legislation recognised the auditor as essential to the governance of the company,[24] the role of auditor *independence* as part of good corporate governance, was only recently acknowledged. The lack of auditor independence is especially prevalent in many large corporate failures, as illustrated by the activities of the now defunct auditing giant, Arthur Andersen.

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[20] Cf 3 4 infra.
[21] Porter et al *External auditing* 64.
[22] Stewart in Porter et al *External auditing* 64.
[23] *Cf* 3 6 *infra*.
[24] For example, s 38 of the UK's Joint Stock Companies Act of 1844 required all companies to appoint an auditor.

1 2 2 CORPORATE COLLAPSE AND THE EXTERNAL AUDITOR: A CASE STUDY OF ARTHUR ANDERSEN

The 1990's hailed a new era of corporate fraud. With several high profile companies collapsing, leaving a myriad of investigations, lawsuits and disillusioned shareholders in their wake, the question begs: Who is to blame?

It is acknowledged that companies fail for a multitude of reasons, some of which are not necessarily a result of a lack of adherence to good corporate governance or auditor independence principles.[25] Yet suspiciously often, it is insufficient adherence by the auditor to precisely these principles that significantly contribute to these failures. This section does not attempt to explore all the reasons for corporate failures, but rather aims to recognise the importance of the effective regulation of the external auditor as a means of preventing future disasters. Arthur Andersen's role in numerous high profile corporate failures, eventually resulting in its own demise, aptly illustrates the danger in under-regulating the auditing industry.

A scrutiny of Arthur Andersen's business practices reveals abundant examples of independence concerns: The delivering of both audit and non-audit services, employment of the audit clients' ex-employees and *vice versa,* the competitive nature of the industry and little or no audit firm or audit partner rotation all provide ample opportunity to disregard good corporate governance practices in favour of the bottom line.[26] The prevalence of these concerns should be noted throughout the discussion *infra.*

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[25]Inadequate internal control systems, non-adherence to auditing principles and insufficient auditing experience are all considered to be contributory factors in the fall of Arthur Andersen. For a discussion of these factors see Cunningham & Harris "Enron and Arthur Andersen: The Case of the Crooked E and the Fallen A." 2006 *Global Perspectives on Accounting Education* 27-48.
<http://gpae.bryant.edu/~gpae/ Vol3/Enron%20and%20Aurhur%20Andersen.pdf>.
Cunningham and Harris summarise the various reasons for Enron's collapse as follows: "Enron was a massive failure, partly because of its size, partly because of its complexity, partly because the controls to protect the integrity of capital markets failed, and especially because of the massive greed and collusion of key participants. Management failed, auditors failed, analysts failed, creditors/bankers failed, and regulators failed. The intersection of multiple failures sent a signal of structural problems…The speed with which the system responded indicates the importance of fairly presented financial information."
Cunningham & Harris *Global Perspectives* 47.

[26] *Cf* 3 6 *infra.*

1 2 2 1 The rise of Arthur Andersen

Originally a highly reputable firm often referred to as "the conscience of the accounting industry",[27] auditing giant Arthur Andersen ("Andersen")[28] managed to plummet to notoriety and complete financial and operational ruin in a matter of months. Not only did Andersen contribute to the collapse of some of their clients, but Andersen itself is also a prime example of a corporate failure in its own right. A study of Andersen's business practices reveals a remarkable pattern of dubious corporate governance methods that originated in the 1950's and eventually culminated with Enron, leading to the once prolific auditor's rapid downfall.[29]

In the early days of Andersen, auditing was a much less contentious affair with almost no scandal, lawsuits and ethical crises.[30] The 1950's heralded a significant change in the auditing profession as large companies were introducing computerised accounting systems as part of their daily operations. Andersen started building up a technology practice that resulted in Andersen both auditing a client's financial statements and installing computer systems.[31] Andersen's eagerness to match the growing demand for a variety of non-audit services escalated in the following years, whilst staying on track with the rapid computerisation and internationalisation of companies.

The major part of Andersen's corporate backslide took place from the early 1990's: the company divided their functions into two subsidiaries under the umbrella of the newly created holding company known as Andersen Worldwide SC in 1989. Andersen continued to render auditing services while Andersen Consulting provided solely consulting services. A profit-sharing scheme was instituted whereby the more profitable of the two subsidiaries had to hand over a percentage of their profits to the other, thereby ensuring a certain degree of interdependence between the companies.[32]

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[27]Brown & Dugan "Arthur Andersen's Fall from Grace is a Sad Tale of Greed and Miscues" *Wall Street Journal* (2002-06-07) <http://bodurtha.georgetown.edu/enron>.

[28] It should be noted that Arthur Andersen only changed its name to "Andersen" in 2001. The shortened reference is used throughout for the sake of consistency.

[29] Andersen generated $9.3 billion in revenue worldwide and stood 85 000 employees as recent as 2001. Brown & Dugan *Wall Street Journal* (2002-06-07).

[30] Founder Arthur Andersen famously refused to approve suspicious transactions with influential clients, regardless of whether his bottom line and even solvency were at stake. The founder's integrity was often hailed as an example to the auditing industry. Brown & Dugan *Wall Street Journal* (2002-06-07).

[31] *Cf* 3 6 1 *infra.* S 201(2) of the Sarbanes Oxley Act now precludes the rendering of financial information systems design and implementation by the external auditor.

[32] Brown & Dugan *Wall Street Journal* (2002-06-07).

As the consulting industry boomed, largely because of the increasing need for technology and technology-related services, profits still had to be shared and the consulting side had to hand over increasingly larger slices of the revenue pie to the auditors. This created what would later appear to be an irreconcilable tension between the two companies.[33] By 1993, Andersen was so far behind Andersen Consulting in terms of profit, that Andersen Consulting was paying up to $150 million a year to the ailing auditor. Andersen Consulting officially severed its ties with Andersen in 2000 and changed its name to Accenture.[34] With no subsidy to rely on, the audit company introduced a strict new profit-seeking policy whereby partners were expected to sell non-audit services to clients in a 2:1 ratio: partners had to bring in twice the amount in non-audit services than they have done with auditing services up to date.[35] This shift of focus required auditors to trade their traditional role as independent watchdogs of financial propriety for the less desirable role of salespeople in a cutthroat environment. Employees who did not conform to the new bottom line oriented "Andersen Way" were promptly dismissed.[36]

1 2 2 2 Waste Management

Andersen established a close 26-year long auditor-client relationship with refuse company Waste Management since Waste Management went public in 1971. Waste Management made full use of Andersen's pool of expertise: in the period of 1971 to 1997, Waste Management recruited their financial director and chief accountants from the Andersen family until there eventually were fourteen ex-Andersen staff in senior financial positions.[37]

A 1993 audit of Waste Management revealed accounting discrepancies to the value of $128 million. Andersen incorrectly issued an unqualified audit report and reorganised the accounting affairs so that the $128 million loss was amortised over five to seven years, instead of being written off immediately.[38] Other questionable accounting practices, such as understating depreciation on fixed assets to overstate both profit and assets, were either

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[33] Brown & Dugan *Wall Street Journal* (2002-06-07).
[34] Niece & Trompeter "The demise of Arthur Andersen's One-Firm Concept: A Case Study in Corporate Governance" 2004 *Business and Society Review* 183-197.
[35] Brown & Dugan *Wall Street Journal* (2002-06-07).
[36] Chicago Tribune "The Fall of Andersen" (2002-09-01). <www.chicagotribune.com/news>
[37] Basson "Change of Culture Will Take Some Doing" *Finance Week* (2004-08-11). *Cf* 3 6 3 *infra.*
[38] This approach is contrary to GAAP. Basson *Finance Week* (2004-08-11).

ignored or purposely overlooked by the auditors.[39] It is believed that the Waste Management audit committee's decision to limit the audit fee paid to Andersen provided the auditor with additional incentive to expand their non-audit services as the only way to enhance profits from Waste Management.[40] The total amount of audit fees paid to Andersen during the period of 1991 to 1997 was only $7.5 million, whereas the total non-audit fees paid was a hefty $17.5 million.[41] The wide array of non-audit services provided to Waste management included tax, legal, consulting and attest services.[42]

Once the accounting irregularities as condoned by Andersen came to light in 1999, Waste Management was forced to make the "greatest restatement of income statement figures in US corporate history".[43] The auditor had to pay Waste Management $20 million on grounds of accounting malpractice. This followed a hefty class action settlement agreement of $229 million, paid by Andersen and Waste Management to the latter's investors in response to allegations of dubious accounting practices.[44] The Securities and Exchange Commission ("SEC") reacted to Andersen's role in Waste Management's restatement by charging Andersen for "'knowingly or recklessly' issuing substantially false and misleading audit reports".[45] In June 2001, Andersen was fined a record $7 million by the SEC.[46]

1 2 2 3 Enron

The collapse of energy giant Enron is the largest and most significant in a series of Andersen client failures. Enron hurtled towards bankruptcy in a matter of months: three months before its demise, the seventh largest company in the US stood $62.8 billion strong on paper. The Enron share price plummeted from $75 to 72c in less than a year, after Enron eventually admitted to overstating its profits by $586 million since 1994.[47]

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[39] Brown & Dugan *Wall Street Journal* (2002-06-07).
[40] Niece & Trompeter Business and Society Review 199.
[41] Brown & Dugan *Wall Street Journal* (2002-06-07).
[42] Niece & Trompeter 2004 *Business and Society Review* 199.
[43] Enron replaced Waste Management's short-lived record mere months later. In turn, WorldCom later overtook Enron as the biggest corporate collapse in US history.
[44] CNN "Waste Management Settles" (2001-11-07). <http://money.cnn.com/2001/11/07/news/waste_mgt/index.htm>.
[45] CNN (2001-11-07). *Cf* 2 2 1 *infra* for a discussion of the SEC.
[46] Basson *Finance Week* (2004-08-11).
[47] Vinten "The Corporate Governance Lessons of Enron" 2002 *Corporate Governance* 5; Deakin & Konzelmann "Learning from Enron" 2004 *Corporate Governance* 135-136.

The severity of the behemoth's collapse and the scope of previously hidden losses sent shockwaves through the global corporate community. Approximately 11 000 employees[48] lost both their livelihood and their pension, as the Enron employee pension fund constituted 62% of Enron's total shares, all of which was now rendered completely worthless.[49] An unsuccessful attempted merger with Enron's smaller energy competitor, Dynergy, signalled the end of an era: On the first of December 2001, Enron filed for bankruptcy protection.

As the external auditor of the company since it changed its name to Enron, Andersen was the only external auditor for sixteen years. Andersen implemented a newly designed "integrated audit" package that combined a wide array of audit and non-audit services: this package left Andersen in charge of the whole internal audit function since 1994, after securing a lucrative five-year contract with Enron worth $18 million.[50] The integrated audit package also included business and legal advice.[51] As Enron employees themselves were previously in charge of the internal auditing function before the task was outsourced to Andersen, the whole Enron internal audit team was promptly hired by the external auditor.[52] Andersen employees even set up their office inside Enron's Houston building. The overly close relationship between Enron and Andersen staff was strengthened by the fact that many ex-Andersen employees were snapped up by Enron and consequently, Andersen auditors were auditing the work of ex-colleagues.

Andersen was doing its utmost to appease its largest and most profitable client in Texas. Andersen's Professional Standards Group, an internal committee of experts that determined the accounting protocol to be followed by all Andersen staff, frequently questioned the methods used by the Andersen staff on the Enron audit, only to cave under pressure from their client. Enron continued to increase pressure on Andersen to approve the use of "creative and aggressive"[53] accounting methods and even "intelligent gambling"[54] with revenue figures

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[48] Michalowski & Kramer "Beyond Enron: Toward Economic Democracy and a New Ethic of Inclusion" 2003 *Risk Management: An International Journal* 37 37.
[49] BBC News Online "Enron: Timeline" *BBC* (2007-12-16) <http://news.bbc.co.uk/hi/english /static/in_depth/ business/2002/enron/timeline/12c.stm >.
[50] Brown & Dugan *Wall Street Journal* (2002-06-07); Chicago Tribune "Ties to Enron Blinded Andersen" (2002-09-03) <http://www.chicagotribune.com/business/chi-0209030210sep03,0,6882143.story.>. *Cf* 3 6 1 *infra*.
[51] Lepaku "Non-audit Services" 2006 *Juta's Business Law* 160 160-162.
[52] *Cf* 3 6 3 *infra*..
[53] Oppel & Eichenwald "Enron's Collapse: The Overview; Arthur Andersen Fires an Executive for Enron Orders" *New York Times* (2002-01-16) <http://query.nytimes.com/gst/fullpage.html>.
[54] Deakin & Konzelmann 2004 *Corporate Governance* 140.

and off-balance sheet transactions.[55] Enron's demands eventually resulted in the dismissal of a member of the Professional Standards Group who repeatedly objected to Enron's proposed accounting methods.[56]

The amount of influence that Enron exercised over its auditor is directly in contrast to the principle of independence. As word spread that the SEC would launch an investigation into Enron's spectacular third quarter losses, the audit partner in charge of the Enron audit ordered the mass shredding of Enron paperwork and deletion of electronic records.[57] The shredding only stopped more than two weeks and approximately 30 000 computer files and emails later on 8 November 2001, pursuant to the issue of a subpoena against Andersen.[58] It is this mass erasure that resulted in the obstruction of justice charge, the indictment alleging that Andersen had "knowingly, intentionally and corruptly persuade[d] and attempt[ed] to persuade other persons, to…withhold…and… alter, destroy, mutilate and conceal objects with [the] intent to impair the objects' integrity and availability for use in such official proceedings".[59]

Andersen was subsequently found guilty on the charge of obstruction of justice, and ceased auditing public companies by 31 August 2002, due to pressure from the authorities to give up its auditing license.[60] On 31 May 2005, the Supreme Court unanimously overturned the Andersen conviction, citing that the jury instructions "failed to convey the requisite consciousness of wrongdoing", which left the scope to determine intent too wide.[61] This technicality, although saving Andersen some dignity, did not allow the defunct auditor a re-

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[55] Vinten 2002 *Corporate Governance* 5; Deakin & Konzelmann 2004 *Corporate Governance* 135-136. Enron was involved in a number of questionable off-balance sheet accounting transactions, which enabled them to manipulate the official profits. This created the illusion of rapid growth whilst hiding losses in off-balance sheet entities. High-risk liabilities and resultant losses were ringfenced in Special Purpose Entities ("SPE"s). Andersen knowingly cleared off-balance sheet transactions as legitimate, even when it did not comply with the necessary accounting requirements. Andersen later reversed its approval, forcing Enron to disclose their SPEs complete with their hidden liabilities in the consolidated statements. This led to the second largest profit restatement in the history of corporate America and a complete revaluation of Enron's assets and liabilities.

[56] Housworth "Enron and Arthur Andersen: To Comply is Not Enough" 2002 *CriticalEye* <http://spaces.icgpartners.com/get_document.asp?guid=FCA0F3E8E2064F9784460B5CD5A17049>.

[57] United States District Court Southern District of Texas *Indictment (US v Arthur Andersen, LLP)* (2002-03-07) <http://news.findlaw.com/hdocs/docs/enron/usandersen030702ind.html>.

[58] Oppel & Eichenwald *New York Times* (2002-01-16); Chicago Tribune "Ties to Enron blinded Andersen" (2002-09-03).

[59] United States District Court *Indictment* (2002-03-07).

[60] BBC News Online (2002-06-17) <http://news.bbc.co.uk/2/hi/business>.

[61] *Arthur Andersen LLP v United States* (04-368) 544 US (2005) 9.

entry in the auditing industry.[62] All of Andersen's clients had defected to rival auditors[63] leaving only a few employees at the Andersen office to tie up loose administrative ends: a shameful end to a once highly esteemed auditing powerhouse.

1 2 2 4 Conclusion

Waste Management and Enron, although the major Andersen failures, are by no means the only ones. Andersen's failed audit of US car company DeLorean in the 1980's, resulted in a £80 million loss to the UK government and had Margaret Thatcher banning Andersen from auditing any UK public sector entity.[64] In another case, appliance company Sunbeam was advised by Arthur Andersen to adjust their sales figures to the extent that it was effectively artificially inflated. In May 2001, Arthur Andersen eventually reached a settlement[65] of $110 million with Sunbeam investors, after reporting irregularities came to light.[66] This would be the first of three SEC investigations into Arthur Andersen's alleged misconduct.[67] Other cases where Andersen has agreed to settle include Colonial Realty,[68] Baptist Foundation of Arizona[69] and WorldCom[70] among several other high profile cases.[71] Most of these collapses

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[62] Cunningham & Harris 2006 *Global Perspectives* 34.
[63] Arthur Andersen was well-known as the largest of the "Big Five" international auditing companies in the industry. Its demise left its peers Ernst&Young, KPMG, PricewaterhouseCoopers and Deloitte remaining as the "Big Four".
[64] Hughes "No Accounting for greed" *BBC News Online* (2002-07-23). <http://news.bbc.co.uk/1/hi/ business/2147095.stm>.
[65] All of Andersen's settlements were reached "without admitting any wrongdoing." Kadlec "Enron: Who's Accountable?" *New York Times* (2002-01-13). <http://www.time.com/time/business/article/ 0,8599,193520,00. html>.
[66] Brown & Dugan *Wall Street Journal* (2002-06-07).
[67] The other investigations were with relation to Waste Management and Enron.
[68] Settled by 1993. Andersen paid $90 million. The Connecticut Attorney General's office investigated alleged shredding of documents and an overly close auditor-client relationship as reasons for the collapse. Connecticut Attorney General's Office *Press release* (2002-01-17) <http://www.ct.gov/ag/cwp/view.asp?A=1777&Q=28 3758>.
[69] Settled in March 2002. Andersen agreed on a $217 million settlement. The Foundation administered an illegal Ponzi scheme, whereby the first investors are paid with the money of later investors. About 13 000 investors lost almost $600 million. This was the biggest collapse of a non-profit organization in US history. "The Enron bankruptcy was the same type of thing as the Baptist Foundation, it was just more zeros. There's the same hiding of debt, the same overstatement of profits, the same easiness of spotting it once you looked." Hughes *BBC News Online* (2002-07-23); Bernstein Litowitz Berger & Grossman LLP *BFA Liquidation Trust v Arthur Andersen, LLP* <http://www.blbglaw.com/cases/bfa_v_arthur_andersen.html>; Iwata "Andersen to pay $217M in Baptist Foundation case" *USA Today* (2002-01-03). <http://www.usatoday.com/money/finance/2002-03-01-andersen-baptist-settlement.htm>.
[70] Settled in 2005. Andersen paid $65 million. *Cf* CBS News "$65 Million Tab for WorldCom Auditor" (2005-04-26) <http://www.cbsnews.com/stories/2005/04/26/national/main690961.shtml>; Carpenter "Andersen's WorldCom story similar to Enron excuse" *Associated Press* <http://www.chron.com/disp/ story.mpl/special/

have striking similarities in the excessively close auditor-client relationships, the destruction of key documentation, the overlooking of obvious accounting errors and fraud and an eagerness to comply to the wishes of the client, even if it implied pushing the boundaries of acceptable standards.

Although all the large auditing companies have their fair share of failed audits,[72] Andersen has surpassed them with regard to the scope, frequency and publicity of the collapse of some of its major clients. Although there were several investigations and government intervention in the aftermath of these auditing failures, these were merely reactive measures.[73] The lack of sufficient preventative measures in the regulatory framework at the time of these corporate failures, created an environment in which it could become easier and even common practice to push the limits of acceptable auditing practice, sometimes even to the point of fraud.

The US legislator has since intervened by promulgating the Sarbanes-Oxley Act which now prohibits most of the independence concerns listed *supra.* This new legislation initiated a worldwide trend of corporate law review. To ban certain non-audit services and to legislate precautionary measures is no guarantee that an Andersen-like debacle will not repeat itself. It is up to the integrity of the auditor, combined with its adherence to corporate governance principles and independence in both fact and appearance, to ensure that the corporate disasters on the scale of Enron and WorldCom will not be repeated.

Andersen/1474232.html>; Bernstein Litowitz Berger & Grossman LLP *Background.* <http://www.world comlitigation.com/html/casebackgroundm.html>.

[71] For a discussion of these and further cases, see Hughes *BBC Online* (2002-07-23); Kelly "Andersen linked to other shady cases" *Associated Press* (2002-01-18) <http://seattlepi.nwsource.com /business/54925_ andersen18.shtml>; Bodurtha *Scandal Scorecard* (2002-11-02). <http://bodurtha.georgetown.edu/enron/ scandal_scorecard_021102.htm>.

[72] For a comprehensive discussion of the Big Five auditing firms and each of their failures inside and outside of the US, see Simms "Five Brothers: The Rise and Nemesis of the Big Bean Counters" 2002 *New Economics Foundation.* <http://www.neweconomics.org/gen/z_sys_publicationdetail.aspx?pid=100>.

[73] The reactionary provisions of Sarbanes-Oxley has led David Skeel to comment: "These reforms...were so clearly inspired by the recent scandals that they might well be called the Future Enron Prevention Act." Skeel *Icarus and American Corporate Regulation* in Armour & McCahery (ed) *After Enron. Improving Corporate Law and Modernising Securities Regulation in Europe and the US* (2006) 129 135-136.

1 3 AIM, SCOPE AND LIMITATIONS OF THIS STUDY

The aim of this study is to evaluate the extent to which the modern emphasis on corporate governance has changed the regulation of the external auditor of public companies. The effectiveness of the realisation of the corporate governance mandate in new and pending South African regulation is criticised and compared with the regulatory frameworks of the USA and the UK. The scope of the study is limited to public companies, both listed and unlisted. Key aspects of the role of the external auditor will be discussed in detail. Each provision will be weighed against the main goals of legislation, namely the protection of shareholders and creditors and the prevention of future corporate failures, to determine the accuracy and effectiveness thereof.

Chapter one has served as a background on corporate governance, the role of the auditor and illustrated the problems with the regulation of the auditor with a case study on Arthur Andersen. Chapter two will focus on general aspects of auditor regulation. It will briefly describe the historical development of South Africa's auditing legislation, and set out the regulatory framework for each jurisdiction to be discussed, i.e. the US, UK and South Africa. Because of the importance of the audit committee in the reform of audit legislation, a discussion of the South African audit committee is included. The chapter concludes with an analysis of current statutory auditor liability.

Chapter three provides a detailed look at the more contentious areas of audit legislation. In particular, the focus will be on auditor independence, and how key aspects of independence (non-audit services, rotation, cross-employment, competition and disclosure) have been addressed by recent legislation. Throughout all the chapters, suggestions for improvement will be made by means of comparative analysis with the US and UK. Chapter four will conclude.

CHAPTER 2

THE LEGAL REGULATION OF THE EXTERNAL AUDITOR: GENERAL ASPECTS

2 1 HISTORICAL DEVELOPMENT OF AUDITING LEGISLATION IN SOUTH AFRICA

The South African auditing profession, as in the rest of the world, was originally self-regulated by several provincial accounting bodies and societies. These South African societies were all mainly established around the turn of the 20th century.[74]

The first attempt at auditing legislation was made in 1912 in the form of the Union Accountants' Registration Bill as an attempt to secure uniform legislation for all four provinces. Previously, each province regulated these matters separately. This attempt failed. The next legislative attempt was made in 1923 to establish one national accounting body that would regulate all chartered accountants. This attempt, too, failed, but the introduction of the Companies Act of 1926 paved the way for the increased legislation of individuals and professions involved in corporate affairs. Subsequently, in 1927, the first national legislation on the company auditor was passed in the form of the Chartered Accountants' Designation Act.[75] However, this act did not regulate the auditor substantively but only determined when chartered accountants were authorised to use the official CA(SA)[76] designation.[77]

Finally, after much deliberation, the first comprehensive piece of legislation, the Public Accountants' and Auditors' Act,[78] came into operation on 1 November 1951. This act provided a comprehensive framework for the regulation of auditors on a national level. This act also established the Public Accountants' and Auditors' Board ("PAAB"). The act

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[74] The first professional accounting body was established in the Transvaal in 1894, known as The Institute of Accountants and Auditors in the South African Republic. Natal followed suit in 1895 with the establishment of The Institute of Accountants. The Transvaal Society for Accountants was created later in 1904, with the Natal Society for Accountants established in 1909. The Cape Province and Orange Free State followed suit in 1907 with their establishment of similar provincial societies. In an attempt to unify the provincial societies, the first national society was established in 1946, called the Joint Council of Chartered Accountants. Puttick & van Esch *Auditing* 4.
[75] 13 of 1927.
[76] Chartered Accountant (South Africa).
[77] Puttick & van Esch *Auditing* 4-5.
[78] 51 of 1951.

empowered the PAAB with the power to regulate the academic requirements and registration of accountants and auditors. Other important statutory functions of the PAAB included a general investigatory function and the authority to regulate professional insurance of registered accountants and auditors. The 1951 act thus mainly focused on nationalising the educational requirements for becoming a registered accountant and establishing the PAAB as regulatory entity.[79]

The 1951 act was repealed by the Public Accountants' and Auditors' Act 80 of 1991. This 1991 act did not change any major provisions. The 1991 act was recently repealed with the promulgation of the Auditing Profession Act in 2006.[80]

[79] Ss 21-28 of the Public Accountants' and Auditors' Act 51 of 1951.
[80] *Cf* 2 2 2 *infra* for a discussion of the Auditing Profession Act 26 of 2005.

2 2 PRESENT REGULATORY FRAMEWORKS

2 2 1 UNITED STATES

US corporate law consists of a dual legislative system: federal law and individual state law. Congress has the express constitutional power to regulate, on federal level, any activity that has a direct or indirect impact on interstate commerce.[81] As a corollary, each state has the implied power to enact regulation on any interstate commercial activity that has been left unregulated by Congress.[82] When applied to the area of company law, a substantive distinction can be observed between the type of matters usually left to the states to regulate and the scope and application of federal law. As David Skeel explains:

> "Whereas federal law provides the market infrastructure, regulates disclosure, and deputizes the principal outside watchers, state corporate law focuses on the internal affairs of the corporation – in particular, on the relations among shareholders, managers and directors. This includes everything from fiduciary duty and shareholder voting rights, to standards for effecting mergers and other transactions...Painting with a very broad brush then, American corporate law consists of two parallel and interlocking systems, state corporate law and the federal over- and underlay."[83]

However, the division between the two systems is not always clear: it has become increasingly popular for federal law to regulate affairs traditionally left to state law, such as

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[81] Article 1 section 8 of the United States Constitution. The commerce clause gives a pervasive power to Congress to regulate all aspects of in*ter*state commerce, in*tra*state activities that "substantially" affect interstate commerce as well as the channels and instrumentalities of interstate commerce. These channels include the postal service, highways as well as cars and airplanes. This is also known as the "affectation doctrine" as formulated in *National Labor Relations Board v Jones and Laughlin Steel Co.* 301 US (1937). *Cf* Jones "Does Federalism Matter? Its Perplexing Role in the Corporate Governance Debate" 2006 *Wake Forest Law Review* 879 880.

[82] This implied power is known as the dormant commerce clause. Legislation enacted under the dormant commerce clause will usually be upheld if it is non-discriminatory and does not impose an undue burden on interstate commerce. *Dean Milk Co. v City of Madison* 340 US 349 (1951); *City of Philadelphia v New Jersey* 437 US 617 (1978); *Fort Gratiot Sanitary Landfill v Michigan Department of Natural Resources* 504 US 353 (1992).

[83] Skeel *After Enron* (2006) 139-142.

the conduct of directors.[84] The Securities Act,[85] Securities Exchange Act[86] and the recently enacted Sarbanes-Oxley Act[87] form a major part of the structure of US corporate law.[88] Self-regulating organisations such as the NYSE also contribute to the *corpus* of regulation. Thompson emphasises that modern US corporate law can only be understood if the roles of the three main participants, namely state law, federal law and stock exchanges' listing requirements, are viewed as a "collaborative venture".[89] This section attempts to provide a brief outline of the main role players and newcomers to the US regulatory structure.

2 2 1 1 Securities and Exchange Commission ("SEC")

The Securities Exchange Act[90] established the SEC in 1934 to act as central authority and federal watchdog of the securities industry.[91] The SEC has broad regulatory powers, which include "the power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as [overseeing] the nation's securities self-regulatory organizations" ('SRO's).[92] The Securities Exchange Act defines an SRO as a registered securities exchange or registered securities association. These SROs include the stock exchanges such as the

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[84] The conduct of directors and managers is considered part of the "internal affairs" of a company. Renee Jones warns that one should not attempt to demarcate certain areas of law as exclusive to either the federal or the state system, as there is a great amount of overlapping between the regulated areas. An attempt to define a distinction merely detracts one from the real debates and policy issues at hand. Jones 2006 *Wake Forest Law Review* 879-886. Thompson aptly summarises the scope of state corporate law: "State statutes put all corporate powers in the board of directors. Shareholders do only three things: vote, sell or sue, and each in very limited doses." Thompson "Collaborative Corporate Governance: Listing Standards, State Law and Federal Regulation" 2003 *Wake Forest Law Review* 961 963-964. For an argument against the present system of concurrent jurisdiction, see Hills "The Political Economy of Cooperative Federalism: Why State Autonomy Makes Sense and 'Dual Sovereignty' Doesn't" 1998 *Michigan Law Review* 813.

[85] 1933. Title 15 USC.

[86] 1934. Title 15 USC.

[87] 2002. S 2673 Pub L No 107-204, 116 Stat 745.

[88] Other legislation affecting corporate and securities law include the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940 and the Investment Advisers Act of 1940. SEC *The Laws that Govern the Securities Industry* (2007-04-27). <http://www.sec.gov/about/laws .shtml#secact1933>.

[89] Thompson 2003 Wake Forest Law Review 981.

[90] 1934. These acts were enacted in the wake of a flurry of corporate collapse very similar to the context of Sarbanes-Oxley. For a discussion on the inception of earlier American corporate laws, see Skeel *Icarus and American Corporate Regulation* 139-142; Ribstein "Bubble Laws" 2003 *Houston Law Review* 77 90-97.

[91] S 4(a) of the Securities Exchange Act.

[92] S 3A(26) of the Securities Exchange Act. Macey identifies credit rating agencies and the markets for corporate control and IPOs as other important corporate governance regulators. Macey "The Politicization of American Corporate Governance" 2006 *Virginia Law & Business Review* 10 11-12; SEC *The Investor's advocate: How the SEC protects investors, maintains market integrity and facilitates capital formation.* <http://www.sec.gov/about/whatwedo.shtml>.

NYSE and NASDAQ, both of which have recently implemented more stringent listing requirements pertaining to corporate governance.[93]

The SEC also has the power to form and adapt accounting and auditing standards[94] and to define the layout of financial statements.[95] However, the SEC has always delegated this standard setting function to non-governmental organisations such as the Financial Accounting Standards Board ("FASB"),[96] the American Institute of Certified Public Accountants ("AICPA")[97] and until 2001, the Independence Standards Board ("ISB").[98] The SEC still oversees the FASB's decisions and actions[99] and can exercise disciplinary powers over SEC-registered entities.[100] The SEC has thus constructed the framework within which regulatory bodies can create and implement auditing, accounting and related standards and rules. However, this system of self-regulation was brought to an end by the enactment of Sarbanes-Oxley.

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[93] For more detail on the regulation of these SROs, see SEC "Order Approving NYSE and Nasdaq Proposed Rule Changes Relating to Equity Compensation Plans" *Exchange Act Release No. 34-48108* (2003-06-30) <http://www.sec.gov/rules/sro/34-48108.htm>; Emen "Corporate Governance: The View from NASDAQ" 2004 <http://www.nasdaq.com/about/ViewFromNASDAQ_EmenArticle_032304.pdf>; NYSE *Corporate Governance Listing Standards* <http://www.nyse.com/regulation/listed/1101074746736.html>; Thompson 2003 *Wake Forest Law Review* 961-982. All national securities exchanges have to be registered with the SEC pursuant to s 6(a) of the Securities Exchange Act.

[94] These standards include the creation of independence standards for auditors. Jaenicke "A Pathology of the Independence Standard Board's Conceptual Framework" 2002 *Accounting Horizons*. <http://www.allbusiness.com/accounting-reporting/auditing/376339-1.html>.

[95] S10A of the Securities Exchange Act.

[96] The SEC has affirmed its continued use of the FASB as accounting standards setter pursuant to fulfilling the requirements for recognition as set out in section 108 of the Sarbanes-Oxley Act. The FASB has been authorised accordingly since 1973. S 108 of the Sarbanes-Oxley Act amends s 19 of the Securities Act of 1933. SEC *Policy Statement: Reaffirming the status of the FASB as a designated private-sector standard setter* (2003-04-25) <http://www.sec.gov/rules/policy/33-8221.htm>; Facts about FASB 2007 <http://www.fasb.org/facts/facts_ about_ fasb.pdf>

[97] AICPA is the national self-regulating body to which all Certified Public Accountants ("CPA"s) belong. AICPA's main objective is to provide support functions to registered CPAs. It is also the official body for the setting of professional standards. AICPA Mission Statement 1995. <http://www.aicpa.org/About+the+AICPA/AICPA+Mission/>.

[98] The ISB was formed by the SEC, AICPA and a number of international auditing firms in 1997 to establish standards on auditor independence. The members of this private entity were three CEOs from the then-Big 5 accounting giants, the head of AICPA and 4 CPAs. The SEC also had a delegate on the Board with "observer status". Yet the SEC also issued their own set of independence rules, which rendered the function of the ISB ineffective to a large extent. The ISB voluntarily dissolved in 2001 mostly because of the lack of support from the SEC. Jaenicke 2002 *Accounting Horizons.*

[99] Niece & Trompeter 2004 *Business and Society Review* 184.

[100] SEC The Investor's advocate: How the SEC protects investors, maintains market integrity and facilitates capital formation. <http://www.sec.gov/about/whatwedo.shtml>.

2 2 1 2 The Sarbanes-Oxley Act ("Sarbanes-Oxley")

The Sarbanes-Oxley Act, passed into law on 26 July 2002,[101] initiated a significant change in the form of US corporate governance regulation. Before Sarbanes-Oxley, corporate governance was mostly a self-regulatory matter, with formalistic disclosure requirements being the main regulatory aspect on federal level.[102] Sarbanes-Oxley changed this position to a large extent by implementing substantive corporate law provisions: an area that was previously left to individual states as part of the increasing federalisation of corporate governance in the US.[103]

Sarbanes-Oxley amended a number of Securities Exchange Act provisions:[104] The main features of Sarbanes-Oxley include the creation of a new accounting oversight board, the PCAOB[105] and the increased regulation of auditor independence and corporate responsibility.[106] It also provides for stricter financial disclosure requirements,[107] the ordering of certain studies and reports on, *inter alia,* the consolidation of accounting firms[108] and enhanced criminal and corporate accountability.[109] The act applies to all companies, public or otherwise, that have registered their securities with the SEC.

The Sarbanes Oxley Act[110] was passed in a politically charged climate amidst huge controversy and public pressure. The content of the act is widely criticised by commentators

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[101] Sarbanes-Oxley is the culmination of a long-standing battle for corporate reform led by Democratic Senator Paul Sarbanes, House representative Michael Oxley and previous SEC-chairman, Harvey Pitt. The idea of corporate governance reform originated many years before the Enron collapse. The movement for change has initially been strongly resisted by members of both the accounting profession and the Republican Party. Not even Enron's collapse was a crisis big enough to have the radical legislative reforms approved by Congress: it took WorldCom's dramatic collapse and a build-up of severe public outrage to put enough public and political pressure on Congress: the Act was eventually passed unanimously. Alexander "The need for international regulation of auditors and public companies." 2002 *The Company Lawyer* 341 341-344; Romano 2005 *Yale Law Journal* 1526-1529;

[102] Corporate governance can be viewed as part of the internal affairs of a company: traditionally an area of state regulation.

[103] Romano "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance" 2005 *Yale Law Journal* 1523-1611 1523. For a detailed analysis of the interaction between state and federal law, see Jones 2006 *Wake Forest Law Review* 879-912.

[104] Sarbanes-Oxley is not the first federal law that regulates conduct, traditionally an area left to states to legislate, thereby further obscuring the distinction between areas of state and federal law. Previous conduct-regulating legislation include the Williams Act of 1968 and the Foreign Corrupt Practices Act of 1977. Jones 2006 *Wake Forest Law Review* 887-888.

[105] Title I.

[106] Title III.

[107] Title IV.

[108] Title VII; S 701.

[109] Titles VIII; IX and XI.

[110] 2002.

as over-regulation,[111] a "political blunder"[112] and "panic regulation".[113] Among the most contentious issues are the cost of compliance to especially section 404,[114] the extent and application of new criminal sanctions,[115] the inherently political nature of the Act,[116] the ineffectiveness with which the Act addresses the problems it was created to legislate[117] and the increased personal accountability by CEOs and CFOs as a result of section 302 compliance.[118]

The scope of Sarbanes-Oxley is too comprehensive to be discussed here in detail. The salient provisions directly affecting the regulation of the external auditor will be revisited throughout this document.

2 2 1 3 Public Company Accounting Oversight Board ("PCAOB")

The PCAOB has been created by Sarbanes-Oxley to "oversee the audit of public companies that are subject to the securities laws...in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit

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[111] Ribstein 2003 *Houston Law Review* 97.
[112] Romano 2005 *Yale Law Journal* 1529.
[113] Ribstein points out that the regulators have overlooked several alternative solutions to corporate failures, including possible market remedies. The writer calls for the deregulation of corporate governance and financial markets. Ribstein 2003 *Houston Law Review* 88-97.
[114] S 404 requires every company to provide an audited report on the effectiveness of their system of internal control. The high cost of compliance with s 404 has led to numerous complaints to the SEC, which has responded by only providing the smaller companies with an extended deadline instead of decreasing the extent of compliance. Jones submits that if the SEC, instead of Congress, was legislating the detail of compliance in the internal control report it would have had a less severe financial impact on issuers. Jones 2006 *Wake Forest Law Review* 904-905. The high cost of compliance to Sarbanes-Oxley in general causes unintended consequences: it encourages the delisting of smaller companies and acts as a deterrent for foreign companies from listing on US stock exchanges. Ribstein "International Implications of Sarbanes-Oxley: Raising the Rent on US Law" 2003 *Journal of Corporate Law Studies* 299 299-327.
[115] *Cf* Moohr "An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime" 2003 *Florida Law Review* 937.
[116] *Cf* Macey 2006 *Virginia Law & Business Review* 10.
[117] Romano contends that the considerable public pressure to react to Enron hastened the usual deliberation process in Congress to the extent the provisions enacted do to a large part not address the concerns created by Enron accurately, thereby creating a situation where a repeat of Enron might take place. As a possible remedy, Romano suggests that the provisions of Sarbanes-Oxley should be "stripped of their mandatory force and rendered optional". As a less radical alternative, the writer proposes the introduction of mandatory review procedures for every act that was passed in "emergencies or similar crisis-like circumstances." Romano 2005 *Yale Law Journal* 1529-1530. Ribstein also warns that the Act will only serve to "discourage risk-averse executives from engaging in profitable business activities that produce earnings surprises." Ribstein 2003 *Houston Law Review* 89.
[118] S 302(a) of the Sarbanes-Oxley Act determines that the CEO and CFO have to personally attest to the correctness of the financial statements and the effectiveness of the company's internal controls.

reports."[119] The financially independent, not-for-profit PCAOB[120] is significant as it is the first quasi-federal entity to regulate auditors: a move away from the state and self-regulation that previously regulated the audit industry.[121] The PCAOB functions independently of the US Government and the SEC, and can only be disbanded by an Act of Congress.[122] All audit companies, whether US or foreign, have to be registered with the PCAOB if they are to perform audit work and issue audit opinions on US public companies.[123]

Although the PCAOB fulfils many tasks usually ascribed to a state organisation and the SEC still has to preapprove all rules and standards passed by the PCAOB before they become effective, the PCAOB is not a functionary of the state.[124] The SEC is empowered with general supervision of the activities of the PCAOB, and can review and overturn PCAOB decisions if a public auditor objects to such decision.[125] The SEC also appoints the members of the PCAOB on a five year basis[126] and approves the PCAOB's budget.[127] It can also terminate employment of PCAOB members and place members under censure when considered necessary.[128]

The PCAOB consists of five individuals[129] appointed on a full-time basis for a once renewable five year period.[130] Although the position of a PCAOB member requires thorough knowledge of financial disclosures, securities laws and an understanding of the auditor's role and responsibilities, only two members are allowed to be qualified CPAs.[131] A CPA may only

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[119] S 101(a) of the Sarbanes-Oxley Act.
[120] The PCAOB is not state-funded: its funds are derived from an "auditing support fee" that is taxed on all PCAOB-registered companies proportional to their equity market capitalisation of the previous year. The constitutionality of this levying of taxes by the PCAOB is still under debate. Currently, the PCAOB can tax all registered companies with almost none of the usual governmental supervision that is normally afforded to state entities. Although a US District Court has ruled in favour of the PCAOB, a further appeal is still pending. *Cf* ss 109(c) -109(g) of the Sarbanes-Oxley Act; *Free Enterprise Fund et al v Public Company Accounting Oversight Board et al No. 06-217*; Bader & Berlau "The Public Company Accounting Oversight Board: An Unconstitutional Assault on Government Accountability" 2005 *Issue Analysis* <http://www.cei.org/gencon/025,04873.cfm>; Wallison "Rein in the Public Company Accounting Oversight Board" 2005 *American Enterprise Institute for Public Policy Research.* <http://www.aei.org>.
[121] Shapiro "Who Pays the Auditor Calls the Tune? Auditing Regulation and Clients' Incentives" 2003 *Seton Hall Law Review* 1029 1056-1057. The PCAOB replaces the self-regulating Public Oversight Board ("POB") See in general <http://www.pcaobus.org/> and <http://www.publicoversightboard.org/about.htm>.
[122] S 101(a) – (b) of the Sarbanes-Oxley Act.
[123] S 102 of the Sarbanes-Oxley Act.
[124] S 107(b)(2) of the Sarbanes-Oxley Act.
[125] S 107 of the Sarbanes-Oxley Act.
[126] S 101(e)(5)(A) of the Sarbanes-Oxley Act.
[127] S 109(b) of the Sarbanes-Oxley Act.
[128] S 107(d) of the Sarbanes-Oxley Act.
[129] S 101(e)(1) of the Sarbanes-Oxley Act.
[130] S 101(e)(3) – 101(e)(5) of the Sarbanes-Oxley Act.
[131] S 101(e)(2) of the Sarbanes-Oxley Act.

be appointed as chairperson of the PCAOB if he or she has not practised as such for at least the previous five years.[132] The limited number of permitted CPAs on the PCAOB has drawn reactions of widespread concern from the CPA community, as the PCAOB's role of both standard setter and overseer presupposes a significant amount of insight and experience in a highly technical field.[133] Wallison rightly points out that the restriction of the quantity of CPAs on the PCAOB to a minority, directly contradicts the whole concept of a self-regulating body. He further argues that the PCAOB has caused a "sense of adversity" between CPAs and the regulating bodies, as the CPA restriction is preventing the accounting and auditing industry from self-regulating. The fact that the PCAOB is not funded by the industry that it serves,[134] restricts the ambit of industry control that is usually prevalent in the workings of a self-regulating entity.[135]

The PCAOB has the power to further delegate the creation of auditing standards to another self-regulating entity.[136] However, the PCAOB decided against further delegation and has since created various standards that has been approved and passed by the SEC.[137] In the process the PCAOB has partially side-lined AICPA in the setting of auditing standards.[138] Yet the *raison d'être* of the PCAOB is not that of a standard setter but rather an overseer:[139] the inspection and enforcement of compliance of all registered firms to all relevant Sarbanes-Oxley provisions remains a central function of the PCAOB. Other PCAOB duties include the registration of public auditing firms; conducting disciplinary proceedings against any

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[132] S 101(e)(2) of the Sarbanes-Oxley Act.
[133] Hill, McEnroe & Stevens "Auditors' reactions to Sarbanes-Oxley and the PCAOB" 2005 *The CPA Journal* <http://www.nysscpa.org/cpajournal/2005/1105/special_issue/essentials/p32.htm>.
[134] The PCAOB is funded by the business community and serves the accounting and auditing profession. *Cf* n 121.
[135] Wallison 2005 American Enterprise Institute for Public Policy Research http://www.aei.org.
[136] S 108(b)(A) of the Sarbanes-Oxley Act.
[137] See for example PCAOB "Statement regarding the Establishment of Auditing and other Professional Standards" 2003 *PCAOB Release No. 2003-005* <http://www.pcaobus.org/Rules/Docket_004/2003-04-18_Release_2003-005.pdf > and in general <http://www.sec.gov/rules/pcaob/> for a list of approved PCAOB directives and related comments by the SEC.
[138] The AICPA continues to be a prominent self-regulatory standard setter, especially with regard to private companies. Ascierto "New World Order: As the PCAOB Takes Shape, the AICPA's role is blurred" 2003 *California CPA* 1-5 <http://findarticles.com/p/articles/mi_m0ICC/is_10_71/ai_103088813/pg_2>. Hamilton is of the opinion that this shift of power from the AICPA by the PCAOB should not affect the scope of the SEC's disciplinary powers over self-regulating entities. Hamilton "The Crisis in Corporate Governance: 2002 Style" 2003 *Houston Law Review* 1 57-58.
[139] *Cf* n 137.

registered company that does not adhere to PCAOB rules, performing any duty that the SEC delegates to the PCAOB and managing its own budget.[140]

Whether Sarbanes-Oxley and the PCAOB will realise their goals and prevent future corporate collapse remains to be seen. Concerns raised about the effectiveness of this Act are certainly legitimate.[141] Shapiro goes as far as to contend that the PCAOB does not reduce the independence concerns of auditors at all,[142] and McDonnel is sceptical about whether the PCAOB inquiry process will be able to trace flaws in the audit engagements of registered firms.[143] However, Moore remains positive about the recent legislation:

> "On the regulatory front, Sarbanes-Oxley addresses weaknesses in the present administrative scheme, especially those that pertain to accountants and auditors. Those weaknesses were perceived as contributing to the fraud at Enron and… accounting firms. In creating the Public Accounting Oversight Board, the Act strengthens the ability of government regulators to monitor and enforce administrative remedies...the Act promises to use regulatory law to control corporate misconduct."[144]

As the latest developments in US corporate law, the scope and content of numerous provisions in Sarbanes-Oxley can certainly be criticised. No system will ever be free of controversy. However, one cannot deny that the current framework has more checks and balances in place than the pre-Enron system had. With the recurring failure of self-regulation mechanisms, a less stringent approach could not have been expected. It will be up to the SEC to ensure the continuous fine tuning and improvement of both the Sarbanes-Oxley Act and the PCAOB.

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[140] Ss 101(c)(1)-(7) of the Sarbanes-Oxley Act.
[141] *Cf* 2 2 1 2 *supra*.
[142] Shapiro 2003 *Seton Hall Law Review* 1058.
[143] McDonnel "The PCAOB and the future of oversight" 2004 *The Journal of Accountancy Online* <http://www.aicpa.org/pubs/jofa/dec2004/mcdonn.htm>.
[144] Moohr 2003 *Florida Law Review* 972-973.

2 2 2 SOUTH AFRICA

2 2 2 1 Legislation

It is trite that the existing Companies Act[145] is outdated in many regards and in need of a complete overhaul.[146] Whilst the content of the new Companies Bill[147] is still being finalised, the Corporate Laws Amendment Act ("The Amendment Act")[148] currently serves as the latest update of South African company law.

The Amendment Act, operational since the fourteenth of December 2007,[149] introduced a number of new provisions on the auditor in particular. Most of these provisions have been welcomed as long-awaited updates and innovations, while others are more controversial. More importantly, there is concern about the high cost of compliance to these new provisions as the Companies Bill is expected to be passed in the near future.[150] When enacted, the Companies Bill will be the final result of a long review process that started with the publication of "Guidelines for Corporate Law Reform", a 2004 directive from the Department of Trade and Industry ("DTI").[151] The promulgation of the Companies Bill will leave the current Amendment Act with a short lifespan.

The Amendment Act introduced a contentious new categorisation of companies by creating and distinguishing between "widely held" and "limited interest" companies.[152] This distinction does not detract from or replace the current distinction between public and private companies.[153] A company is widely held if "its articles provide for an unrestricted transfer of shares; it is permitted by its articles to offer shares to the public; [or] it decides by special

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[145] 61 of 1973. Ss 269-283 of the Companies Act govern the position of the auditor of a company and are discussed *infra.*

[146] The Minister of Trade and Industry emphasised the inevitability of corporate law reform as a result of the extensive economic, financial and political change South Africa has experienced since the early 1970's. DTI "Companies Bill, 2007 under the spotlight" *Speeches & Statements* (2007-02-20) <http://www.info.gov.za /speeches/2007/07022111151002.htm>.

[147] 2008.

[148] 24 of 2006.

[149] Proc 47 in *GG 30594* of 2007-12-14.

[150] Significant delays can still be expected as the initial proclamation date in the DTI Guidelines was projected as June 2006. Projected promulgation dates remains speculation. GN 1183 in *GG* 26493 of (2004-06-23).

[151] DTI Speeches & Statements (2007-02-20).

[152] S 1(h) of the Corporate Laws Amendment Act.

[153] Private companies may be classified as widely held companies if they are subsidiaries of widely held or public companies. Conversely, all public companies with unrestricted transferability of shares automatically qualify as widely held companies. S 1(h) of the Corporate Laws Amendment Act.

resolution to be a widely held company".[154] A company also qualifies as a widely held company if it is a subsidiary of a widely held company, regardless of possible restrictions on the subsidiary's shares. A limited interest company is defined as any company that is not a widely held company.[155] As widely held companies per definition include all public companies (with unrestricted transfer of shares), the size and complexity of its affairs necessitate stricter compliance requirements than limited interest companies. The majority of the new provisions regarding, *inter alia*, greater accountability of companies with regard to financial disclosure and increased independence of auditors, apply to widely held companies only.[156]

The Amendment Act addresses a number of important aspects relating to the status and independence of the external auditor, thereby aligning the Companies Act with the Auditing Profession Act.[157] The Amendment Act regulates the use of audit committees in widely held companies,[158] the appointment and rotation of the external auditor,[159] as well as the prohibition of certain non-audit services to be rendered by the external auditor.[160]

Key provisions on the independence of auditors include the more detailed regulation of the interaction between the auditor and the audit committee.[161] One of the most significant provisions of the Amendment Act is that for the first time, the appointment of an audit committee and adherence to Generally Accepted Accounting Principles ("GAAP") and International Financial Reporting Standards ("IFRS") are made compulsory for certain

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[154] S 1(h) of the Corporate Laws Amendment Act.
[155] S 1(h) of the Corporate Laws Amendment Act.
[156] The text of the Amendment Act reveals some remarkably apparent oversights with regard to terminology. In the final version of the Act, there are two references to so-called "public interest companies". The first is in the heading of s 24 of the Amendment act and refers to "Audit committees for public interest companies". As headings of sections carry no legal meaning on their own, and can only be used for consultative or explanatory purposes, this error is legally irrelevant. The second reference is in s 53 of the Amendment Act which inserts s 440S in the Companies Act. S 440S determines the functions of the newly established Financial Reporting Standards Council, a significant provision to legislate incorrectly. The Amendment Act further provides no definition for "public interest companies". As the Amendment Bill initially distinguished between "public interest" and "limited interest" companies, it is submitted that this reference is a remnant from the poorly revised Companies Law Amendment Bill of May 2006. It is thus submitted that "public interest companies" is intended to refer to "widely held companies". Henochsberg supports this view. The latest version of the Companies Bill has done away with these new distinctions as introduced by the Amendment Act. S 8 of the Companies Bill 2008; Ss 24, 53 of the Amendment Act; Du Plessis 2002 *Re-Interpretation of Statutes* 245; Henochsberg 518.
[157] 26 of 2005.
[158] S 24 of the Corporate Laws Amendment Act inserts ss 269A – 271 into the Companies Act.
[159] S 29 of the Corporate Laws Amendment Act replaces s 274 of the Companies Act; s 30 of the Corporate Laws Amendment Act inserts s 274A into the Companies Act.
[160] S 32 of the Corporate Laws Amendment Act inserts s 275A into the Companies Act.
[161] S 45 of the Corporate Laws Amendment Act inserts s 300A into the Companies Act.

companies.[162] Previously, there was only indirect pressure via the King codes or JSE listing requirements to comply with these principles.[163] The Amendment Act also inserts a new chapter on financial reporting standards in the Companies Act that entrenches the use of IFRS by all "public interest companies".[164] The Financial Reporting Standards Council ("FRSC") is established as a regulatory entity along with an investigatory branch, the Financial Reporting Investigatory Panel ("FRIP"), to ensure conformity of financial methods used by public interest companies.[165]

The Companies Bill, by no means law yet, is still subject to change. The Minister of Trade and Industry, Mandisi Mpahlwa, described the purpose of the new Bill as follows:

> "The objectives of the reform are to reduce the cost of registering and maintaining a company and the regulatory burden and compliance costs for small and medium-sized businesses, while at the same time enhancing corporate governance, transparency and accountability of large and widely-held firms. It will also result in improved regulatory oversight and better redress for shareholders. Very significantly, the Bill introduces a new business rescue scheme that will facilitate the turnaround of struggling firms."[166]

The main purpose of the corporate reform process, according to the DTI, is for corporate legislation to be "appropriate to the legal, economic and social context of South Africa as a constitutional democracy and open economy".[167] Yet to a large extent, versions of the Companies Bill have been at odds with these objectives as several new provisions can be traced directly to corporate structures and reform in the United States. For example, the Companies Bill establishes a new regulatory body known as the Companies and Intellectual

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[162] In this instance, widely held companies.
[163] Abrahams "The changing face of South African corporate law: the introduction of new concepts" 2007 *Webber Wentzel* <http://www.webberwentzel.com/wwb/view/wwb/en/page5872?oid=15555&sn=>. For a discussion of other new provisions see Geldenhuys "Important changes to company law" *Floor Inc Attorneys* (2007-06-08) <www.informationlaw.co.za/news/article.asp?newsID=152>; Sher "The overhaul of South African corporate law" 2006 *Juta's Business Law Review* 87; Van Wyk "Wette speel woer-woer met Maatskappye" *Die Burger* (2008-01-08). <http://www.news24.com/Sake/Rubrieke/0,,6-103_2248013,00.html>.
[164] This term is undefined by statute. S 53 of the Corporate Laws Amendment Act.
[165] S 53 of the Corporate Laws Amendment Act inserts ss 440O – 440JJ into the Companies Act. There is no mention of the FRIP in the 2008 Companies Bill.
[166] DTI *Speeches & Statements* (2007-02-20). The Bill also provides for the extensive decriminalisation of corporate law.
[167] GN 1183 in *GG* 26493 of (2004-06-23).

Property Commission, which will fulfil a function very similar to the American SEC.[168] However, the latest version of the Companies Bill has been welcomed as a more streamlined, customised approach.[169] It is submitted that when updating law to keep it in line with international trends, a balance should be found between merely looking towards other jurisdictions for guidance and somewhat blindly copying their approach.[170]

2 2 2 2 The King Reports on corporate governance

In reaction to the Cadbury Code of 1992, the first King Report on Corporate Governance ("King I") was released in 1994.[171] Whilst the Cadbury Code had a narrow focus on financial disclosure,[172] King I sought a wider application. Chaired by former Supreme Court Judge and businessman, Mervyn King, the committee sought to address unique South African transformational and political problems especially prevalent in the mid-1990's transition to a democratic society. This comprehensive report included support for affirmative action, a

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[168] The Companies Intellectual Properties Commission combines CIPRO and the DTI enforcement functions and adds extensive regulatory powers. The Companies Bill also transforms the role of the major regulating entities, the FRSC and SRP, and creates a Companies Ombuds. The roles of the Minister of Trade and Industry and the Registrar of Companies are also affected. Both the JSE and SAICA has raised concerns about the demotion of the FRSC from a watchdog in the Amendment Act to a mere advisory committee in the current Bill. *Cf* DTI "Explanatory memorandum" *Companies Bill of 2007* 7; SAICA *Companies Bill, 2007 – Main Features* (2007-02-23). http://www.saica.co.za/documents; Lund "JSE raises alarm on new Bill" *Fin24* (2008-08-13) < http://www.fin24.com/articles/default/display_article.aspx?Nav=ns&ArticleID=1518-24_2375103>.

[169] IODSA *Comments from the IoD and King Committee on the Companies Bill* 2008 <http://www.iodsa.co .za/downloads/comments/IoD-ing%20Final%20submission_IoD%20Comments%20on%20Companies%20 Bill.pdf>.

[170] For a critique of the American elements in the Companies Bill and the Amendment Act see Van Wyk "Nuwe maatskappyewet se VSA-onderrok hang uit" *Die Burger* (2004-11-11). <http://www.news24.com /Sake/Rubrieke/0,,6-103_1619269,00.html>. Although the 2007 version of the Companies Bill replaced the term "limited interest" with "closely held" and introduced the concept of "public interest companies", the 2008 version of the Companies Bill has abolished this distinction, and has essentially reintroduced the public/private distinction as used in the 1973 Act. The position of the auditor under the Companies Bill significantly updates the 1973 position, but may erase some of the welcomed renewal that has been introduced by the Amendment Act of 2006. For a brief discussion of some of these provisions, see n ??? Ss 1; 8-9; 103-108 of the Companies Bill of 2007; DTI "Explanatory memorandum" *Companies Bill of 2007*; Van Wyk "SA wet praat Amerikaans" *Die Burger* (2007-05-28) <http://www.news24.com/Sake /Rubrieke/0,,6-103_2120637,00.html>; Moodley "New Companies Bill aims to provide business climate, lower barriers to entry" *Engineering News* (2007-02-20). <http://www.engineeringnews.co.za /print_version.php?a_id=102249>. For a further discussion of the Companies Bill, see Van Wyk "Reddingsboei in nuwe wet" *Die Burger* (2007-04-16) <http://www.news24.com/Sake/Rubrieke/0,,6-103_2099662,00.html>; Rossouw "The New Companies Bill and Tax Practitioners Bill" *AuditAlliance* (2007-04-05). <http://www.auditalliance.co.za/article_detail.asp?ID=12>; Van Wyk *Die Burger* (2008-01-08); SAICA *Companies Bill* (2007-02-23). IODSA *Comments* 2008.

[171] Although South Africa has also had its fair share of corporate failures, both King codes have been drafted to stay in line with international standards, rather than in reaction to local corporate failures. South African corporate failures include Masterbond, TTB Holdings, Macmed Healthcare, Saambou Bank and Leisurenet. For a discussion of these corporate failures see Sarra *Strengthening domestic corporate activity in global capital markets: a Canadian Perspective* (2004-05-11) <http://ssrn.com/abstract=628702>; Nel Commission 2001 *Final Report of the Commission of Inquiry into the Affairs of the Masterbond Group and Investor Protection in South Africa.*

[172] *Cf* 2 2 3 *infra.*

proposal that all companies adopt a Code of Ethics as well as greater corporate accountability and disclosure of non-financial matters.[173] At the time, King I was widely recognised as one of the leading corporate governance codes worldwide.[174]

Regulatory change over the following years necessitated a review of King I: the code was superseded by King II on the first of March 2002. While King II applies to all "affected companies" as defined,[175] voluntary compliance by any other entity is encouraged.[176] It will thus be considered good corporate governance if any company opts to comply with King II. King II gives substantial attention to the position of the auditor, audit committees and the regulation of non-audit services.[177]

Although King II expressly describes itself as a self-regulatory document, many of its recommendations have since been legislated.[178] King II follows the "comply or explain" principle, whereby those companies that should comply but do not, have to furnish acceptable reasons. Only once no acceptable explanation can be provided, will the company be deemed to be in contravention of the code.

Although the King Codes have been mostly welcomed by the business community, it is certainly not shy of criticism. The shareholder theory as endorsed by King II has been criticised for not providing an alternative means of ensuring accountability.[179] Lubbe and Vorster argue that codes such as the King report are meaningless if they are not also reflected

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[173] Armstrong "The King Report on Corporate Governance" 1995 *Juta's Business Law* 65. King II does not have affirmative action provisions, as these were fully addressed by legislation following King I.
[174] Cliffe Dekker King Report on Corporate Governance for South Africa 2002 <http://www.cliffedekker.com /literature/corpgov/>.
[175] King II 1.1. "Affected companies" include all JSE listed companies, banks, financial and insurance entities and certain public sector enterprises that are governed by Public Finance legislation. The JSE has amended its listing requirements accordingly to include King-compliance as a prerequisite for listing. *Cf* par 3.84, 20.4 of the JSE Listing Requirements <http://www.jse.co.za/listing_requirements.jsp>.
[176] King II 1.2.
[177] King II Section 5.
[178] Examples of King Code influence in subsequent legislation can be seen in the Public Finance Management Act 1 of 1999, the Labour Relations Act 66 of 1995, the National Environmental Management Act 107 of 1998, the Basic Conditions of Employment Act 75 of 1997 and the Employment Equity Act 55 of 1998. King I also led to the inclusion of a compulsory company secretary in the Companies Amendment Act 37 of 1999. It has amended s 247 and inserted ss 140A and 268A-268J in the Companies Act 61 of 1973. The most recent influence of King II can be seen in legislation of provisions on audit committees, non-audit services and accounting standards like IFRS in the Corporate Laws Amendment Act. King II *Introduction and Background* 9.
[179] The shareholder theory holds that the company is accountable to their shareholders only, whilst King II rejects the stakeholder theory on the basis that "be[ing] accountable to everyone would result in their being accountable to no one." King II *Introduction and Background* 7; Sarra *Strengthening domestic corporate activity* (2004-05-11).

in the spirit and culture of the business community at large. They emphasise that the soft law nature of these codes will only be effective if compliance is continuously monitored.[180]

There is already talk of an updated version of King II, currently referred to as King III,[181] that is expected to take form over 2008 in reaction to the new provisions of the Companies Bill. As most of the revision of the role and independence of the auditor has already been completed in King II and the Amendment Act, King III is not expected to change much regarding the position of the auditor.

2 2 2 3 Auditing Profession Act 26 of 2005

The Auditing Profession Act is the final result of the long-standing review of the Public Accountants' and Auditors' Act[182] and reform of South Africa's auditing industry. The Auditing Profession Act was signed into law on 12 January 2006, and subsequently became effective from 1 April 2006, thereby repealing the Public Accountants and Auditors' Act as a whole.[183]

During the extensive review process, the Draft Accountancy Profession Bill[184] ("the Draft Bill") was created and released for public comment. A Ministerial Panel for the Review of the Draft Accountancy Bill, chaired by Len Konar, was assembled to analyse and respond to the Bill. The result was the Report to the Minister of Finance ("Konar Report"). One of the main findings of the Konar Report was that the auditing and accountancy legislation should be separated, and that the Draft Bill should pertain to the positions of auditors only.[185] Although the Minister of Finance disagreed with this proposal, he did agree with most of the recommendations, and indicated that the recommendations will be incorporated in the Bill.

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[180] For further discussion on this topic, see Lubbe & Vorster "Die nakoming van sekere korporatiewe beheerbeginsels in jaarverslae van genoteerde Suid-Afrikaanse maatskappye" 2000 *Tydskrif vir Regswetenskap* 88 89.

[181] For a discussion on the aspects that are expected to be addressed by King III, see Dippenaar "Another Change to the South African Corporate Landscape..." *Floor Inc.Attorneys* (2007-10-09). <http://www.floor-inc.co.za/news/article.asp?newsID=169>.

[182] 80 of 1991.

[183] S 58(1); Schedule to the Auditing Profession Act.

[184] 2001.

[185] Ministerial Panel for the Review of the Draft Accountancy Profession Bill *Report to the Minister of Finance* (30-09-2003) ("Konar Report").

The result was the Auditing Profession Act which now regulates the auditing profession alone.[186]

In certain respects, the Auditing Profession Act ("APA") differs significantly from its predecessor, the Public Accountants' and Auditors' Act ("PAAA").[187] For example, the APA expressly states that one of the main objectives of the act is to protect the public,[188] whereas the PAAA described its mission as the protection of the auditors. This shift in focus reflects the international trend to acknowledge the public as a central stakeholder in need of protection.

The Auditing Profession Act addresses most of the concerns regarding the independence of auditors. Substantive provisions regarding non-audit services, rotation and the like will be discussed below.

2 2 2 4 Independent Regulatory Board for Auditors ("IRBA")

The IRBA is newly established by the APA as a separate juristic person[189] to replace its predecessor, the Public Accountants' and Auditors' Board ("PAAB"). The IRBA is a state organisation that is strictly regulated by statute, and is also subject to the Public Finance Management Act.[190] The IRBA answers to the Minister of Finance and is subject to annual ministerial review.[191]

Importantly, only a registered auditor according to IRBA may be appointed as auditor. This requirement is echoed in the Amendment Act.[192]

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[186] The Auditing Profession Act was promulgated following extensive public commentary and a lengthy review process. These comments include the opinions of major industry role players such as KPMG, PWC and the PAAB and can be viewed at length at <http://www.treasury.gov.za/legislation/bills/2004apbcomments /default.aspx>.
[187] 80 of 1991.
[188] S 2(a) of the Auditing Profession Act.
[189] S 3(1)(a) of the Auditing Profession Act.
[190] S 28(a) of the Auditing Profession Act.
[191] S 28(1)-28(2) of the Auditing Profession Act.
[192] S 23 of the Corporate Law Amendment Act inserts s 269(6)-(7) into the Companies Act. A new JSE regulation now requires all audit firms of listed companies to register with the JSE. These new regulations have been criticized as merely duplicating the role of the IRBA. The implementation of this register is still in progress. Hasenfuss "JSE auditors' list within weeks" *Fin24* (2008-07-04) < http://www.fin24.com /articles/default/display_article.aspx?ArticleId=1518-24_2351825>.

The IRBA was established to regulate the audit profession in South Africa by, *inter alia*, exercising its investigatory and disciplinary powers over the conduct of registered auditors, establishing committees for auditor ethics and auditing standards[193] that will promote auditor standards and ethical matters,[194] as well as the promotion of the auditing profession and protection of the public in general.[195] The committee for auditor ethics is charged with the responsibility of developing a code of professional conduct.[196] The IRBA also has to fulfil statutory mandates with regard to auditing education and matters regarding the accreditation of related auditing professional organisations. Because the IRBA has to "develop a system of delegation that will maximise administrative and operational efficiency and provide for adequate checks and balances",[197] it functions as a self-regulating entity within a statutory framework. Odendaal calls this hybrid system "delegated self-regulation".[198]

The IRBA has to consist of six to ten non-executive persons. Members are appointed by the Minister of Finance, pursuant to the receipt of nominations from the public.[199] At least 60% of the Board members are not allowed to be registered auditors.[200] There is no provision barring the chairperson of the Board from being a registered auditor.

Kariem Hoosain, CEO of the IRBA, maintains that the IRBA's independence from the auditing profession can only be assured if the number of registered auditors on the Board is

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[193] International Standards of Auditing (ISAs) were adopted by South Africa in January 2006. Previously, South African Auditing Standards (SAAS), a local rework of the ISA rules, were used as auditing guidelines. Agulhas "South Africa adopts international standards" 2004 *Accountancy SA* <http://findarticles.com/p/articles /mi_qa5377/is_200407/ai_n21351761>.

[194] Ss 4(1)(a), 20(1) - 22 of the Auditing Profession Act.

[195] Ss 4(b)-2(d) of the Auditing Profession Act.

[196] S 21(2)(a) of the Auditing Profession Act.

[197] S 19 of the Auditing Profession Act.

[198] Odendaal Regulering van die Ouditeursprofessie in Suid-Afrika (2006) 211.

[199] S 11(1) -11(5) of the Auditing Profession Act. The Minister also has to take the public nominations, availability and demographics of prospective Board members into account in the appointment process. S 11(3) of the Auditing Profession Act.

[200] S 11(4) of the Auditing Profession Act. A "registered auditor" is defined in s 1 of the Auditing Profession Act as "an individual or firm registered as an auditor with the [IRBA]". It should be noted that the PCAOB follows roughly the same proportionality approach: only 40% of PCAOB members are allowed to be CPAs. *Cf* 2 2 1 *supra.* The IRBA has elected to make full use of their allowed capacity, and currently consists of four registered auditors, and six non-auditors. The Act also allows for the appointment of an alternative Board member for every member appointed, who will act in the capacity of a Board member if the official member is not able to do so. Currently there are only two vacant alternative positions. It thus seems as if the IRBA is fulfilling its personnel mandate in terms of the Act. IRBA *Board Members and Alternative Members 2007*. <http://www.irba.co.za/pdf _frame.asp?PDF=/documents/doc_00911.pdf>; S 11(6) of the Auditing Profession Act.

limited to a minority.[201] Yet it can be argued that this position is contrary to the very concept of self-regulation that the IRBA claims to pursue.

Members of the IRBA are appointed for a once renewable period of two years.[202] Despite this restriction, the Minister of Finance has the discretion to extend any member's term with up to a further twelve months, as well as the discretion to terminate a member's appointment if such member has been rendered incapable of efficiently performing his or her function.[203] Reasons for incapability may vary from continuous illness to substandard performance.[204] There is also a rather stringent provision in place that deems a member's appointment terminated if that member has failed to attend two consecutive meetings of the Board without obtaining the necessary permission.[205]

2 2 2 5 Conclusion

The redrafting of auditing legislation also affects the status and scope of company legislation. The Konar Report pointed out that the Minister of Finance is responsible for financial markets and holds authority over the IRBA (previously PAAB) and stock exchanges such as the JSE. Conversely, the Companies Act, which partly regulates public listed companies as well as corporate governance matters, is subject to the authority of the Minister of Trade and Industry. The Konar Report is against this split of authority and recommended that the jurisdiction of the Companies Act should be shifted to the Minister of Finance.[206] It is important that company law be revised to align company law with the regulation of the auditing industry.

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[201] IRBA "Call for applications for board of auditing profession's regulator" *Press Release* (2006-10-19). <http://www.paab.co.za/news_item.asp?Item=155>.
[202] S 12(1)-(2) of the Auditing Profession Act.
[203] S 12(3) of the Auditing Profession Act.
[204] S 12(4)-12(5) of the Auditing Profession Act.
[205] S 13(3)(d) of the Auditing Profession Act. Other stringent performance measures include adherence by the CEO to the provisions of a performance agreement as entered into upon appointment. S 18(1) of the Auditing Profession Act.
[206] Konar Report par 9.1-9.10.

2 2 3 UNITED KINGDOM

> "We believe that our approach, based on compliance with a voluntary code coupled with disclosure, will prove more effective than a statutory code. It is directed at establishing best practice, at encouraging pressure from shareholders to hasten its widespread adoption, and at following some flexibility in implementation. We recognise, however, that if companies do not back our recommendations, it is probable that legislation and external regulation will be sought to deal with some of the underlying problems..."[207]

The UK is an undisputed leader on corporate governance. With the arguably excessive legislative intervention of the US, the UK is, in comparison, an example of a stable and robust response to corporate failure.

The position of the external auditor has been most prominently regulated by corporate governance codes since the publication of the UK's first corporate governance report, the Cadbury Report, in 1992. Yet recently, the regulatory focus has shifted from codes and soft law[208] towards increased legislative intervention. After the initial flurry of codes in the early to mid 1990's, a second wave of reform took place in the wake of the collapse of Enron and WorldCom. Although the UK had no significant corporate failures during that time, or at least none on the scale of the US, 2003 saw the release of new governance reports on a number of important governance matters, including the regulation of auditors. Legislative reform only took place in 2004 with the Companies (Audit, Investigations and Community Enterprise) Act. Today, most of the provisions of this act have been replaced by the new Companies Act of 2006 which is currently being phased into operation.[209]

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[207] Cadbury Report par 1.10.

[208] Gower and Davies argue that the Combined Code should not be considered soft law because of the nature of *enforcement* (via listing requirements instead of legislation), but rather because of the somewhat superficial nature of *compliance.* Under the Combined Code actual compliance is not required because of the "comply or explain" principle. Thus whether the Code is enforced by statutory power or listing rules is irrelevant to its soft law status. Davies *Gower & Davies' Principles of Modern Company Law* (2003) 322-333.

[209] *Cf* 2 2 3 2 *supra*.

2 2 3 1 Corporate governance codes and reports

The Cadbury Report was adopted in 1992 as the UK's first corporate governance code. This report was initiated by the London Stock Exchange ("LSE") and Financial Reporting Council ("FRC") in 1991 to review the financial aspects of corporate governance in listed companies.[210] The Cadbury Committee was established mostly in reaction to early UK corporate scandals[211] and influenced several other reports, both inside and outside the UK.[212] The Cadbury Report addressed the need for increased regulation of the audit committee[213] and identified independence concerns regarding the position of the company auditor.[214] The report also established a Code of Best Practice, which mostly regulated directors, both executive and non-executive.[215] It is this code that was subsequently adopted by the LSE as part of their listing requirements.[216] It should be noted the Cadbury Report is the first of its kind to employ listing requirements as an enforcement mechanism to promote compliance to its principles in a previously self-regulated area.[217]

The Cadbury Report was only the first in a flurry of corporate governance reports. In 1995, the Greenbury Report on directors' remuneration was published.[218] The report made recommendations regarding the improvement of transparency and accountability of directors' remuneration packages.[219] The provisions of the report were also included in the LSE listing requirements. The Hampel Report in 1998 reworked its two predecessors and eventually resulted in the refinement and consolidation of the Greenbury, Cadbury and Hampel Reports

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[210] Cadbury Report par 1.3.
[211] UK corporate scandals include BCCI, Polly Peck, Maxwell and Guinness. *Cf Guinness Plc v Saunders* 1990 2 AC 663; *Polly Peck International Plc v Asil Nadir* 1992 2 Lloyd's Rep. 238; Kerry & Brown "The BCCI Affair. A report to the Committee on Foreign Relations United States Senate" 1992 *Federation of American Scientists.* <http://www.fas.org/irp/congress/1992_rpt/bcci/>; Arcot & Bruno "In letter but not in spirit: an analysis of corporate governance in the UK 2006 *Social Science Research Network.* <http://ssrn.com/abstract=819784>.
[212] Other countries substantially influenced by the UK's Cadbury Report include India, France, Hong Kong, Belgium, Canada and Italy. For a comprehensive review of these jurisdictions and more, see Cheffins "Corporate governance reform: Britain as an exporter" *1999 Hume Papers on Public Policy* 5-8 <http://ssrn.com/abstract=215950>.
[213] Cadbury Report par 4.33-4.38.
[214] Cadbury Report par 5.7-5.12.
[215] Cadbury Report 58-59.
[216] Cadbury Report par 1.3.
[217] Mongalo "The emergence of corporate governance as a fundamental research topic in South Africa" 2003 *South African Law Journal* 173 188-189. South Africa followed suit in 1994 with the first King Report. *Cf* 2 2 2 *supra*.
[218] Greenbury Report 1995.
[219] Greenbury Report 1995 21-36.

to create the first version of the Combined Code in 1998. The Hampel committee was the first to address corporate governance in its entirety.

The Turnbull Report on matters of internal control was published in 1999 by the ICAEW. In 2003, the Higgs Report on non-executive directors and the Smith Report on audit committees joined the *corpus* of governance codes. The Combined Code was updated in 2003 to include the recommendations of these reports and to take the then-recent failure of corporations abroad, like Enron, into account.[220]

The Combined Code was reviewed again in 2006 without significant amendments. The final version as it currently stands has been effective from the first of November 2006.[221] A notable feature of UK governance codes is its stability and robust nature. An extensive 2006 review of the Combined Code concluded that the codes in place were working well and only minor amendments were recommended. This does of course not mean that the Code will not have to be continuously reviewed in the future, or that it is shy of criticism. For example, Turnbull criticises the Combined Code for not addressing the conflicting director-auditor relationships inherent in the audit of a company.[222]

Listed companies have a wide discretion, according to the "comply or explain" principle, to disclose how they complied with the Combined Code, and if not, why they have not complied.[223] The main provisions contained in the Combined Code that affect the company auditor, are recommendations regarding the duties and composition of the audit committee.[224] In particular, the Combined Code refers to the role of the audit committee on matters of internal control as well as in the appointment, remuneration and removal of the external auditor.[225] Furthermore, if the external auditor were to provide non-audit services as well, the annual report should state how auditor independence and objectivity was maintained.[226]

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[220] Turnbull Report 1999; Higgs Report 2003; Smith Report 2003.
[221] Combined Code 2006 *Preamble* par 3.
[222] Turnbull "How US and UK auditing practices became muddled to muddle corporate governance principles" 2005 *Working Paper Social Science Research Network* <http://ssrn.com/abstract=608241> *Cf* 2 3 1 *infra*.
[223] Combined Code 2006 *Preamble* par 4.
[224] Combined Code 2006 C.3.
[225] This is the result of the incorporation of many of the essential recommendations of the Smith Report in the Combined Code. *Cf* Combined Code 2006 C.3.2; C.3.5-C.3.6.
[226] Combined Code 2006 C.3.7. Other areas addressed in the Combined Code include the usual suspects on the terrain of corporate governance: executive and non-executive directors, shareholders, directors' remuneration, disclosure and transparency.

As in South Africa, the Combined Code has been included with stock exchange rules as part of the listing requirements for relevant public companies. The Combined Code has superseded any previous code that was included in the listing requirements. The UK approach towards corporate governance is, as in South Africa, a "comply or explain", soft law measure without statutory effect. The company thus has the option to deviate from the Combined Code provisions if the company deems it necessary, provided that acceptable reasons for doing so can be furnished. This leaves the company with a wide discretion. A significant problem with this principle in practice, is that it is very difficult to evaluate the quality of the explanation.[227]

2 2 3 2 Legislation

The Companies Acts of 1985 and 1989 used to regulate the position of the company auditor together. Part XI of the 1985 Act regulates the appointment of the external auditor. The 1989 Act was established mainly to acknowledge the UK's membership of the EU and to consequently incorporate the EU's Seventh and Eight Company Law Directives into UK company law.[228] With regard to the auditor, the 1989 Act regulates the appointment and removal of the auditor specifically.[229]

In 2002, the first white paper on proposed company law was issued as part of the company law reform process that was initiated in 1998.[230] However, the promulgation of this complete overhaul was temporarily delayed, as corporate failures like Enron shifted the focus of international review from general company law towards the more effective regulation of auditing and accounting regulation and related independence issues. The result of this fast-tracking of auditing concerns was the Companies (Audit, Investigations and Community Enterprise) Act[231] which became operational on 8 April 2005. New provisions concern the increased regulation of the company auditor in the areas of access to information and the

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[227] Arcot, Bruno & Faure-Grimaud "Corporate governance in the UK: Is the 'comply or explain' approach working?" (2005) *London School of Economics and Political Science* <http://www.lse.ac.uk/collections/corporateGovernance/pdf/isTheComplyOrExplainApproachWorking.pdf>.
[228] Cooper ICSA Handbook on good boardroom practice (2004) 4.
[229] Ss 24-29; 118-124 of the Companies Act 1989.
[230] The White Paper's main features regarding the auditor was the regulation on areas of competition, liability and audit quality. *Cf* DTI *White Paper Company Law Reform Cm 6456* March 2005 par 2.5; Belcher "Audit Quality and the market for audits: an analysis of recent UK regulatory policies" 2006 *Bond Law Review* 1-3.
[231] 2004 (c. 27).

disclosure of non-audit services.[232] The act was the final result of an exhaustive review process which included several review papers the most important of which is the Final Report from the Co-ordinating Group on Audit and Accountancy Issues ("CGAA Report").[233]

The revised Companies Act comprises 1300 sections and received Royal Assent on the eighth of November 2006. The new Companies Act does not wholly repeal the 1985, 1989 and 2004 acts, but only replaces a large majority of their provisions.[234] The new act, generally regarded as the longest act in UK legislative history, is expected to be fully operational by October 2009.[235] Key provisions and changes include the simplification and deregulation of capital maintenance requirements, the introduction of comprehensive electronic communication regulation as well as the first legislative codification of directors' duties and a renewed focus and simplification of regulation affecting small businesses. Of the provisions affecting the auditor, few have survived. Part XI of the 1989 Act has now been repealed completely as well as the entire section in the 1989 act that governs the auditor. The recent 2004 act was also by no means left intact. The only surviving provisions are the sections regulating community interest companies and the sections regulating the supervision of accounts and reports with, importantly, the Secretary of State's delegating power remaining entrenched and unchanged.[236]

The new Companies Act has introduced a new statutory offence with regard to auditing. Section 507 now makes it an offence to "knowingly or recklessly cause... [an] auditor's report on company's annual accounts to include any matter that is misleading, false or deceptive in a material particular."[237] A new provision allowing companies to limit the liability of their auditors in the case of negligence or breach of duty on the part of the auditor is now included.[238] The extent of this limitation will vary depending on the particular agreement, and is largely subject to the discretion of the company. Furthermore, section

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[232] *Cf* ss 7-8 of the Companies (AICE) Act of 2004.
[233] CGAA *Final Report* 2003 <http://www.berr.gov.uk/files/file20380.pdf>. Other consultative papers, most of whom support the new recommendations entirely, include DTI *Review of the regulatory regime of the accountancy profession: legislative proposals* 2004 <http://www.berr.gov.uk/files/file20686.pdf>;
[234] For a complete list of surviving provisions, see Morse *Palmer's company law* (2007) 1001.
[235] Timms *Written statement Companies Act 2006* (2007-12-07) <http://www.berr.gov.uk/bbf/co-act-2006/whatsnew/page42866.html>; Morse *Palmer's company law (Annotated)* 1030.
[236] Ss 14-18; 26-63. S 16 grants the Secretary of State a wide discretionary power to delegate *inter alia* the creation, issuing and enforcing of accounting standards to any supervisory or qualifying accounting body.
[237] S 507 of the Companies Act 2006.
[238] S 515 of the Companies Act 2006. *Cf* 2 4 *infra.*

503[239] now provides that the senior auditor on the audit is obliged to sign his own name when approving the client's financial statements, instead of the audit firm's name. Part 16[240] governs the position of the company auditors whilst Part 42[241] regulates "statutory auditors" which mostly includes, but is not limited to, the company auditor as regulated by Part 16.[242] Part 42 determines the eligibility of certain persons and firms to act as a company auditor with special regard to their appropriate affiliation and the relevant regulatory organisations. All sections directly regulating the auditor, including the substantive components of Parts 16 and 42, has come into effect on 6 April 2008.

2 2 3 3 Supervisory bodies

The Financial Reporting Council ("FRC") is the official regulator of corporate governance in the UK. It promotes a wide array of financial interests which include the setting and monitoring of auditing and accounting standards as well as the statutory regulation of auditors, overseeing the functions of the independent accounting and auditing bodies and performing general investigatory functions.[243]

The FRC was originally intended to function only as an umbrella company to the newly established FRRP and ASB, the result of which was the Cadbury Report. The FRC initially had a limited role to only ensure the independence and funding of its group.[244] Upon the reconsideration of UK auditing regulation in 2003, the powers of the FRC were significantly expanded to now include seven operating bodies.[245] Among these bodies, the Auditing Practices Board ("APB") functions as the auditing standard setter. In particular, the APB has to create and implement ethical standards ensuring auditor independence.[246]

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[239] Companies Act 2006.
[240] Ss 475 - 539 of the Companies Act 2006 .
[241] Ss 1209 – 1264 of the Companies Act 2006.
[242] S 1210 of the Companies Act 2006.
[243] FRC *The FRC* <http://www.accountancyfoundation.com/about/>.
[244] FRC *Consultation paper on the governance structure of the FRC* 2007 <http://www.frc.org.uk/images/uploaded/documents/FRC%20Structure%20-%20Consultation%20Paper%20FINAL1.pdf>.
[245] The operating bodies are the Accounting Standards board ("ASB"), Auditing Practices Board ("APB"), Accountancy and Actuarial Discipline Board ("AADB"), Committee on Corporate Governance ("CCG"), Financial Reporting Review Panel ("FRRP"), Professional Oversight Board ("POB"). The Audit Inspection Unit ("AIU") investigates the audit quality of listed companies' audits under command of the POB. <http://www.frc.org.uk>. For more detail, see FRC *Regulatory Strategy Appendix C* 2007.
[246] FRC *About the APB* <http://www.frc.org.uk/apb/about/>. Membership to at least one of the self-regulatory bodies is required to practice as an accountant. In the UK, these bodies are: Institute of Chartered Accountants

2 2 3 4 Conclusion

It can be argued that the regulation of corporate governance and the legislative review of company law in the UK has now reached saturation point. During the 2007 review of the Combined Code, the FRC noted that respondents seem to have "regulatory fatigue"[247] as they already had to comply with the new Companies Act and all the previous versions of the Combined Code. Although there is always room for debate, and the continuous discussion of company legislation certainly is necessary to ensure that the law stays relevant, it is submitted that the current companies act and the corporate governance codes together provide an effective and updated legislative framework.

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in England and Wales ("ICAEW"), Institute of Chartered Accountants of Scotland ("ICAS"), Institute of Chartered Accountants in Ireland ("ICAI"), Association of Chartered Certified Accountants("ACCA") and the Association of Authorised Public Accountants ("AAPA").

[247] FRC 2007 *Review of the Combined Code: Report on the main findings of the review 2007* 11 <http://www.frc.org.uk/corporate/2007review.cfm>.

2 3 OTHER ROLE PLAYERS IN THE AUDIT PROCESS

2 3 1 THE AUDIT COMMITTEE IN SOUTH AFRICA

Although audit committees only became widely used in corporate South Africa after King I was published in 1994,[248] audit committees first received regulatory attention in the US in 1978, when the NYSE required all listed companies to have an audit committee.[249] In South Africa, the audit committee was the first board committee to be recognised and widely used as a corporate governance watchdog.[250] After the Companies Act's silence on this topic, the Amendment Act now provides that every widely held company should have an audit committee.[251]

The increased international focus on audit committees during recent years has led to extensive new regulation in this field. Legislative developments have significantly expanded the role and responsibilities of audit committees. In a 2005 review among their top 50 global clients, consulting company Spencer Stuart found that 65% of these audit committee members reportedly spent at least 50% more time on audit committee affairs than only two to three years before.[252] In the US, audit committee meetings increased from 7.3 to 9.5 times per year over the past three years.[253] Yet South African data do not reflect the same trend. In Spencer Stuart's most recent South African Board Index of 2007, the results showed that the number of annual audit committee meetings declined slightly from 3.5 to 3.4 times per year. It was also found that only 68% of audit committees are chaired by an independent non-

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[248] Wixley and Everingham What you must know about corporate governance (2002) 61.
[249] Buchalter & Yokomoto "Audit Committee's Responsibility and Liability" (2003-03-03) *CPA Journal.* <http://www.nysscpa.org/cpajournal/2003/0303/features/f031803.htm>
[250] Wixley & Everingham *Corporate governance* 61.
[251] S 24 of the Amendment Act insert s 269A(1) into the Companies Act. There are a few cases where a widely held company may be exempt from appointing an audit committee. These include instances where the holding company has committed to execute the audit committee function on behalf of the subsidiary, or if the Minister identifies and exempts certain classes of companies on the grounds that having an audit committee would not benefit the company. Once a company ceases to be a widely held company, the company is of course free to dissolve their audit committee, although it would be in the company's best interest to not do so. S 24 of the Amendment Act inserts s 269A(2) into the Companies Act.
[252] Spencer Stuart *The Global 50: Perspectives of leading audit committee chairs* (2005) 11 <http://content.spencerstuart.com/sswebsite/pdf/lib/Global_50_2005.PDF>.
[253] Spencer Stuart *South Africa Board Index 2007.* <http://content.spencerstuart.com/sswebsite/pdf/lib /ZABI_2007.pdf>.
In 2006, the frequency of UK audit committee meetings varied between 3 and 13 times per year. The number of meetings held is not necessarily indicative of increased efficiency, but it does indicate an increased awareness of the value and importance of the audit committee. Spencer Stuart *2006 UK Board Index* <http://content.spencerstuart.com/sswebsite/pdf/lib/UKBI-2006.pdf>.

executive director, and it was concluded that chairperson independence has not improved since 2004.[254] It is apparent that the South African audit committee has not entirely evolved to the prominent role of its UK and US counterparts. It should, however, be kept in mind that these South African results were based on data from 2005 and 2006, when audit committees were regulated by King II only. It is submitted that the Amendment Act will lead to a marked improvement in the prominence and importance of the South African audit committee over the next few years.

The audit committee has been primarily established to protect the interests of the shareholders with special regard to matters of financial reporting, internal control and the appointment and oversight of company auditors.[255] The nature of the audit committee's role is one of oversight and monitoring and should not be construed as to intrude upon the role of the board of directors.[256] In assisting the board in some of its tasks, the audit committee is able to attend to certain board functions in greater detail than the board would have time for on their own. Ideally, the committee should function independently from management but not from the board, and should never be in the position that it usurps the duties of any other person, functionary or director of the company.[257] Turnbull warns that although the non-executive directors are appointed to the committee to help resolve the conflict between directors and shareholders, this may give rise to a new conflict between the non-executive directors who serve on the audit committee and the rest of the board members.[258]

The Amendment Act gives the audit committee a wide range of statutory rights and duties. Although the majority of functions as set out in the Amendment Act are substantially very similar to those determined by UK and USA authorities, differences do occur. The scope of this thesis does not allow a detailed discussion of all the audit committee powers and duties, but major provisions will be briefly overviewed.[259] All the aspects pertaining to the

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[254]Spencer Stuart South Africa Board Index 2007.
In 2006, UK audit committee meetings varied between 3 and 13 times per year. The number of meetings held are not necessarily indicative of increased efficiency, but it does indicate towards an increased awareness of the value and importance of the audit committee. Spencer Stuart *2006 UK Board Index*.

[255] Smith Report par 1.6; Combined Code C.3.

[256] Combined Code C.3; S 26 of the Amendment Act inserts s 270A(3) into the Companies Act. S 270A(3) provides that the audit committee only reduces the board's functions in respect of the appointment, remuneration and terms of engagement of auditors.

[257] Smith Report par 1.6; 1.10; Smith Report *Background* par 17-20.

[258] Turnbull 2005 *SSRN.*

[259] For a detailed discussion of US audit committees see the SEC, NYSE & NASD *Report and recommendations of the Blue Ribbon Committee on improving the effectiveness of corporate audit committee.* 1999 ("Blue Ribbon Report") <http://www.nasdaq.com/about/Blue_Ribbon_Panel.pdf>.

relationship between the audit committee and the external auditor will be revisited in greater detail *infra*.[260]

2 3 1 1 Appointment and composition

The Amendment Act instructs the board of directors of widely held companies to annually appoint the members of the audit committee.[261] Section 24 of the Amendment Act provides for a minimum of two members on an audit committee, whereas Sarbanes-Oxley has no minimum requirements.[262] The Combined Code recommends a minimum of three members except in the case of smaller companies where the smaller size may justify only two members.[263] The Smith Report recommends an absolute minimum of three members. In turn, King II does not require a minimum membership number but does require that the chairperson of the board of directors should not also be the chairperson of the audit committee. According to both King II and the Smith Report, the chairperson should ideally not serve on the audit committee at all, but should rather attend the audit committee meetings only upon invitation.[264] It is further recommended by the Smith Report that the external audit partner and finance director be regularly invited to attend audit committee meetings in their capacity as non-members.[265]

The Amendment Act, Combined Code and Smith Report all provide that the committee should entirely consist of independent non-executive directors.[266] King II, on the other hand, only recommends that the *majority* of the committee members as well as the chairperson of the committee should be independent non-executive directors.[267] The Amendment Act defines a non-executive director as one who "is not involved in the day to day management of the business and has not in the past three financial years been a full-time salaried employee of

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[260] Cf 3 6 infra.
[261] S 24 of the Amendment Act inserts s 269A(1) into the Companies Act; Combined Code par C.3.1.
[262] S 24 of the Amendment Act inserts s 269A(3) into the Companies Act. The Companies Bill now requires a minimum of 3 members. S 94(2) of the Companies Bill 2008.
[263] Combined Code par C.3.1.
[264] King II par 6.3.2; Smith Report par 3.2. There is no maximum restriction on the number of audit committee members in either legislation or governance reports. Audit committee size will vary according to the size of the company, but it is submitted that too large a committee may render decision making ineffective.
[265] Smith Report par 3.2.
[266] S 24 of the Amendment Act inserts s 269A(3) into the Companies Act; Smith Report par 3.1; 3.6; Combined Code par C.3.1.
[267] King II par 6.3.1 – 6.3.2.

the company or its group [and] is not a member of the immediate family of… [such aforementioned] individual."[268]

A director is regarded as independent in terms of the Amendment Act if the director is "not related to the company or to any shareholder, supplier, customer or other director of the company in a way that would lead a reasonable and informed third party to conclude that the integrity, impartiality or objectivity of that director is compromised by that relationship".[269] The Combined Code and Smith Report do not provide a definition of independence, but delegates this function to the board of directors. The Combined Code only provides that the board should be satisfied that directors are independent "in character and judgment" and the board should decide whether there are extraneous factors that could impede the directors' ability to remain independent.[270] In the US, the definition of independence as determined by section 301(3) of the Sarbanes-Oxley Act is applied to audit committee members. For an US audit committee member to be sufficiently independent in terms of this section, the member is not allowed to receive any payment from the firm other than for services as a board director or for services rendered on a board committee.[271]

With regard to the minimum desired qualifications of committee members, the Amendment Act is silent. There is no required level of financial literacy for non-listed South African audit committees, which is an unsatisfactory position.[272] King II only recommends that the majority of the members should be "financially literate".[273] The Institute of Directors in Southern Africa ("IODSA") supports this view.[274] King II does not define "financially literate", but IODSA suggests that "a working knowledge of accounting and auditing standards" would suffice.[275] The Combined Code requires that at least one of the committee

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[268] S 24 of the Amendment Act inserts s 269A(4)(b) into the Companies Act.
[269] S 24 of the Amendment Act inserts s 269A(4)(c)(ii) into the Companies Act. The Amendment Act also defines independent actions as the impartial expressing of opinions as well as impartial judgment or decision making. S 24 of the Amendment Act inserts S269A(4)(b)(i) into the Companies Act.
[270] Combined Code par A.3.1; Smith Report par 3.1.
[271] S 301(3)(B) of the Sarbanes-Oxley Act. The Companies Bill requires that all audit committee members be directors who are not involved in the daily operations of the company nor has been for the previous three years. Directors who have been employees or customers of the company, and their relatives, are also excluded from potential membership. S 94(4) of the Companies Bill 2008.
[272] The Companies Bill now determines that the Minister may prescribe minimum qualification requirements for audit committee members. S 94(5) of the Companies Bill 2008.
[273] King II par 6.3.1.
[274] IODSA *Comments on the Companies Amendment Bill.* <http://www.iodsa.co.za/downloads/comments /Companies%20Ammendment%20Bill.pdf>.
[275] IODSA Comments.

members should have "recent and relevant financial experience".[276] It is left to the discretion of the board of directors to determine whether this requirement is met.[277] The Smith Report avoided an overly prescriptive approach by recommending that committee members should ideally have a combination of skills and professional qualifications.[278] Smith also suggests that it might be beneficial to have a less financially literate member with a critical mind on the committee, as such a person might question certain financial practices that more qualified members would not.[279] In terms of the Sarbanes-Oxley mandate to create rules,[280] the SEC found it insufficient to leave the determination of who would constitute a financial expert to the subjective discretion of each board. The SEC has consequently defined the term "audit committee financial expert" as an individual with experience with complex accounting issues, an understanding of general accounting principles of relatively the same nature and complexity of the company's accounting matters, and an understanding of both financial internal controls and audit committee functions. An accounting or relevant qualification is recommended but not necessary.[281]

Both the Amendment Act and King II are silent on the term length of committee members. Smith recommends that members be appointed for a twice renewable period of three years, permitting the member continues to satisfy the independence criteria.[282]

2 3 1 2 Powers, duties and responsibilities

One of the most important changes brought about by the recent introduction of the audit committee in legislation, is that the committee is now responsible for the appointment and remuneration of the external company auditor. This function has been described in the US as "the single most important provision of the [Sarbanes-Oxley] Act".[283] The shifting of these responsibilities from the directors to the audit committee is welcomed as the appointment and

[276] Combined Code par C.3.1.
[277] Combined Code par C.3.1.
[278] Smith Report *Background* par 31-32.
[279] Smith Report *Background* par 33.
[280] S 407 of the Sarbanes-Oxley Act determines that the SEC must issue rules regarding the disclosure of the number of financial experts on the audit committee.
[281] SEC *Standards relating to listed company audit committees* (2003-04-25). <http://www.sec.gov/rules/final/33-8220.htm#P238_65597>.
[282] Smith Report par 3.4. The Combined Code has no recommendation on the length of the term of an audit committee member.
[283] Friedland "The Sarbanes-Oxley Act: corporate governance, financial reporting and economic crime" 2002 *The Company Lawyer* 384.

remuneration of the auditor is closely related to another important function of the audit committee, namely the ensuring of auditor independence.

With regard to independence, the committee has to publish a report declaring whether the committee is satisfied with the degree of independence of the auditor with the annual financial statements. In addition, a report on "how the audit committee carried out their functions" should be included.[284]

Significantly, there is no whistleblowing provision in King II or the Amendment Act. Section 270A(1)(g) of the Amendment Act does provide that the committee should "receive and deal appropriately with" internal and external complaints.[285] Sarbanes-Oxley similarly provides that the audit committee should establish the necessary structure to deal with complaints received by the company and complaints submitted by employees.[286] The Smith Report states that the audit committee should create and ensure that the necessary structures are in place to efficiently deal with complaints from *personnel* only.[287] This provision is echoed in the Combined Code with an added requirement that submitted complaints should be treated as confidential.[288] In this regard, the provisions of the Amendment Act and Sarbanes-Oxley seem to find wider application as the provisions of the UK.

Furthermore anyone, be it an employee, director or an outsider, may lodge complaints with the committee regarding any aspect of the internal or external auditing process as well as the contents of the financial statements.[289] The Smith Report requires a more onerous burden of inspection in this regard: where the Amendment Act and Sarbanes-Oxley[290] only require the committee to act upon a complaint, the Smith Report requires that the audit committee should "monitor the integrity of financial statements", which is a more continuous responsibility.[291]

With regard to the scope and content of audit committee duties, the UK requires that each audit committee should adopt its own terms of reference by which the powers and duties of

[284] S 26 of the Amendment Act inserts s 270A(1)(f) into the Companies Act.
[285] S 26 of the Amendment Act inserts s 270A(1)(g) into the Companies Act.
[286] S 301(4) of the Sarbanes-Oxley Act. Sarbanes-Oxley can be distinguished from the Amendment Act in that it guarantees the confidentiality of internal complaints in section 301(4)(B).
[287] Smith Report par 5.9.
[288] Combined Code par C.3.4.
[289] S 26 of the Amendment Act inserts s 270A(1)(g) into the Companies Act.
[290] S 301(4) of the Sarbanes-Oxley Act.
[291] Smith Report par 2.1.

the particular committee are made known to investors.[292] There is no such mandate in the US, but SEC rules determine that if there is a charter governing an audit committee, it should be disclosed.[293] Regrettably, the Amendment Act does not provide for such a document. King II does recommend that all companies should have written terms of reference and that the committee's performance should be evaluated as disclosed against the terms of reference.[294] This determination and limitation of committee powers are especially important when legislation leaves a certain amount of discretion to the board by not providing a *numerus clausus* of audit committee powers. Section 270A(1)(h) of the Companies Act provides that the audit committee may also perform any other function as determined by the board of directors. The South African board clearly has a broad discretion in this regard. It is submitted that every South African company should be legislatively required to adopt terms of reference. This move will promote the transparency, accountability and efficacy of the audit committee.[295]

Finally, with regard to liability, it should be kept in mind that audit committee members are directors as well. Committee members are potentially just as liable as the rest of the non-executive board members.[296] Spencer Stuart recommends that because of this equal liability, non-executive directors should aim to serve on the audit committee, as this would lead to a more active role in the limitation of one's own liability.[297]

2 3 1 3 Conclusion

The mere existence of an audit committee is of course no guarantee against corporate mismanagement. Most of the examples of corporate collapse, including Enron and WorldCom, had an audit committee in place.[298] What is needed, apart from formalistic compliance with audit committee rules, is a commitment to integrity, efficacy and transparency by approaching problems with, as Olsen calls it, an attitude of "constructive

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[292] Combined Code par C.3.3.
[293] SEC Standards relating to listed company audit committees (2003-04-25); SEC Commission adopts rules strengthening auditor independence (2003-01-23) <http://www.sec.gov/news/press/2003-9.htm>.
[294] King II par 6.3.3-6.3.4.
[295] It should be noted that the duties of the audit committee as determined by the Amendment Act have not been materially changed in the Companies Bill. *Cf* s 94(7) of the Companies Bill 2008.
[296] Smith Report Background par 21; Blackman, Jooste & Everingham *Commentary on the Companies Act* Vol 2 2004 8-193; Combined Code *Schedule B*.
[297] Spencer Stuart *The Global 50* 5.
[298] *Cf* 1 2 2 *supra*.

skepticism".[299] If functioning effectively, the audit committee with its new legislative framework can make a significant contribution to the decline in corporate failures.

As noted in the Smith Report:

> "The work of the committee should however go beyond catching inappropriate reporting or inadequate auditing. Rather its work should be more pervasive and seek to build into the organisation a culture of compliance and fair reporting, an environment in which issues are openly discussed and resolved before they become matters of real concern."[300]

[299] Olsen "How to really make audit committees more effective" 1999 *The Business Lawyer* <http://www.kpmg.com/aci/docs/practices/businesslawyer.pdf>.
[300] Smith Report *Combined Code Guidance* par 12.

2 4 STATUTORY LIABILITY OF THE EXTERNAL AUDITOR

The external company auditor is subject to three main forms of liability, namely common law liability, statutory liability and disciplinary liability as imposed by the appropriate regulatory bodies. With regard to regulatory bodies, the South African auditor may be held accountable by means of disciplinary hearings by the IRBA, as set out in the Auditing Profession Act.[301] The US has also seen an increase in the liability of the public company auditor with the shift of the oversight function from the self-regulatory and inherently industry-friendly AICPA to the more removed, *quasi* governmental PCAOB. The PCAOB now has the power to inspect any matter regarding the liability of the auditor and can fine the auditor up to a maximum of $750 000 per natural person, or $15 million for a juristic person.[302]In the UK, the AADB is responsible for the establishment and enforcement of the disciplinary framework of FRC members and member firms.[303]

The auditor is also subject to common law liability through contract or delict. With the auditor's acceptance of the audit engagement, a contract is formed. Breach of this contract by the auditor can lead to contractual liability.[304] The negligent auditor can also be held liable by third parties who rely on the auditor's assurances.[305] Common law liability is hereby acknowledged and excluded as beyond the scope of this thesis. This section will focus on statutory liability only, both civil and criminal.

A client is defined in the Auditing Profession Act as "the person for whom a registered auditor is performing or has performed an audit".[306] The same act defines third parties as "any person other than a client".[307] It should be noted that this distinction implies that any employee or natural person or functionary of the client company would qualify as a third person, as only the company itself would be defined as the client.[308]

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[301] Ss 4; 47-50 of the Auditing Profession Act.
[302] S 105(c)(4)(D) of the Sarbanes-Oxley Act.
[303] Aims & Objectives. <http://www.frc.org.uk/aadb/about/aims.cfm>.
[304] Puttick & van Esch *Auditing* 105-109.
[305] Baker & Prentice "The origins of auditor liability under the United States common law" 2008 *Business Network.* <http://findarticles.com/p/articles/mi_qa3933/is_200805/ai_n25500710>.
[306] S 1 of the Auditing Profession Act.
[307] S 1 of the Auditing Profession Act.
[308] Cilliers & Benade *Korporatiewe reg* 428.

This section does not aim to comprehensively review all potential areas of liability for the auditor, but does attempt to highlight the more important statutory offences.

2 4 1 SOUTH AFRICA

2 4 1 1 Statutory civil liability

The auditor has numerous statutory duties, most of which are discussed or referred to in greater detail in Chapter Three.[309] The breach of any of these statutory duties towards its client may lead to civil liability on the part of the auditor.[310] Apart from this general breach of statutory duty as a cause of action, the Companies Act and Auditing Profession Act sets out further potential forms of liability.

Section 8(2) of the Companies Act provides that no auditor will be held liable for any report, opinion, statement, account or document made unless it was made negligently or maliciously.[311] Henochsberg submits that "negligently" should be construed to mean action without "reasonable care or diligence".[312] Proof on the part of the auditor that he acted in good faith would thus be an absolute defense, and plaintiffs arguing on the basis of this section would have to specifically prove malice or negligence on the part of the defendant in addition to the other elements of the cause of action.[313] This provision is essentially echoed in the Auditing Profession Act, which determines that a registered auditor may not be held liable without malicious or fraudulent actions or negligent performance of its duties.[314]

Section 46(3) of the Auditing Profession Act determines that the registered auditor may be liable to third parties if that third party has relied on the negligent and mistaken statement, opinion or report and the third party has suffered financial loss as a result of this reliance.

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[309] *Cf* 3 4 *infra.*
[310] Cilliers & Benade *Korporatiewe reg* 418.
[311] S 8(2) of the Companies Act 1973.
[312] Henochsberg Vol 1 21. Henochsberg also submits that "maliciously" should be read as used in *May v Udwin* 1981 (1) SA 1 (A) at 19.
[313] Henochsberg Vol 1 21.
[314] S 46(2) of the Auditing Profession Act.

2 4 1 2 Statutory criminal liability

The Companies Act determines, inter alia, that it is an offence for an auditor to knowingly make a false statement in any "statement, return, report, certificate, financial statement or other document required by...this Act".[315] The auditor will also be held criminally liable for perjury if that auditor has "wilfully" given false evidence on "any matter arising under this Act" whilst under oath or affirmation.[316]

Furthermore, the auditor may be held criminally liable if it assists, or is responsible for, the issuing, circulating or publishing of any materially false "certificate, written statement, report or financial statements in relation to any property or affairs of the company".[317] The auditor may, in his defence prove that he concluded after a reasonable investigation that there was "reasonable grounds" to believe that the content of the disputed document was true.[318]

The auditor will also be subject to criminal liability if he was appointed as auditor whilst falling under the prohibited list of persons banned from being appointed as such, as determined by section 275 of the Companies Act.[319]

Section 250 of the Companies Act also makes it a criminal offence for anyone to conceal, destroy, falsify or otherwise tamper with any book, document, record or statement of the company. No mental state is required in order to contravene this offence.[320] However, it would be a sufficient defence to prove lack of intent to defraud, conceal or do an act that would lead to civil or criminal liability.[321] Section 250(2) requires that lack of intent would constitute a sufficient defence.

A second offence created by section 250, is the erasure of any information in any company record, document or statement. This offence expressly requires a mental state, namely the *intent* to defraud or deceive, and thus the onus to prove intent will rest on the prosecution. Again, subsection 2 provides that proof of a lack of intent would suffice in order to avoid liability under this section. Section 250 notably applies to any person, whereas section 251

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[315] S 249(1) of the Companies Act.
[316] S 249(2) of the Companies Act.
[317] S 251(1) of the Companies Act. *Cf R v Milne and Erleigh* (7) 1951 (1) SA 791 (A) 858-859.
[318] S 251(2) of the Companies Act.
[319] S 275(4) of the Companies Act.
[320] S 250(1) of the Companies Act
[321] S 250(2) of the Companies Act.

only applies to any person paid by the company for the rendering of "special work or service".[322]

With regard to punishment, the Companies Act holds that these criminal offences *supra* are all punishable by a fine or a maximum imprisonment of one year, or both.[323]

Other criminal offences include the case where the auditor fails to complete the requisite form wherein his appointment is accepted, and when the auditor fails to give the client fourteen days notice of any change in his particulars as reflected in the register of directors and other officers.[324] The Companies Act does not prescribe or limit a particular penalty for the auditor in the case of contravention of these provisions.

Finally, a registered auditor who fails to report a "reportable irregularity" as set out in section 45 of the Auditing Profession Act, or who "knowingly or recklessly expresses an opinion or makes a report or other statement which is false in a material respect" will be guilty of an offence.[325] This section further determines that the auditor may be held liable to a maximum of ten years imprisonment or a fine, or both.[326] If the auditor is a firm, the individual registered auditor in terms of section 44(1)(a) may be held personally liable. This section does not detract from or replace the capacity of the disciplinary board to initiate disciplinary hearings concurrent to, or instead of, the criminal actions taken.[327]

[322] S 250(1); s 251(1) of the Companies Act.
[323] S 441(1)(e) of the Companies Act.
[324] Ss 276(2)-(5) of the Companies Act. S 215(2) of the Companies Act determines that the following detail of the auditor should be included in the register of directors and other officers: the auditor's name and date of appointment as well as any change regarding this name or date of appointment.
[325] S 52(1) of the Auditing Profession Act.
[326] S 52(3) of the Auditing Profession Act.
[327] S 52(2) of the Auditing Profession Act.

2 4 2 US STATUTORY LAW[328]

2 4 2 1 Securities Act of 1933

Civil liability under this act is determined by section 11. This section determines that *any* person who buys securities in a company, unaware of an "untrue statement of material fact" or omission of a material fact in the companies' SEC registration statement, may hold any auditor liable that was involved in the preparation or certification of any valuation, statement or report contained in that registration statement.[329]

This section has limited application, as only persons that acquire securities under allegedly misleading circumstances, may claim damages.[330] Damages are generally limited, with some exceptions, to the difference between the actual amount paid and the market price of the disputed shares.[331] As the 1933 Act only regulates the initial registration of securities (IPOs), a claim under this section will only be available to the original buyers of the securities. This section thus finds limited application.

2 4 2 2 Securities Exchange Act of 1934

Where the 1933 act only applies to the initial registration of securities, the 1934 act applies to the continuous disclosure of company statements. Although there are significant similarities

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[328] The focus will be on federal law, with state law excluded as beyond the scope of this thesis. It should, however, be noted that auditors may also be held liable by state law on either civil or criminal grounds, depending on each state and its laws.

[329] S 11(a) of the Securities Act. The auditor is only one of many possible persons that can be held jointly and severally liable in terms of this act. Other persons include the underwriters of the registration statement, directors or partners as well as any person who signed the registration statement. S 11(a); (f) of the Securities Act.

[330] However, these plaintiffs, only have to prove that they incurred a monetary loss and that the registration statement was misleading. The plaintiff does not have to prove the additional requirements that there was reliance on the misleading statement or that the auditor was negligent. This imposes a high burden on the auditor, as the auditor has to provide an affirmative defence to prove his innocence. Although there are several defences available to the auditor, the most popular is the due diligence defence. This entails proving that that an adequate audit has been conducted and that the auditor reasonably believed it to be an accurate reflection of the company's financial status. For more detail on the application of the due diligence defenses, see Sjostrom "The due diligence defense under section 11 of the Securities Act of 1933" 2006 *Brandeis Law Journal* 1-62; Whittington & Pany *Principles of Auditing* (1998) 106-107; Arens & Loebbecke *Auditing* (1997) 125; *Escott v BarChris Construction Corporation* 283 F. Supp. 642 (1968).

[331] S 11(e) of the Securities Act. The maximum amount of damages allowed under this penalty is the amount paid for the securities. S 11(g) of the Securities Act.

in the civil liability section, those in the Exchange Act finds broader application, as companies are required to continuously update the financial information registered with the SEC.

Similar to section 11 of the Securities Act, section 18 of the Securities Exchange Act determines that any information contained in any document filed with the SEC which is "false or misleading with respect to any material fact" may hold any person liable who did not know of the nature of the misstatement. Only persons who relied, in their acquiring of securities in a particular company, to their detriment on the misstatements and suffered a loss, may claim damages.[332]

Section 10(b) of the Exchange Act is an anti-fraud provision that makes it unlawful for any person to use securities exchanges, the mail or interstate commerce as a vehicle for any "manipulative or deceptive device" that would contravene applicable rules and regulations, and would be *contra* public and investor interest.[333] Section 10(b) should be read with Rule 10b-5 of the SEC, which determines that it is unlawful for any person to act fraudulently, by for example, making untrue statements or employment of any scheme to defraud, with regard to the purchase or sale of securities.[334]

Section 32 of the Exchange Act also provides maximum criminal penalties for any person who "wilfully and knowingly" makes or is in involved in the making of, any statement in the registration statement, which is "false or misleading with respect to any material fact".

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[332] In extreme cases, the auditor may be held liable for treble damages under the Racketeer Influenced and Corrupt Organizations Act (RICO), a fraud statute. This act requires participation in management of the client company, and will thus only be applicable if the auditors cross independence boundaries and become involved in management functions. Although RICO can impose both civil and criminal liability, the impact of RICO has over years been largely diminished by the courts. Goldsmith M "Resurrecting RICO: removing immunity for white-collar crime" *Harvard Journal on Legislation* 2004 <http://www.law.harvard.edu/students/orgs/jol /vol41_1/goldsmith.php#fn2> *Reves v Ernst & Young* 494 U.S. 1092 (1990).

[333] S 10(b) of the Securities Exchange Act. With section 10 liability, the onus is on the plaintiff to prove that the auditor acted with scienter (fraudulent intent).

[334] More specifically, rule 10b-5 states that:

" It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) to employ any device, scheme or artifice to defraud, (b) to make any untrue statements of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security."

The well established claim of aiding and abetting under s 10(b) was abolished by the Supreme Court in 1994 in *Central Bank of Denver, NA v First Interstate Bank of Denver, NA* 511 U.S. 164, 191 (1994). For the application of s 10(b) and Rule 10b-5, see *Ernst & Ernst v Hochfelder* 425 US 185 (1976); *Fund of Funds Limited v Arthur Andersen & Co* (1982) 545 F Supp. 1314 (S.D. N.Y.).

2 4 2 3 Private Securities Litigation Reform Act of 1995

This act provides several reform measures to the liability provisions of the securities acts, which often lead to relief for the auditor. Among others, these include the introduction of proportionate liability to replace the previous system of joint and several liability.[335] This system of proportionate liability means that auditors will now only be held liable under this act for their own percentage of fault, an amount which, as pointed out by academics Weiss and Berney, may not be enough to justify legal action against the auditors in the first place.[336]

The Reform Act also introduced a new duty on the auditor similar to South Africa's "reportable irregularity"[337] duty. In terms of section 301, if the auditor becomes aware of an illegal act that has a material effect on the financial statements, and constitute a departure from accounting and auditing standards, the auditor has to bring it under senior management's attention. If management refuses to take action to rectify the situation, the matter should be reported to the board. The board, in turn, only has one day to file the matter with the SEC. The Reform Act further provides that the auditor will not be held liable in any civil action resulting from management or the board's refusal to rectify the situation. This act thus gave the auditor a new statutory duty to report fraud.[338]

2 4 2 4 Sarbanes-Oxley Act of 2002

Sarbanes-Oxley has increased the potential liability of the auditor. Section 201 of the Sarbanes-Oxley Act now makes it unlawful for an auditor to perform, subject to certain exemptions, any of the listed non-audit services.[339] Section 802 of Sarbanes-Oxley requires auditors to retain their audit working papers for five years after the completion of the financial year to which those papers apply.[340] By "knowingly or wilfully" contravening this

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[335] S 201(g) of the Private Securities Litigation Reform Act.
[336] Weiss & Berney 2004 *Harvard Journal of Legislation* The authors criticise the fact that this act decreases auditor liability. It should be noted that auditors may still be held jointly and severally liable if they commit *criminal* offences.
[337] *Cf* 3 4 3 *infra.*
[338] For extended commentary on the PSLRA and its shortcomings, see Augenbraun "Liability of accountants under the federal securities laws" *CPA Journal* <http://www.nysscpa.org/cpajournal/old/16531678.htm>; Weiss & Berney 2004 *Harvard Journal of Legislation*.
[339] S 201 of the Sarbanes-Oxley Act. *Cf* 3 6 1 *infra*.
[340] S 802(a)(1) of Sarbanes-Oxley Act.

section, the auditor may be fined or imprisoned for a maximum period of ten years, or both.[341]

Section 804 of Sarbanes-Oxley also extends the period in which a civil action can be made under the Securities Exchange Act from one year after the date of discovery of the facts to two years after discovery, and from three years after the actual violation took place to five years.[342] This extended window period may increase the auditor's liability. Sarbanes-Oxley has also increased the maximum penalties for mail and wire fraud from five years to twenty years' imprisonment.[343]

2 4 3 UNITED KINGDOM

The auditor's statutory liability is less comprehensive in the UK. A new provision in the 2006 Companies Act now makes it a criminal offence for any person to "knowingly or recklessly" cause an auditor's report to contain "any matter that is misleading, false or deceptive in a material particular".[344] A person who "knowingly or recklessly" causes the audit report to omit certain statements may also be held criminally liable.[345]

The Theft Act[346] also applies to the company auditor. The Theft Act provides that any person who "destroys, defaces, conceals or falsifies" any document or record pertaining to accounting matters, or misrepresents any accounting document which to that person's knowledge "is or may be" materially deceptive or false, will be guilty of a criminal offence. The act requires that the guilty party must act "dishonestly, with a view to gain for himself or with intent to cause loss to another".[347]

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[341] S 802(b) of Sarbanes-Oxley Act.
[342] S 804(b) of the Sarbanes-Oxley Act.
[343] S 903 of the Sarbanes-Oxley Act.
[344] S 507(1) of the Companies Act.
[345] S 507(2) of the Companies Act 2006. The Companies Act sets out 3 audit statements that may not be omitted by the auditor if circumstances demand that it should be included. These are statements that adequate accounting records have not been kept, that the individual accounts are not "in agreement" with the companies accounting records and that the directors' remuneration does not reconcile with the companies accounts. Ss 498(2)(a)-(c) of the Companies Act.
[346] 1968.
[347] S 17(1) of the Theft Act.

The auditor may further be held secondarily liable to another's crime under the Accessories and Abettors Act[348] The auditor may be held liable for aiding and abetting, conspiracy and assisting an offender to evade arrest or prosecution[349]

2 4 4 Conclusion

There are not many statutory offences directly relating to the auditor. This does not mean that they cannot easily be held liable: the common law grounds for auditor liability has been well developed and applies in most of the cases involving auditor liability. Statutory liability has not added any major new offences for auditors.

Yet the more popular common law and even disciplinary actions does not render the statutory offences unnecessary. Statutory liability is a valuable tool with which to develop auditor-related offences more coherently and systematically than the courts may do. Liability provisions previously used for disciplinary issues only, may be entrenched. Yet with the current international trend of the *de*criminalisation of company law, an increase in statutory auditor liability is not foreseen.

[348] 1861.
[349] S 8 of the Accessories and Abettors Act. For the application of this provision, see *Maxwell v DPPNI* (1978) 3 All ER 1140; *Tuck v Robson* (1970) 1 All ER 1171; *Rubie v Faulkner* (1940) 1 All ER 285.

CHAPTER 3

THE LEGAL REGULATION OF THE EXTERNAL AUDITOR: SPECIFIC ASPECTS

3 1 INTRODUCTION

> "By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."[350]

Several aspects of the auditor's "public watchdog" function, both substantive and procedural, are regulated in detail by statute in South Africa. Recent legislative reform has materially changed the nature of the appointment and remuneration of the auditor in particular. This chapter will examine in detail, the regulation of auditor appointment, remuneration, the auditor's rights and duties and resignation and removal of the auditor as well as the underlying independence concerns in regulating these aspects. The focus will be on the current statutory regulation of the South African company auditor in these respects. Regulatory and ethical codes will only be used occasionally as an additional source or as a recommendation when there is no legislation addressing a particular issue. The second part of this chapter is devoted to a study of the more controversial aspects of auditor independence. Core issues and differences with other jurisdictions will be compared and contrasted with the regulations in the US and UK. Interpretative and legislative recommendations will be made throughout.

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[350] *United States v. Arthur Young & Co*., 465 U.S. 805, 817–18 (1984).

3 2 APPOINTMENT

Auditors are traditionally appointed by the shareholders of a company to ensure that their company is managed responsibly.[351] However, the external auditors still report to and work alongside the board of directors on a daily basis when auditing. This situation fuels independence concerns and potentially creates undue pressure for the auditors to abide by the wishes of the directors.

Another reason for the need for independent appointment, is that with increased shareholder passivity and the increasing size of companies, shareholder participation is often reduced to a bare minimum. The subsequent appointment of the auditor as nominated by the directors, is usually not questioned by the individual shareholders. The need arose for an independent, yet informed source to take charge of the nomination and appointment of the external auditor. The Amendment Act's attempt to address this potentially conflicting relationship is generally welcomed.

The Amendment Act now requires all widely held companies[352] to appoint an audit committee. The audit committee is now responsible for the nomination of specific auditors who are eligible for appointment by the shareholders.[353] All auditor appointments, whether recommended by the committee or otherwise, are subject to the approval of the audit committee who will consider possible independence conflicts. The audit committee also has the power to determine the terms of appointment of the auditor. and recently replaced the shareholders as the party responsible for the approval of the remuneration of the auditors.[354]

The Companies Act has significant provisions regulating the appointment of the company auditor. The following section will overview the provisions in the Companies Act, as updated by the Amendment Act, and supplemented by the Auditing Profession Act.

The first auditor of a newly established company is appointed by the shareholders of the company. The first auditor is deemed to be appointed by the company if he has submitted written consent in acknowledgment of his appointment with the companies' documents of

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[351] S 270(1) of the Companies Act 61 of 1973.
[352] Select categories of widely held companies are exempt from this provision. *Cf* s 24 of the Corporate Laws Amendment Act which inserts s 269A(2) in the Companies Act 61 of 1973.
[353] S 26 of the Corporate Laws Amendment Act inserts 270A(1)(a) in the Companies Act 61 of 1973.
[354] S 26 of the Corporate Laws Amendment Act inserts 270A(1)(b) in the Companies Act 61 of 1973.

incorporation to the Registrar.[355] If, three weeks after the date of incorporation, the company has failed to appoint an auditor, the directors are burdened with the appointment of the auditor.[356] If the directors fail to appoint, the Registrar of Companies has to appoint an auditor and all the directors will be guilty of an offence.[357] The appointment of the first auditor will last until the first annual general meeting ("AGM"), when the company has to either re-appoint the auditor, or appoint a new auditor.[358] Again, should the company fail to appoint or re-appoint an auditor at the AGM, the duty to appoint shifts to the directors after 30 days.[359] If the directors fail to make an appointment after a further seven days, the Registrar steps in to appoint an auditor and all directors who knowingly failed to comply, as well as the company, will be guilty of an offence.[360] No appointment by the widely held company will be valid unless the audit committee has determined that the auditor is adequately independent.[361]

The length of any appointed auditor's term extends only from the end of the AGM in which that auditor is appointed, to the end of the next AGM. However, an auditor is deemed to be automatically re-appointed at the end of his term unless he is not qualified for re-appointment, or has been removed by the company at the AGM or has given notice of his unwillingness to remain the auditor of the company.[362] Although an auditor can be a firm or an individual, certain individuals within the company are not allowed to be appointed as auditors. These individuals include a director, officer, employee, secretary or bookkeeper of the company, as well as any partner, employee or employer of such director and any member of a company that performs secretarial work for the company.[363] These persons are also automatically disqualified for appointment as auditor of the company's holding company, subsidiary or subsidiary of the same holding company.[364] The reason for prohibiting the appointment of a person too closely related to the company as auditor, such as employees, is

[355] S 269(1) of the Companies Act of 1973; Beuthin & Luiz *Beuthin's basic company law* (2000) 166-167.
[356] S 269(2) of the Companies Act.
[357] Ss 269(4)-(5) of the Companies Act.
[358] Ss 269(3); 270(1) of the Companies Act.
[359] S 271(1) of the Companies Act.
[360] Ss 271(2)-(3) of the Companies Act.
[361] S 271(4) of the Companies Act.
[362] Ss 270(1) - (2) of the Companies Act.
[363] Ss 274; 275(a)-(g) of the Companies Act. Although the 1973 Act does not prohibit the auditor form delivering any non-audit services *per se*, it does by means of s 275 indirectly prohibit the auditor from rendering certain services. Secretarial work as well as the tasks usually left to directors and employees of the company are indirectly excluded from the scope of the auditor's services.
[364] S 275(2) of the Companies Act.

that the auditor might have too close a financial interest in the company to function independently.

The Amendment Act has expanded a number of provisions in the Companies Act and has brought about the following innovations:

The Amendment Act has inserted provisions in s 270 of the Companies Act. The Companies Act now provides that, apart from the reasons not to reappoint as mentioned *supra,* an auditor is also rendered ineligible for re-appointment if the audit committee objects to such re-appointment or if the auditor has reached the end of his now limited five-year term, as well as when the audit committee does not approve of its re-appointment.[365]

The most important change with regard to appointment brought about by the Amendment Act is that widely held companies and their directors no longer have the final say in the appointment of the auditor. The audit committee is now burdened with this task.[366] No appointment by the widely held company will be valid unless the audit committee has determined that the auditor is adequately independent.[367]

The audit committee of a widely held company has to nominate an auditor for appointment by the shareholders at the next AGM and ensure that the appointment process does not contravene any relevant legislation, be it company laws or other applicable auditing regulation.[368] The company is also free to appoint any other auditor that they wish, but if an auditor who has not been nominated by the committee is appointed at the AGM, the validity of his appointment will be contingent upon the determination of his independence by the committee.[369] This ability of the audit committee to veto an appointment may lead to an unsatisfactory position: if the audit committee does not approve the appointment of an auditor, this will leave the company without an auditor. Section 270A(2) provides that if the audit committee does not approve the appointment of the auditor, the appointment will not be valid, but does not clarify where that leaves the company. Henochsberg submits that the provisions of section 271(1) enter whereby the directors consequently appoint the auditor.[370]

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[365] S 25 of the Amendment Act inserts ss 270(d)-(e) into the Companies Act; s 24 of the Amendment Act inserts s 269A(1) into the Companies Act.
[366] S 26 of the Amendment Act inserts s 270A(1) into the Companies Act.
[367] S 271(4) into the Companies Act
[368] S 26 of the Amendment Act inserts ss 270A(1)(a); (c) into the Companies Act.
[369] S 26 of the Amendment Act inserts s 270A(2) into the Companies Act.
[370] Henochsberg Vol 1 521.

It is submitted that this situation is unsatisfactory and should be addressed and resolved by the Companies Bill, as it creates the exact situation that audit committees were designed to prevent, namely to disallow the appointment of the auditor by the board .

Furthermore, the Amendment Act has inserted provisions into section 269 providing that only a registered auditor as defined by the Auditing Profession Act may be legitimately appointed.[371]

The Amendment Act now requires that, for the appointment of a firm of auditors of a widely held company to be valid, the individual auditors must also be identified *in the appointment*.[372] Yet the Auditing Profession Act determines that the individuals only need to be identified *after* the firm has been appointed.[373] Henochsberg submits that the Amendment Act will take preference over the Auditing Profession Act, as section 273(3) of the Companies Act cannot be validly effected unless the individuals are named beforehand, in the appointment.[374] This view is supported.

It should be noted that this section 44(1) of the APA is a new provision that was not included in the act's predecessor, the PAAA. The purpose of the naming of individual auditors is for responsibility and accountability. The auditor's names must be made available to the company and may be made available to the IRBA on request.[375] These provisions apply when the disciplinary provisions of the act become applicable.[376]

The Companies Act provides that the directors should fill any casual vacancy of the auditor's position.[377] Although this provision still stands, the Amendment Act now provides that, upon a casual vacancy, the directors have 21 days to recommend a suitable auditor to the audit committee for approval.[378] If the audit committee does not approve or reject the proposal within ten days, the directors may go ahead and appoint that auditor.[379] The audit committee thus has a limited timeframe in which to exercise their authority. Henochsberg submits that if the audit committee does in fact reject the proposed auditor, the process will be repeated until

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[371] S 23 of the Amendment Act amended s 269 of the Companies Act.
[372] S 274(3) of the Companies Act.
[373] S 44(1) of the Auditing Profession Act.
[374] Henochsberg Vol 1 519.
[375] S 44(1)(a)-(b) of the Auditing Profession Act.
[376] Ss 48-51 of the Auditing Profession Act. *Cf* 2 4 *supra.*
[377] S 273(1) of the Companies Act.
[378] S 273(2) of the Companies Act.
[379] S 273(4) of the Companies Act.

the audit committee is satisfied with the auditor. This may result in an unreasonably protracted appointment period during which time there will be no auditor in office. Furthermore, if the firm is not entirely removed, but an individual only has been removed, another individual from the same firm must be appointed.[380] If the designated auditor (usually the audit partner) has created a casual vacancy, the whole audit firm will not be removed, and another designated auditor from the same firm will have to be appointed. The audit firm will thus retain the client.[381] A mere change in composition of the audit firm is not regarded as a casual vacancy. A casual vacancy regarding a firm will only arise if more than 50% of the members change since the previous appointment.

Although the auditor is appointed and compensated by the company, it has a duty to remain independent of the company at all times.[382] The auditor can never be a functionary or agent of the company it audits, and in doing so would seriously impede the reliability of any auditing results.

S 30 of the Amendment Act provides that there must be at least a two year waiting period before re-appointing an auditor in his previous position if the auditor was the auditor for at least 2 or more consecutive financial years.[383] The auditor may give notice to the company of his unwillingness to be reappointed at the next AGM.[384]

The audit committee of a widely held company has to nominate an auditor for appointment by the shareholders at the next AGM and has to ensure that the appointment process does not contravene any relevant legislation.[385] The audit committee is also responsible for the determination of the auditor's remuneration as well as the other terms on which the auditor is appointed by the company.[386]

It can be argued that section 270A(3) of the Amendment Act creates the impression that the functions of the board are somewhat diminished by the shifting of this responsibility for these appointment functions to the audit committee. However, it is submitted that the powers of the board are in fact not reduced to the extent that there is an infringement upon the concept of a

[380] S 273(3) of the Companies Act.
[381] Jackson & Stent *Auditing Notes* 3/37.
[382] The auditor can either be a registered firm or individual. S 274 of the Companies Act; s 37 of the Auditing Profession Act.
[383] S 30 of the Amendment Act inserts s 274A into the Companies Act.
[384] S 270(2)(c) of the Companies Act.
[385] S 26 of the Amendment Act inserts ss 270A(1)(a)-(c) into the Companies Act.
[386] S 26 of the Amendment Act inserts s 270A(1)(b) into the Companies Act.

unitary board system. The board is still free to nominate and appoint other auditors, as long as acceptable reasons are provided and the audit committee is satisfied of the appointee's independence.[387] PriceWaterhouseCoopers welcomes this shift in responsibility as it reduces the risk that the auditor will view management as a client and feel compelled to compromise the outcome of the audit because of management pressure.[388]

[387] S 26 of the Amendment Act inserts s 270A(2)-(3) into the Companies Act.
[388] PWC *The Sarbanes-Oxley Act of 2002. Board and audit committee roles in the era of corporate reform* (2003) 17-18. <http://www.pwc.com/Extweb/NewCoAtWork.nsf/docid/D0D7F79003C6D64485256CF30074D66C/$FILE/Final_SO_WP_2-BoardsAC.pdf>.

3 3 REMUNERATION

The remuneration of the auditor is determined by section 283 of the Companies Act. This section only requires that the company that appoints the auditor has to determine the remuneration.[389] The only change brought about by the Amendment Act is the insertion of section 270A(1)(b) which determines that the responsibility with regard to remuneration now lies with the audit committee.[390]

The IRBA emphasises that the remuneration should be fair and objectively determined and that the *quantum* is subject to negotiation with due regard taken to the value of the services to the client, and the skill, knowledge, training, time and responsibility required.[391] Although there are no statutory limitations on the types of services the auditor may render, the Act did mandate that *all* fees paid to the auditor, whether for an auditing purpose or otherwise, shall be disclosed in the annual financial statements.[392]

Remuneration is a particular contentious issue with regard to independence. Auditor remuneration affects many independence debates, especially non-audit services and competition. Remuneration also becomes relevant with financial statement disclosures. These will all be discussed under separate headings *infra.*

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[389] S 283(1) of the Companies Act of 1973.
[390] As with appointment, the Companies Act of 2006 makes no reference to the role of audit committees *vis-à-vis* the remuneration of the external auditor. This means, again, that the audit committee requirements with regard to remuneration will only be applicable to UK listed companies, but to the wider group of widely held companies in South Africa. Combined Code C 3.2.
[391] IRBA *Code of conduct* par 11.1-11.5.
[392] S 283(2) of the Companies Act; par 42(I) of the 4th Schedule of the Companies Act.

3 4 RIGHTS AND DUTIES

> "The management of a business concern is responsible for safeguarding the assets of the undertaking and is not entitled to rely upon the auditor for protection against defects in its administration and control. An auditor is not to be confined to the mechanics of checking vouchers and making arithmetical computations. His vital task is to take care to see that errors are not made, be they errors of computation, or errors of omission or commission or downright untruths. To perform this task properly, he must come to it with an enquiring mind - not suspicious of dishonesty - but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none."[393]

Section 282 of the Companies Act conveys a broad authority on the auditors to carry out its functions and report to the members of the company according to the provisions of the Companies Act and the Auditing Profession Act.[394] No contract can amend or remove any of these statutory duties, but contractual agreements may add to existing duties.[395]

3 4 1 Auditor opinions and the auditor report

The main statutory duty of the external auditor is to examine and report on the accuracy of the company's annual financial statements and *not* to detect fraud, as often perceived by the public.[396] The auditor has to state in its opinion that it is satisfied that the financial statements accurately reflect the true financial position of the company in all material respects and that the financial statements are properly prepared in accordance with the applicable financial reporting standards.[397]

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[393] *Tonkwane Sawmill Co Ltd v Filmalter* (1975) (2) SA 453 (W).
[394] S 282 of the Companies Act.
[395] Henochsberg 536.
[396] The annual financial statements are comprised from an income statement, balance sheet, cash flow statement, directors' report, auditors' report and general explanatory notes ito s 301 of the Companies Act. S 286(2) of the Companies Act. IAS 1.08 requires an additional statement of changes in equity. Henonchsberg on the Companies Act 516(7).
[397] S 44(2) of the Auditing Profession Act.

The Auditing Profession Act determines the content of a favourable audit opinion to determine that the audited financial statements "fairly presents in all material aspects the financial position of the entity and the results of its operations and cash flow; and [the statements] are properly prepared in all material respects in accordance with the basis of the accounting and financial reporting framework as disclosed in the relevant financial statements".[398]

It is also important to note that auditors are not gaurantors of the accuracy of financial statements and cannot provide 100% assurance of the accuracy of financial statements, but only fair assurance of all material aspects. The court in *Novick v Comair Holdings* explained the reason for using the qualifier "fairly" as follows:

> "The choice of the word "fairly", rather than the word "truly" involves a recognition of the fact that in respect of many of the matters to be reflected in the accounts, there is no absolute truth, or no truth which is ascertainable with certainty.[399]

Sections 300 and 301 of the Companies Act determine the extent of inspection that is statutorily required. Mainly, these sections provide that the auditor should ensure the accuracy of the financial statements before it is presented at the AGM and the accuracy of minutes, attendance registers and accounting records. The auditor should also verify the existence and detail of the company's securities, reconcile the register of contracts with the minutes of director's meetings, reconcile group financial statements with accounting records and issue an opinion on the company's ability to remain a going concern.[400] The auditor's opinion, compiled in a report, must be presented at the AGM.[401] In the report, the auditor should conclude whether "in his opinion [the financial statements] fairly present the financial position of the company and its subsidiaries…in the manner required by this Act."[402]

The ideal opinion is an unqualified one. If the auditor detects a material discrepancy, a qualified opinion should be issued with reasons why a favourable opinion cannot be made. If the auditor was unable to form an unqualified opinion because of directors or other company

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[398] S 44(2)(a)-(b) of the Auditing Profession Act.
[399] Novick v Comair Holdings Ltd 1979 (2) SA 116 (W), 140H.
[400] S 300 of the Companies Act.
[401] S 301(1)-(2) of the Companies Act.
[402] S 301(1) of the Companies Act

functionaries' refusal to release the requested documents needed to make such a opinion, this fact should be disclosed in the auditors' report.[403]

The Auditing Profession Act forbids the auditor to issue a favourable opinion unless he is satisfied that the audit was carried out free from restrictions and according to the applicable auditing standards, that the existence of all assets and liabilities as shown on the financial statements have been verified by the auditor and that proper and accurate accounting records have been kept continuously.[404] The auditor also has to ensure that all documentation necessary for the issue of a favourable opinion was received,[405] that no reportable irregularity has been sent to IRBA, of if it has been sent, that no reportable irregularity is currently taking place, that the auditors themselves have complied with all the applicable laws.[406] Ultimately, the auditor must have been assured that the statements are fair and correct with due regard of the nature of the entity and audit.[407]

3 4 2 Access to documents and information

The auditor has a right of access to the "accounting records and all books and documents of the company" and its subsidiaries.[408] This provision gives the auditor broad access to just about any document relevant to his function.[409] Blackman submits that matters that affect the auditors' task such as the falsification of books and records, should also be considered part of

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[403] S 301(2) of the Companies Act; Henochsberg Vol 1 532.
[404] Ss 44(3)(a)-(c) of the Auditing Profession Act.
[405] The equivalent of this section can be found in s 281 of the Companies Act.
[406] Ss 44(3)(d)-(f) of the Auditing Profession Act.
[407] S 44(3)(g) of the Auditing Profession Act. The UK Companies Act provides that the auditor's report should state whether, in the auditors opinion, the financial statements reflect a "true and fair view" of the company's "state of affairs", especially its profit or loss. The Act further provides that the auditor's report should contain an opinion on whether the relevant financial reporting standards as mentioned in the financial statements was in fact applied by the client, and that the financial statements have been prepared in accordance with the Companies Act and relevant IAS regulation. The auditor must also issue a statement on the accuracy of the directors' report as well as the auditable part of the directors' remuneration, in the case of a quoted company. The Act also determines that an auditor's report "must be either qualified or unqualified, and must include a reference to any matters that the auditor wishes to draw attention by way of emphasis without qualifying the report". Ss 495(3)(a) - 496 of the UK Companies Act.
[408] S 281 of the Companies Act. It should be noted that the right to access extends only to subsidiaries and not to joint ventures or associates.
[409] S 1(1) defines "accounting records" as including "account, deeds, writings and other documents". In turn, "books and/or papers" are defined as to include "accounts, deeds, writings, electronic data reduced to paper format and other documents". These documents of access will include a variety of company documentation such as minute books, attendance registers and registers of interests in contracts as per s 300(c)-(d).

the auditor's function, as construed under the Companies Act.[410] Blackman also emphasises that the nature of the auditors' access should be unrestricted.[411] The auditor has a wide discretion to insist on any explanations and additional information from directors and officers of the company to enable him to efficiently carry out his duty and to further his understanding of the company's financial affairs.[412] Blackman submits that employees should also be included as they are usually a main source of information.[413]

If the auditor has been appointed by the holding company, and not the subsidiary, the auditor still has a right of access to all financial statements of the subsidiary.[414] The auditor has the right to request explanatory information from the officers or directors of the subsidiary regarding such statements, but the auditor has no right of access to the records and books of the subsidiary.[415] The auditor also has a duty to ensure that minute books and attendance registers are kept by the company, according to the requirements of the Companies Act.[416]

3 4 3 Reporting of irregularities

Section 45 of the APA makes provision for the reporting of irregularities and determines that an auditor should immediately investigate a suspected irregularity and submit a written report on the matter to the IRBA.[417] During this investigation, the client is legally obligated to give the auditor access to all books and records the auditor would normally have access to.[418] The Auditing Profession Act replaces the term "material irregularity"[419] as used by its predecessor, with "reportable irregularity" and defines the term as "any unlawful act or omission committed by any person responsible for the management of an entity, which (a) has caused *or* is likely to cause material financial loss to the entity or to any partner, member,

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[410] Blackman 10-19.
[411] Blackman 10-17.
[412] Ss 281(a)-(b) of the Companies Act.
[413] Blackman 10-18.
[414] S 281(a) of the Companies Act.
[415] S 281(b) of the Companies Act
[416] S 246 of the Companies Act. Requirements for these documents are set out in sections 242 and 245 of the Companeis Act.
[417] S 45(1) of the Auditing Profession Act.
[418] S 45(5) of the Auditing Profession Act.
[419] The court has provided the following definition for the term "material": "Materiality in this context is understood to refer to an item or matter which is significant in relation to the substantial correctness of the financial statements as a whole and which would ordinarily be calculated to influence a client (or any other regular reader of the financial statements) in his assessment thereof." *Thoroughbred Breeders' Association v Price Waterhouse* 2001 (4) SA 551 (SCA) 570H-I.

shareholder, creditor or investor of the entity in respect of his, her or its dealings with the entity; or (b) is fraudulent and amounts to theft or (c) represents a material breach of any fiduciary duty owed by such person to the entity or any partner, member, shareholder, creditor or investor of the entity under any law applying to the entity or the conduct or management thereof".[420]

The Auditing Profession Act further determines that the auditor must submit a detailed report, the content of which is left to the discretion of the auditor, to the IRBA.[421] After the report has been submitted, the auditor has three days to notify the board of the client company in writing about the action taken by the auditor as well as the relevant provisions in the Auditing Profession Act which demands such action.[422] The auditor must subsequently discuss the irregularities with the management board of the client within 30 days in an effort to resolve the matter, after which the auditor must submit another report to the IRBA reporting on whether there has in fact been no irregularity, or that there has been an irregularity but the matter is no resolved, or whether the irregularity is still continuing and the meeting with the board did thus not resolve the concern.[423] If the irregularity remains unresolved, in the latter case mentioned, the IRBA should notify the appropriate regulator.[424]

Wixley and Everingham emphasise that "the audit committee should ensure that arrangements within the company facilitate the raising of concerns by staff about possible improprieties, their investigation and follow-up.[425]

3 4 4 Attendance of meetings

The auditor may attend any general meeting of the company and is entitled to the receipt of any documentation related to such meeting to the extent as an ordinary member of the company might have. The auditor also has a right to be heard at any general meeting regarding any matter relevant to his office and function.[426] Henochsberg submits that the right to be heard refers to oral statements, but written statements as an alternative would also be

[420] S 1 of the Auditing Profession Act.
[421] S 45(1)(b) of the Auditing Profession Act.
[422] S 45(2)(a)-(b) of the Auditing Profession Act.
[423] S45(3) of the Auditing Profession Act.
[424] S 45(4) of the Auditing Profession Act.
[425] Wixley & Everingham *Corporate governance* 64.
[426] S 281(c) of the Companies Act.

allowed.[427] There is no provision in South African legislation determining that the auditor should be periodically invited to attend audit committee meetings. It is submitted that a provision to this effect should be included in the Companies Bill.

3 4 5 Going concern statement

S 300(j) of the Companies Act determines that the auditor should verify the going concern status of its client. This would mean that the auditor should make applicable observations and inquiries as to whether the company is "not carrying on business or is not in operation and has no intention of resuming operations in the foreseeable future".[428] The auditor has a statutory responsibility to report such lack of activity to the Registrar.[429]

[427] Henochsberg Vol 1 534
[428] S 300(j) of the Companies Act
[429] S 300(j) of the Companies Act.

3 5 REMOVAL AND RESIGNATION

Any auditor not appointed by the shareholders at the AGM but by the Minister or directors can be removed and replaced at anytime by means of a special resolution.[430] The auditor does thus not have to complete his term, except if the auditor has reported on a material irregularity in terms of section 45 of the APA.[431] The shareholders are also free to decide at any AGM by at least a 75% majority to remove the auditor.[432] This provision applies to all auditors that were appointed by the shareholders, and does not cover situations where the auditor reported on a material irregularity within the firm.[433]

A special notice in terms of s 279 is necessary for the removal of the auditor. In a process similar to the removal of a director, the member of the company proposing removal must give a special notice (28 days) of the intention to pass a resolution to remove.[434] The auditor concerned and all members of the company must be informed of this resolution. The auditor must be allowed the opportunity to make written representations regarding the notice of removal, which must be distributed to all members before the meeting takes place.[435]

Henochsberg points out that there is no provision regulating the removal of an auditor before the end of his term which has been appointed for the first time[436], or normally appointed by the shareholders in terms of section 170 of the Companies Act.[437] It is submitted that this situation be resolved by legislation.

The auditor may resign at any time, provided that provisions in section 280 of the Companies Act and the relevant codes of conduct to which the auditor must comply, are met. Henochsberg submits that this provision overrides the contractual terms between the auditor and the client.[438] In terms of this section, an auditor can only effectively resign if it sends a report to the Registrar in which it asserts that there is no reportable irregularity in terms of the

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[430] S 277 of the Companies Act. Special notice is required ito s 279 of the Companies Act.
[431] S 277 of the Companies Act. The aim of the legislation is to ensure that there was no undue pressure or unreasonable reason behind the resignation or removal of the auditor.
[432] Ss 278 of the Companies Act.
[433] S 278 of the Companies Act.
[434] S 279(1) of the Companies Act
[435] S 279(2) of the Companies Act
[436] Ito s 269 of the Companies Act.
[437] *Cf* 4 2 *supra.*
[438] Henochsberg Vol 1 530.

Auditing Profession Act that he is aware of, and that there is no outstanding follow-up audits to be done by him.[439] The reason behind this is to ensure that the auditor does not resign under undue pressure as a result of irregularities. The resignation of the auditor becomes effective when the company receives his notice of no reportable irregularity in terms of section 280(2).[440] The directors will then be obliged to appoint another auditor within 30 days according to the provisions of section 273 of the Companies Act.[441] The resignation is thus not contingent on any kind of approval or acceptance of the auditor's report or conclusions.

It is important that there is no mystery behind a (sudden) resignation of the auditor, or unresolved issues left by a resigning auditor. Disclosure of all important or material aspects is crucial. As Wixley and Everingham summarise the UK position:

> "A decision to dismiss the auditor should be supported by the audit committee and the full board. The Combined Code requires disclosure in the annual report of any disagreement between the audit committee and the board on the appointment of auditors."[442]

[439] Ss 273(2); 280(2) of the Companies Act.
[440] S 280(4) of the Companies Act.
[441] *Cf* 3 2 *supra.*
[442] Wixley & Everingham *Corporate governance* 64. The Companies Bill 2008 has done away with a lot of the detailed provisions regarding the appointment, remuneration, rights and duties and resignation of the auditor.

3 6 INDEPENDENCE

> "The importance of external auditor independence is a vital pre-condition to the workings of efficient capital markets. Accounting firms and the public benefit when firms have effective quality controls that ensure the independence of external auditors. These controls protect the public and the accounting firms on whose audit the public relies. Public companies benefit as well… A critical unbiased eye gives investors and other users of financial information comfort and faith in the numbers and disclosures presented…More than anything else, it is the external auditors that guard the public interest. It is their duty and unique franchise to protect and honour that interest."[443]

> "[The auditor's] public watchdog's function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."[444]

Auditor independence is integral to the credibility of the audit and can be considered to be the most prominent principle underlying the regulation of the auditor. The Amendment Act now determines that the audit committee should declare in the annual financial statements whether they are satisfied that the auditor has functioned independently.[445] This statement of independence may increase investor confidence in the quality of the financial statements. The Amendment Act also provides the audit committee with criteria for measuring independence, but refrains from defining the term itself.[446]

The importance of independence is emphasised by King II. King II recommends that the standard of auditor independence should be determined by the board of directors and lists factors that should be taken into account by the board in the determination of such independence. These factors include the business relationships of the auditor with rival audit firms which might be able to provide services that the auditor would be prevented to by

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[443] King II 133.
[444] *United States v Arthur Young*, 465 U.S. 805, 818 (1984).
[445] S 26 of the Corporate Laws Amendment Act inserts s 270A(1)(f)(ii) in the Companies Act.
[446] S 26 of the Corporate Laws Amendment Act inserts s 270A(5) in the Companies Act. *Cf* 2 3 1 *supra.*

reason of their employment as auditors, as well as considerations relating to the ownership and structure of the audit firm. King II does, however, not say how these factors would impact auditor independence and the appointment or non-appointment of the auditor.[447] The IRBA also states that, for an auditor "[t]o be recognized as independent, the practitioner must be free from any obligation to, or interest in the client, its management or its owners."[448]

The international auditing profession distinguishes between independence in *fact* or *mind* and independence in *appearance*.[449] SAICA defines independence of *mind* or actual independence, as "the expression of a conclusion without being affected by the influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism."[450] Conversely, SAICA defines independence in *appearance* as follows:

> "The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised."[451]

The problem with independence in *fact* is that it is left to the subjective state of mind of the auditor to determine whether he has sufficient independence with which to execute decisions. As it is virtually impossible to determine that state of mind, the law has to rely on the regulation of *perceived* independence, expecting *factual* independence to follow. Ideally, mechanisms that ensure perceived independence will also serve to enhance factual independence. It is important to realise that perceived independence is the only measure by which investors can observe and determine independence and whereupon investor confidence can be based. The IRBA also emphasises that the degree of *perceived* independence should be used when determining whether independence has been compromised.[452] It should thus be

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[447] King II 134.
[448] IRBA Code of Professional Conduct par 4.3.
[449] The IRBA, SAICA, AICPA, SEC, IFAC and the EC all use this bifurcated definition. *Cf* IRBA *Code* Par 4.3; SAICA *Code of Professional Conduct* par 290.8; IFAC *EC Recommendation on statutory auditor's independence in the EU* 2004 69 <http://www.ifacnet.com/index.php?q=code+of+ethics&site =ifac.org&format=pdf>; SEC *Final rule: revision of the commissions auditor independence requirements* 2001 <http://www.sec.gov/rules/final/33-7919.htm>.
[450] SAICA *Code* par 290.8.
[451] SAICA *Code* par 290.8; CGAA *Final Report* par 1.4.
[452] IRBA *Code* par 28.

kept in mind that the question before the legislator throughout the following debates, is how to best regulate *perceived* independence.

As auditor independence is a pervasive and multi-faceted topic, this section will focus on a few of the more contentious debates and newly legislated independence provisions. The provision of non-audit services, rotation of auditors, competition in the audit industry and cross-employment between the auditor and its clients, will receive specific attention. The final part of this section will refer to other conflicts of interest and to the value of disclosure in the strengthening of perceived independence.

3 6 1 NON-AUDIT SERVICES

> "The typical firm will minimise a companies' tax bill, plug it into the internet age, trouble shoot against changes in the political climate, and through 'reputation assurance' it will play the role of corporate spin doctor. It will deal with every aspect of corporate finance. Oh, and it will also audit the books."[453]

The threat of non-audit services to auditor independence is well-acknowledged in the audit and regulatory environment. As David Costello, president and CEO of the National Association of State Boards of Accountancy in the US, remarked:

> "If you are doing an audit of a firm for a $300,000 fee and you have a consulting contract with the same firm for $1 million, it's hard to see how you can maintain being independent with that audit."[454]

Non-audit services is broadly defined by Sarbanes-Oxley as "any professional service" other than the audit-related services rendered by the auditor to its audit client.[455] The rendering of non-audit services by the auditor is considered a worthwhile business undertaking as it improves the bottom line of both the client and the auditor. As a result of an established business relationship with the auditor, the client company has the reassurance of a less expensive and more reliable, timely and comprehensive non-audit service. The auditor also benefits, as its existing audit services provide the audit firm with a pool of potential non-audit clients who already have strong business ties with, and a degree of trustworthiness in, the auditor. Apart from having an established relationship with the client, auditors are already familiar with the inner workings of their client and the client's industry. This leaves the auditor in a more favourable position than any outside competitor or professional service provider with regard to the rendering of non-audit services at a competitive price. For example, the auditor is, as a result of its unique position, able to supply the client with a package deal similar to the "integrated audit" package that was offered to Enron by its auditor.[456]

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[453] Simms "Five brothers: The rise and nemesis of the big bean counters" 2002 *New Economics Foundation* <http://www.neweconomics.org/gen/z_sys_publicationdetail.aspx?pid=100>.
[454] Costello in Simms *New Economics Foundation* 2002.
[455] S2(1) of the Sarbanes-Oxley Act.
[456] Cf 1 2 2 supra.

The wide variety of non-audit services that an auditor is qualified to render is by its nature a more lucrative venture to pursue than audit services alone. US data from 1999 show that 50% of the then Big Five audit firms' income was derived from non-audit services. Audit services constituted only 31% of the Big Five's 1999 profits.[457] US data further showed that the proportion of non-audit services increased to a remarkable 73% of the audit firms' total 2002 income.[458] As an example of this unequal distribution of services, it should be remembered that, in terms of an Andersen policy, auditors had to ensure that they raised double the income in non-audit services that was raised from the same client with audit services.[459]

In the UK, the situation looks no different: in 2002, 67% of fees paid by the company to their auditor were for non-audit services. Moreover, the percentage of UK companies whose non-audit fees equalled or exceeded the audit fees paid to their auditor increased dramatically from 33% in 1994 to 58% in 2002. This increase has been mostly ascribed to an increased demand for consulting services.[460] There are no similar studies available for South Africa.

In the light of these figures, it is not surprising that international attention has been drawn to the adverse implications that non-audit services might have on auditor independence. King II recognises the potentially compromising nature of non-audit services by pointing out that an audit service "demands objectivity and independence", and that a non-audit service demands "a direct interest in a client's success".[461] The CGAA emphasised that this independence threat is especially problematic when more income is derived from non-audit services than from audit services, as this increases the financial incentive of the audit firm to retain the same company as both audit and non-audit clients.[462] The incentive to continue to render profitable non-audit services threatens independence as it causes undue pressure to issue favourable audit reports, for fear that the client will take its non-audit business elsewhere.

This discussion will focus on how non-audit services are regulated and whether they should be regulated at all, by using the Sarbanes-Oxley definition of non-audit services.

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[457] Report of the Senate Banking Committee 14-15; Barret " 'Tax services' as a Trojan horse in the auditor independence provisions of Sarbanes-Oxley" 2004 *Michigan State Law Review* 1.
[458] IRRC "IRRC finds little change in potential auditor conflicts" *CSRwire* (2002-09-10) <http://www.csrwire.com/PressRelease.php?id=1335>.
[459] Cf 1 2 2 supra.
[460] IRRC *CSRwire* (2002-09-10).
[461] King II par 5.
[462] CGAA *Final report* par 1.33.

3 6 1 1 United States

Suggestions in the US to implement a blanket ban on non-audit services was rightly rejected during the formation stages of Sarbanes-Oxley as too "far-reaching".[463]

The Sarbanes-Oxley Act has dramatically intervened in the sphere of non-audit services and the US is the only jurisdiction to provide an express list of prohibited non-audit services.[464] An auditor may now not render the following services to a client whilst in charge of the external audit: bookkeeping and related accounting services, financial information systems design and implementation, valuation services or opinions, actuarial services, internal auditing services, management or human resource services, investment and related advisory functions and legal services.[465] This is not a closed list, as section 201(a)(9) provides that the PCAOB has the discretion to further identify inadmissible non-audit services.[466]

Sarbanes-Oxley further determines that the provision of any other non-listed, non-audit service by the auditor will only be admissible once the audit committee of the client has approved such service.[467] There are no set criteria for the audit committee by which to determine admissibility, which leaves the audit committee with a relatively unfettered discretion.[468]

Although this stringent, list-based approach stands in sharp contrast to the more principle-based approach of most jurisdictions, this list-based approach was not a new idea initiated by Sarbanes-Oxley. In the SEC independence rules of 2000, most of these listed non-audit services were already prohibited. There were also clear indications by the NYSE and the NASDAQ of imposing more stringent requirements on *inter alia* the role of the audit

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[463] Riesenberg "Non-Audit service restrictions of the Sarbanes-Oxley Act" *The Daily Tax Report* (2002-09-24) <http://www.dgm.com/so_id20.asp>.
[464] S 201(a) of the Sarbanes-Oxley Act.
[465] S 201(a)(1) – 201(a)(8) of the Sarbanes-Oxley Act. Notably the list does not include tax services. The CGAA Report does include tax services as a potentially compromising non-audit service. For a debate on in the nature of tax services and the inclusion thereof in a list of prohibited non-audit services, see Paton "Rethinking the role of the auditor: resolving the audit/tax services debate" 2006 *SSRN* <http://ssrn.com/abstract=1023693>; Barret "'Tax services' as a Trojan horse in the auditor independence provisions of Sarbanes-Oxley" 2004 *Michigan State Law Review* 1; SEC *Final rule: strengthening the commission's requirements regarding auditor independence* (2003-05-06) <http://www.sec.gov/rules/final/33-8183.htm>.
[466] S 201(a)(9) of the Sarbanes-Oxley Act.
[467] S 201(h) of the Sarbanes-Oxley Act.
[468] Riesenberg *The Daily Tax Report* (2002-09-24).

committees with regard to non-audit services.[469] With regard to the list of non-audit services, only internal audit, information technology and certain investment advisory services were new restrictions not previously prohibited by SEC rules.[470]

Section 202(i)(1)(A) again emphasises the abovementioned pre-approval requirement by stating that all audit and non-audit services have to be pre-approved by the audit committee of the client, except when the so-called *de minimis* exception applies. The *de minimis* exception will apply when the non-audit service in question constitutes five percent or less of the total of audit and non-audit fees paid by the client to that specific auditor during that financial year.[471] Pre-approval is also not required when a service only later transpires to be a non-audit service, and was thus not acknowledged as such when originally permitted.[472] In this case, prompt approval is required by the audit committee as soon as the non-audit nature of that service comes to light, providing that the *de minimis* exception does not apply.[473]

Sarbanes-Oxley further provides that the approval of all non-audit services should be regularly disclosed in a report to investors. The audit committee can also delegate the approval function to a single audit committee member.[474]

3 6 1 2 The UK position

UK legislation does not address non-audit services directly, but delegates the power to regulate this topic to the regulatory supervisory bodies.[475] The ICAEW has emphasised its official viewpoint that non-audit services do not impede auditor independence as long as companies comply with the relevant governance codes in place. It warned that the UK regulators should avoid a hurried response to Enron by over regulating the industry in a rush to reform.[476]

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[469] NASDAQ *NASDAQ corporate governance: summary of rules changes* 2003 <http://www.nasdaq.com/about/CorpGovSummary.pdf>; NYSE Corporate governance rules proposals 2002 <http://www.nyse.com/pdfs/corp_gov_pro_b.pdf>; Riesenberg *The Daily Tax Report* (2002-09-24).
[470] Riesenberg The Daily Tax Report (2002-09-24); SEC Final rule: revision of the commissions auditor independence requirements 2001 < http://www.sec.gov/rules/final/33-7919.htm>.
[471] S 202(i)(1)(B)(i) of the Sarbanes-Oxley Act.
[472] S 202(i)(1) (B)(ii) of the Sarbanes-Oxley Act.
[473] S 202(i)(1)(B)(iii) of the Sarbanes-Oxley Act.
[474] S 202(i)(2)-(3) of the Sarbanes-Oxley Act.
[475] Cf 2 2 3 supra.
[476] Harris "Countering the spread of 'Enronitis'" *Company Lawyer* 2002 106.

The CGAA's approach to audit services is based on the following two premises: firstly, that the auditor should not be involved in management decisions and secondly, that auditors should never audit their own work.[477] The CGAA called for the adoption of more stringent criteria by which non-audit services may be allowed, but discouraged the adoption of a list-based approach to non-audit services.[478] In particular, the CGAA emphasises that care should be taken when allowing the specific non-audit services of valuation, information systems implementation, tax and internal audit services to be rendered by the auditor.[479] The CGAA supported the audit committee's role in the approval of non-audit services as proposed by the Smith Report.[480]

The Combined Code and Smith Report suggested that the audit committee should develop a policy which should serve as a guideline when determining the circumstances under which certain non-audit services should be allowed. The audit committee should take relevant ethical rules into account when creating this policy and should report any matter to the board that, according to the discretion of the audit committee, needs improvement or closer scrutiny.[481] The Smith Report further elaborates by calling on the audit committee to take due regard of the interests and relationships of all the relevant parties involved on a case-by-case basis when determining auditor independence. These parties would include management, the internal auditor and the audit committee themselves.[482]

The Smith Report also gives guidelines to the audit committee when developing this independence policy. These factors include having to decide whether the auditor is suitably equipped to provide the non-audit services, whether efficient independence safeguards are in place, the nature of the non-audit services, the proportion of audit to non-audit fees that will be paid and the compensation policy that applies to the auditor.[483]

The Smith Report also determines that the audit committee should distinguish between different classes of audit work, and that the audit committee is free to establish any fee limit with regard to a specific service or class of services. Contrary to the recommendations of the CGAA, the Smith Report sets out three broad categories. The first category comprises of non-

[477] CGAA *Final Report* par 1.35.
[478] CGAA *Final Report* par 1.5.3.
[479] CGAA *Final Report* par 1.5.5-1.5.6; 1.39-1.48.
[480] CGAA *Final Report* par 1.5.7-1.5.9.
[481] Combined Code C.3.2; Smith Report par 2.1; 5.22.
[482] Smith Report par 5.22.
[483] Smith Report par 5.26.

audit services which the external auditor is always barred from providing, whilst the second category consists of services which the auditor may provide without prior or specific approval by the audit committee. The final category consists of services which approval or ratification will depend on a case by case assessment by the audit committee.[484] The Smith Report emphasises the principles by which independence may be compromised. These include situations where the auditor will audit himself and when the auditor assumes the role of an advocate or decision-maker on behalf of the client company.[485]

Non-audit services are thus largely regulated by the relevant corporate governance reports and voluntary codes adopted by regulatory supervisory bodies. The legislator has avoided addressing the non-audit issue directly in the Companies Act. Given the principle-based approach of the UK, this situation is unlikely to change in the foreseeable future.

3 6 1 3 South Africa

The rendering of non-audit services is a newly legislated topic in South Africa which was first addressed by the Amendment Act. Previously, the Companies Act only indirectly addressed this issue through section 275.[486] This section prevents the company directors, employees and bookkeepers from being appointed as the external auditor.[487] The effect of this section is that the auditor is banned from rendering the non-audit services of, *inter alia,* bookkeeping and management or decision-making functions whilst auditing the company's records. This provision was not aimed at regulating non-audit services *per se,* but rather the independence of auditors in general. It is submitted that this section is inappropriate authority for the banning of non-audit services.[488]

The South African Draft Corporate Laws Amendment Bill[489] attempted a short list of prohibited non-audit services. This list bars auditors of what is now known as widely held companies[490] to render accounting services, as well as tax advisory and internal auditing

[484] Smith Report par 5.27-5.28.
[485] Smith Report par 5.29.
[486] S 275 of the Companies Act.
[487] S 275(1). *Cf* 3 2 *supra.*
[488] Section 275 does not cover the situation where, for example, the auditor *later* fulfils management or bookkeeping functions.
[489] [B6- 2006] *GG* 28765.
[490] The Bill still referred to "public interest companies". S 1 of the Amendment Act.

services to the extent that the auditor will compromise its independence by effectively auditing its own work.[491] This was quickly replaced by a principle-based approach in the final version of the Bill which became the Amendment Act, and is now in line with the Auditing Profession Act.[492]

The Amendment Act has delegated the authority to decide which non-audit services to prohibit, to the IRBA. Section 275A(1) of the Amendment Act prohibits the external auditor of a widely held company to deliver any services that have been prohibited by the Committee for Auditor Ethics as established in section 21(2)(a) of the Auditing Profession Act. In turn, section 21(2)(a) provides that the Committee for Auditor Ethics "should assist the Regulatory Board to determine what constitutes improper conduct by registered auditors by developing rules and guidelines for professional ethics, including a code of professional conduct".[493] The Amendment Act further provides in section 275A(2) that the IRBA should include in the abovementioned code of conduct a definition of non-audit services as well as a prohibition on the rendering of non-audit services. As a litmus test for allowing non-audit services, the Amendment Act provides that non-audit services should be prohibited when it would result in the auditor auditing its own work, or essentially reviewing itself.[494]

The Auditing Profession Act determines that an auditor should report on his involvement in the keeping of the accounting records of the client if he is also involved in the auditing of those records.[495] The Act excludes the making of closing entries, framing of financial statements from existing records and assisting with adjusting entries from inclusion in the report.[496] This provision admittedly does not prohibit non-audit services relating to accounting and possibly internal auditing, but it does enforce disclosure, which should at least serve to cast a sceptic light on the auditor's actions.

The Konar Report also submitted that a list-based approach is not practical, and that matters of auditor independence require case-by-case evaluation by the audit committee.[497] In reaction to the Konar Report, the Minister of Finance issued a statement in which he largely agreed with the recommendations in the Konar Report, but cited a few reservations. The

[491] S 275A of the Draft Corporate Laws Amendment Bill.
[492] S 21(2)(a) of the Auditing Profession Act.
[493] S 21(2)(a) of the Auditing Profession Act.
[494] S 32 of the Amendment Act inserts s 275A(2) into the Companies Act.
[495] S44(4) of the Auditing Profession Act.
[496] S44(5) of the Auditing Profession Act.
[497] Konar Report *Executive Summary* par 15.

Minister specifically disagreed with the panel's recommended principle-based approach to non-audit services. He submitted that there are certain services that should never be performed by an auditor, such as internal auditing, bookkeeping and accounting, and that these functions should be expressly prohibited despite the IRBA and the audit committee's general discretion to prohibit certain services.[498] He thus effectively supported the *quasi* list-based approach in the Draft Amendment Bill. The Minister's recommendations with regard to non-audit services were not included in the final version of the Amendment Act.

King II also supports a principle-based approach to the prohibition of non-audit services and acknowledges the important role of the audit committee in the selection of non-audit services.[499] The Amendment Act is well aligned with King II in this regard. However, King II emphasises that the audit committee should have enough business judgment with which to screen auditors for sufficient independence on a case-by-case basis. This type of decision making may lead to a situation where the current auditors may be employed for the non-audit service, if the audit committee regards the current audit firm to be in the best position to do so.[500] King II also rightly pointed out that a complete ban on the rendering of non-audit services by the auditor will lead to a considerable loss of expertise, as non-audit personnel who often provide valuable advice and assistance in advisory aspects of the audit process as well as in their main business of non-audit services, will be forced to work elsewhere.[501]

It should be noted that there is currently no blanket prohibition on specific non-audit services in South Africa. The current IRBA Code uses a principle-based approach to non-audit services. The IRBA Code specifically prohibits the auditor from being involved in any management decisions and emphasises that all management decisions are within the exclusive terrain of the board. Both IRBA and SAICA avoid a prescriptive approach with regard to non-audit services. The IRBA Code only discourages non-audit services if it will "usurp the management functions of client companies".[502] There is currently no indication that the IRBA will amend its current code of conduct.

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[498] Statement by the Honourable Minister of Finance on the Recommendations of the Ministerial Panel for the Review of the Accounting Profession's Bill on 24 March available at <http://www.treasury.gov.za>.
[499] King II par 9-10.
[500] King II par 10.
[501] King II 134; Riesenberg *The Daily Tax Report* (2002-09-24).
[502] IRBA *Code* par 7.14; 7.16.

SAICA warns that certain services, such as the provision of an information system, internal audit work, the preparation of source documents for the client, the custodial holding of the client's assets and certain financial and legal services *may* compromise independence and that the legitimacy of such services in conjunction with audit services should be determined on an *ad hoc* basis.[503] SAICA further determines that the auditor should, out of its own initiative, ensure that the necessary safeguards are in place to secure independence. Such safeguards will include the disclosure of possible independence threats to management and the development of policies and procedures with which to ensure independence.[504]

Importantly, section 275A(3) of the Companies Act empowers the audit committee of a particular company to further limit the extent of non-audit services to be rendered by the auditor, notwithstanding the limitation powers granted to the Regulatory Board in section 275A(1) of the Companies Act. This discretion given to the audit committee reflects the international trend as well illustrated by the UK and is supported as part of a more flexible approach towards the banning of select non-audit services.

It should be noted that South Africa does not follow a list-based approach, but rather a discretionary approach, as the Amendment Act gives each audit committee the power to determine what would constitute forbidden non-audit services, as well as the power to pre-approve all non-audit services to be rendered by the auditor.[505] However, it should also be noted that the entrenchment of non-audit services in the Amendment Act has not yet changed anything regarding the regulation of non-audit services in practice. It is submitted that the IRBA should finalise new guidelines that address issues relating to non-audit services more directly.[506] In the meantime, audit committees of widely held companies should be more alert regarding their regulation of non-audit services as provided to their company.

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[503] SAICA *Code* par 290.158-290.205.
[504] SAICA *Code* par 200.13-200.15.
[505] S 24 of the Amendment Act inserts Ss 270A(1)(d)-(e) in the Companies Act. *Cf* 2 3 1 *supra.*
[506] The Companies Bill provision is the same as the Amendment Act's provision. S 93(3) of the Companies Bill 2008.

3 6 1 4 Sarbanes-Oxley: a questionable approach

Studies of the effects of non-audit services on auditor independence have produced both surprising and conflicting results.[507] One cannot ignore the vast amount of studies that conclude that there is no empirical evidence to suggest or even reliably prove that the delivery of non-audit services interfere with auditor independence at all. Yet, in all major corporate failures, the extent of non-audit services rendered by the auditor was disconcertingly large. All jurisdictions have assumed that the rendering of non-audit services is an impeding factor with regard to auditor independence, and have legislated accordingly. The legislators and regulatory bodies seemed to have all simply concluded that non-audit services were part of the independence concern, regardless of the *corpus* of dissenting and inconclusive studies.[508]

Yale academic Roberta Romano examined the legislative origins of the non-audit provisions of Sarbanes-Oxley,[509] and has sharply criticised the US legislator for not considering the results of studies on the effects of non-audit services before legislating.[510] Romano points out that only five out of the total 63 witnesses testifying in the congressional hearings held during the formation stage of Sarbanes-Oxley, referred to any form of data on non-audit services. Romano further tables the results of twenty-five comprehensive empirical studies, the overwhelming majority of which concluded that there is no correlation between audit quality and auditor independence.[511] This legislative overreaction may have increased companies' Sarbanes-Oxley compliance costs unnecessarily.

It is submitted that further studies need to be undertaken to accurately determine the effect of non-audit services. It is only once this can be determined that effective legislation can be implemented. A hit-and-miss approach when legislating is simply not acceptable. In the meantime, harsh legislation such as the Sarbanes-Oxley Act, might have imposed undue burdens on auditors and their clients. The South African legislator should bear in mind that when looking towards other jurisdictions when legislating, as has been done extensively with

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[507] Romano lists and discusses an exhaustive list of studies. *Cf* Romano *Yale Law Journal* 1581-1584;1606-1610.
[508] Romano *Yale Law Journal* 1581-1584;1606-1610. Romano also blames the political agenda of key individuals in the legislative process, such as SEC chairman Harvey Pitt and senator Paul Sarbanes, for not deliberating key issues such as non-audit services, properly. *Cf* 2 2 1 *supra*.
[509] S 201 of the Sarbanes-Oxley Act.
[510] Romano *Yale Law Journal* 1581-1584.
[511] Independence is measured as a fee ratio of non-audit fees to total fees. Romano *Yale Law Journal* 1606-1610.

the Amendment Act, the reasons behind that legislation should be studied and considered to the same extent as the actual provisions it has influenced.[512]

3 6 1 5 Conclusion

The intelligent, informed decision making of an independent-minded and conscientious audit committee, should be sufficient to determine the independence of the auditor and to allow the auditor to perform certain non-audit services. One should guard against overlegislating. A company is first and foremost a business, and should not be bombarded with excessive legislation that will increase compliance costs unreasonably. It is submitted that a helpful guideline when legislating would be to reassess the merit of restrictions that are more stringent than those already imposed by the audit industry's self-regulatory organisations.[513] The Amendment Act has done well to align legislation with the IRBA's guidelines, and its flexible approach to non-audit services is welcomed. Care should now be taken not to make the new restrictions more stringent in the future.

Although it is argued that there is no more room for extra legislation on this matter, there is room for more *guidance*. It is submitted that the IRBA should provide detailed guidelines which audit committees should adhere to when considering the appointment of an auditor for non-audit services. More specifically, the audit committee should be provided with terms of reference similar to that recommended in the Smith Report, to refer to when deciding on the admissibility of a non-audit service. These terms of reference should, in the interest of transparency, be available upon request to shareholders and potential investors. Once the audit committee is satisfied that the interests of the shareholders are best served by the appointment of a certain auditor for the provision of non-audit services, as determined by the terms of reference guidelines and such reasons are disclosed in the financial statements, further regulation of the issue should be unnecessary. It is further suggested that certain audit services, such as bookkeeping or internal audit services will almost always fail the test of auditing one's own work. The compromising nature of these services should be expressly included in the terms of reference, but has correctly been left out of legislation, as there may be exceptions to the rule where the audit committee might find their discretion helpful. There

[512] *Cf* 2 2 2 *supra.*
[513] For example SAICA, IFAC and the IRBA.

are circumstances that may justify the auditor rendering internal audit services, for example, in another department, without compromising independence. All final decisions regarding non-audit services should be left to the discretion of the audit committee.

The conflicting results of studies on the effects of non-audit services should serve as warning to the South African legislator to be wary of following another country's approach too closely. This is especially true when legislation is passed under abnormal circumstances.[514] Rather, careful consideration of all alternatives should be undertaken, with due regard to problems and circumstances unique to South Africa. A customised approach is needed.

[514] *Cf* 2 2 1 *supra.*

3 6 2 AUDITOR ROTATION

The need for the increased regulation of auditor rotation results from the independence concerns that are perceived to arise when the same auditor or audit team remains at a client for a lengthy period.[515] In a 2003 US survey of the Fortune 1000 companies, the average term of the same auditor's tenure was found to be 22 years. Of all the firms surveyed, 10% reported that the same auditor has been employed for the past 50 years.[516] It should also be remembered that Andersen served as Enron's auditor for sixteen consecutive years.[517] Tenures of this length have been common among companies inside and outside the US, as auditor rotation was mostly left unregulated prior to the corporate failures of the past decade. Recent legislation has attempted to address auditor rotation as part of the auditor independence problem.[518] There are several degrees of auditor rotation. The most stringent regulation would insist on the regular rotation of the entire audit firm, whereas the more popular method is to only rotate the audit partner in charge of the audit team. In the latter method, the same audit firm will retain their appointment and different audit partners from the same firm will be used. The question is now whether South Africa has taken the correct approach in this regard.

3 6 2 1 Audit partner rotation

Rotation policy in South Africa has a short legislative history. In the draft stages of the Auditing Profession Act the possibility of audit firm rotation was considered, but the Konar Report argued that auditor resource constraints in South Africa would hinder the effective implementation of any form of rotation policy. As an alternative, the report suggested that the legislator leave the regulation of auditor rotation entirely to the discretion of each audit committee.[519] The Minister of Finance disagreed with this proposal and merely concluded

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[515] Temkin "Accountants oppose rotation proposals" *Business Day* (2003-05-06) <http://www.businessday .co.za/Articles/TarkArticle.aspx?ID=749590>.
[516] US GAO Report to the Senate Banking Committee. Required study on the potential effects of mandatory audit firm rotation 2003 <http://www.gao.gov/new.items/d04216.pdf>.
[517] *Cf* 1 2 2 *supra.*
[518] S 203 of the Sarbanes-Oxley Act.
[519] Konar Report par 3.4.

that the problem needed further study.[520] As a result, no provisions on auditor rotation were included in the final version of the Auditing Profession Act.[521]

This situation was changed a short while later by the Amendment Act. Section 274A(1) of the Amendment Act provides that "[t]he same individual may not serve as the auditor or designated auditor of a widely held company for more than five consecutive financial years".[522] The Amendment Act also provides that, if the auditor has served as the "auditor or designated auditor" for at least two years, and that auditor resigns or is removed, a two-year cooling-off period will apply before that auditor may be re-appointed *as auditor*.[523]

It is apparent that the Amendment Act does not expressly demand the rotation of audit *partners*, but only refers to "designated auditors".[524] The exact meaning of the phrase "designated auditor" is unclear, as neither the Amendment Act nor the Companies Act defines this term. As the act refers to "individual" auditors in the same section, the phrase "designated auditor" cannot refer to the whole audit firm.[525] Yet as there is often a whole team of individuals functioning as auditors, this provision can easily be interpreted as referring to the rotation of the whole audit team. It is submitted that this interpretation may be too broad. Alternatively, the following interpretation is suggested. It should be remembered that an audit firm is only validly appointed once the name of the individual auditor who will be held accountable for the audit is provided.[526] This is important to identify the responsible individual and to limit liability to that person.[527] In practice, the auditor who is held responsible for the audit will usually be the senior audit partner on the audit. It is thus submitted that "designated auditors" should be understood to refer to the named individual auditors in terms of section 44(1) of the Auditing Profession Act. This interpretation will result in essentially the same situation as audit partner rotation and will align the Amendment Act with the Auditing Profession Act.

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[520] Ministry of Finance Statement by the honourable Minister of Finance of the recommendations of the ministerial panel for the review of the Accounting Professions' Bill 2004 <http://www.treasury .gov.za/com m.media/press/2004/2004032401.pdf>.
[521] Temkin "Doubt about proposed audit policy" *Business Day* (2003-01-29) <http://www.businessday .co.za/Articles/TarkArticle.aspx?ID=688090>; Ministry of Finance *Statement* 2004.
[522] S 30 of the Amendment Act inserts s 274A in the Companies Act.
[523] This should be distinguished from cooling-off periods before cross-employment. *Cf* 3 6 3 *infra.*
[524] S 30 of the Corporate Laws Amendment Act inserts s 274A in the Companies Act.
[525] S 30 of the Corporate Laws Amendment Act inserts s 274A(1) in the Companies Act.
[526] More than one individual auditor may be held responsible in this manner. *Cf* 3 2 *supra.*
[527] Jackson & Stent *Auditing notes* 3/63.

In practice, most of the large audit firms have their own rotation policy in terms of which the audit partner on every audit has to be changed as regular as every seven years.[528] However, this rotation policy has not been problem-free. Philip Hourquebie, CEO of Ernst&Young, admits that the skills shortage in South Africa has led to considerable difficulty in implementing this policy.[529] The deadline for the first compulsory rotation in South Africa will only be at the end of 2012, five years after promulgation of the Amendment Act.[530] By that time the Companies Bill might well be operational.[531] One would have to wait and see whether the South African auditing industry will have the resource capacity to execute the new five year rotation without compromising on audit quality. With the implementation of a seven year partner rotation policy already proving a challenge, it may be difficult to successfully implement the shorter five year tenures.

Sarbanes-Oxley mandates the five-yearly rotation of the lead audit partner who has the primary responsibility for the audit, or the reviewing audit partner.[532] The US legislator did not impose an audit firm rotation policy in Sarbanes-Oxley, but instead ordered further studies to be done to ensure that the best approach is followed.[533] The SEC later passed additional rules which determine that the lead and concurring partners on an audit should rotate after five years, and are subject to a five-year cooling-off period before they may join that audit again. Similarly, other significant partners are compelled to rotate after seven years with a two-year cooling-off period.[534]

In the UK, auditor rotation has been left unaddressed by the Combined Code and corporate legislation. Following recommendations by the CGAA, the ICAEW and ICAS now both require audit engagement partner rotation every five years, and the rotation of all other key

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[528] Deloitte *Setting the direction:Audit frm rotation does not equal audit quality* <http://www.deloitte.com /dtt/article/0,1002,sid%253D123398%2526cid%253D131939,00.html>; Houquebie "Auditor independence: is rotation the solution?" *Ernst&Young* <http://www.ey.com/GLOBAL/content.nsf/ South_Africa /A_word_from_ Philip_-_Auditor_Independence_-_Is_Rotation_the_Solution>.
[529] Hourquebie *Ernst&Young*
[530] The Amendment Act only became operational on 14 December 2007. *Cf* 2 2 2 *supra.*
[531] The Companies Bill does not change the Amendment Act's position on rotation. It only adds an extra provision requiring that, if joint auditors are used, they may not rotate at the same time. S 92 of the Companies Bill 2008.
[532] S 203 of the Sarbanes-Oxley Act.
[533] S 207 of the Sarbanes-Oxley Act.
[534] SEC "Strengthening the commission's requirements regarding auditor independence" *Final rule* 2003 <http://www.sec.gov/rules/final/33-8183.htm>.

audit personnel every seven years.[535] The Smith Report has emphasised the importance of the audit committee in ensuring the effective implementation of partner rotation policy.[536]

It is submitted that audit firms should take care not to compromise on the quality of the audit when implementing rotation policy. The senior partner is the auditor on the team with the most experience and expertise. The constant rotation of this and other key positions will raise the cost of the audit as it takes time to build up a thorough knowledge of the client's financial and operational systems. It should also be remembered that the auditor is appointed on a yearly basis.[537] Although audit partner rotation is supported in principle to promote auditor independence, it is further submitted that audit committees should not rotate the auditors more than necessary. Evidence has shown that the first two years as well as the final year of the auditor's tenure is often lacking in quality: the first years because of the lack of knowledge of the client's business, and the final year because the auditor knows he is soon to be replaced and already has one foot out the door.[538] An audit partner term of five years is submitted to be a minimum acceptable length, although a longer legislative period such as seven years may ensure a larger number of productive years in the middle of the auditor's tenure. To change audit partners more frequently than five years may significantly compromise the quality of the audit.

3 6 2 2 Audit firm rotation

Compulsory audit firm rotation has not been successfully implemented in most jurisdictions. Whilst the idea of mandatory firm rotation was met with stiff opposition by the US and UK,[539] a minority of countries including Italy, Brazil, Austria and Singapore adopted mandatory audit firm rotation policies.[540] However, several studies have found that

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[535] CGAA *Final Report* par 1.5.1-1.5.2; 1.20-1.22.
[536] Smith Report par 5.25.
[537] Cf 3 2 supra.
[538] Temkin "Rash decisions will not restore confidence" Business Day (2003-05-05) <http://www.businessday.co.za/Articles/TarkArticle.aspx?ID=748728>.
[539] The concept was considered and rejected by the US and the UK. Perry "Audit Report: Govt backs away from mandatory rotation of firms" *AccountancyAge* <http://www.accountancyage.com/accountancyage/news/2030461/audit-report-govt-backs-away-mandatory-rotation-firms>; Cadbury Code par 5.12.
[540] For example, Italian legislation demands entire audit firm rotation every 9 years. Temkin "Rash decisions will not restore confidence" Business Day (2003-05-05) <http://www.businessday.co.za/Articles/TarkArticle.aspx?ID=748728>; Hourquebie *Ernst&Young*.

mandatory firm rotation did not improve auditor independence.[541] It has also been found that increased competition reduced audit costs by 40% in Italy. with the efficacy of these cheaper audits in a competitive market being questioned.[542] The Bocconi Report in Italy recently concluded that audit firm rotation has not been successful in ensuring auditor independence.[543] Countries including Spain and Turkey adopted and later scrapped legislation on mandatory audit firm rotation because of apparent ineffectiveness.[544]

The strongest arguments for mandatory audit firm rotation are that the auditor-client relationship may over time compromise independence, as a long familiar business relationship will make the auditor more likely to give in to client pressure to issue favorable audit opinions.[545] The supporters of firm rotation argue that a new team would improve audit quality, partly because the auditors will be less vulnerable to pressure. It is also argued that new auditors' lack of familiarity can count in their favour, as they will be more likely to double check detail that an auditor who is familiar with the client and its systems may not consider necessary. A new audit team on a regular basis may also strengthen perceived independence and reassure investors and creditors that the possibility of auditor-client collusion will be improbable. Advocates of audit firm rotation clearly believe that mere audit partner rotation will be insufficient to achieve these goals.[546] One clear advantage of mandatory firm rotation is that the unsatisfactory situation regarding competition and choice in the audit industry will be improved: by forcing the client to change audit firms on a regular

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[541] Cf US GAO *Report to the Senate Banking Committee* 2003; Jackson, Moldrich & Roebuck "Mandatory audit firm rotation and audit quality" 2007 *SSRN* <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1000076>; Cameron, Merlotti & Di Vincenzo "The audit firm rotation rule: a review of the literature" *SSRN* <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=825404>.

[542] Hourquebie *Ernst&Young.*

[543] Cameron, Merlotti & Di Vincenzo "The audit firm rotation rule: a review of the literature" 2005 *SSRN*. The accounting crisis at Parmalat in the 1990's is a good illustration of how audit firm rotation was abused to deliver favourable accounting results. The outgoing auditor, Grant Thornton, allegedly helped Parmalat to move fraudulent financial transactions to another company, Bonlat. Which Grant Thornton would still audit. By doing this, the problem was obscured from the incoming auditors, Deloitte. This case illustrates how easily the independence ensured by audit firm rotation, can be circumvented. *Cf* Russel "Deloitte, Grant Thornton can be sued for Parmalat" 2005 *WebCPA* <http://www.webcpa.com/article.cfm?articleid=13790&page=1>; Ferrarini & Giudici *Financial scandals and the role of private enforcement: The Parmalat case* in Armour & McCahery (ed) *After ENRON* (2006).

[544] Arel, Brody & Pany "Audit firm rotation and audit quality" 2005 *CPA Journal* <http://www.nysscpa.org/cpajournal/2005/105/essentials/p36.htm>; ICAEW *Mandatory rotation of audit firms 2002* < http://www.icaew.co.uk/publicassets/00/00/03/64/0000036465.PDF>.

[545] Hourquebie *Ernst&Young.*

[546] Glassman "Speech by SEC Commissioner: SEC Initiatives under Sarbanes-Oxley and Gramm-Leach-Bliley" 2003 *US Securities and Exchange Commission* <http://www.sec.gov/news/speech/spch022603cag.htm>; US GAO *Report to the Senate Banking Committee* 2003 13-15; Konar Report par 3.5.

basis, the industry-specific expertise of each audit firm will be forced to spread out more evenly.[547]

The main argument against firm rotation is that the costs will outweigh the benefits. It is argued that the time necessary for the new auditor to learn the company's often complex financial systems will most likely result in compromised audit quality and increased audit costs for both the auditor and the company.[548] The Konar Report pointed out that the practice has developed where the lead audit partner merely walks over to the next audit firm upon rotation and thus manages to stay on the same audit, thereby defeating the purpose of mandatory rotation.[549] Studies have also shown that the audit quality in especially the first two years and again in the final year of the auditor's term is often compromised because of regular rotation.[550]

During the development of Sarbanes-Oxley, the inclusion of a provision that would compel public firms to rotate their whole audit firm on a regular basis was proposed and dismissed.[551] The Report to the Senate Banking Committee essentially recommended that the current system of mandatory audit partner rotation should not be changed. The report suggested that the SEC and PCAOB should monitor the effectiveness of the current system and reconsider the implementation of mandatory firm rotation at a later stage, if deemed necessary.[552] The Report also rightly concluded that resource constraints in the auditing industry would severely limit the number of suitable auditors available to the large public companies in particular.[553] Moreover, the new Sarbanes-Oxley prohibitions on certain specified non-audit services would further limit the available options for large companies.[554] The report suggested that the audit committee would play a key role in determining when the independence principle would demand that the audit firm be rotated. It emphasised that the

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[547] *Cf* 3 6 4 *infra.* Cox *After Enron* 309-310.
[548] US GAO *Report to the Senate Banking Committee* 2003 13-15; Glassman *Speech by SEC Commissioner* 2003; Temkin "Accountants oppose rotation proposals" *Business Day* (2003-05-06) <http://www.businessday.co.za/Articles/TarkArticle.aspx?ID=749590>.
[549] Konar Report par 3.4.
[550] Temkin "Manuel's call for auditor rotation queried by panel" *Business Day* (2003-04-24) <http://www.businessday.co.za/Articles/TarkArticle.aspx?ID=743399>
[551] Alexander, K. "The need for international regulation of auditors and public companies" 2002 *Company Lawyer* 341.
[552] US GAO Report to the Senate Banking Committee 2003 5.
[553] The Big Four currently audit 78% of US listed companies. *Cf* COMPETITION *infra.*
[554] US GAO Report to the Senate Banking Committee 2003 7.

audit committee should play an active role in the regular determination of the auditor's independence, and if necessary, demand auditor rotation.[555]

It is submitted that, at the very least, the audit committee should ensure that no audit firm has unlimited tenure. The Conference Board Commission on Public Trust and Private Enterprise recommends that audit firm rotation should only be considered when some or all of the following circumstances occur: if the auditor has been in office for ten years or longer, if that same auditor also delivers a significant amount of non-audit services, or when cross-employment has taken place between the auditor and the client.[556] Even if all of these factors apply, considerations of rotation should still be reserved to the discretion of the audit committee.

An alternative measure to compulsory firm rotation has been suggested in the form of annual compulsory re-tendering by audit firms. The advantage of retendering is that the appointment of the auditor is reconsidered every year. Knowing that the firm has to bid annually for the position of auditor might improve independence as, in principle, the auditor can be replaced very quickly. The OFT dismissed the competitive advantages of audit firm rotation as "a form of compulsory retendering with one of the bidders excluded."[557] Yet the OFT supported compulsory retendering as a means to encourage competition.[558] Hourquebie regards retendering as an acceptable compromise between partner and firm rotation.[559] For the most part, compulsory retendering is not recommended. The CGAA is not in favour of introducing this principle and that there will most likely only be superficial compliance with the retendering process. The GCAA also points out that there is no guarantee that audit quality will improve and that the costs will outweigh the benefits.[560] It is submitted that, with the auditor already being reappointed by the audit committee on a yearly basis, coupled with the formal criteria that has to be considered by audit committees before nominating an acceptable auditor, there will be little advantage to the introduction of compulsory retendering in South Africa. It is therefore imperative that the audit committee does not simply reappoint the auditor every year, but that a serious reconsideration precedes its reappointment on an annual

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[555] US GAO Report to the Senate Banking Committee 2003 9.
[556] Conference Board Commission on Public Trust and Private Enterprise *Findings and Recommendations: Auditing and Accounting* 2003 33-34 < http://www.ecgi.org/codes/documents/757.pdf>.
[557] CGAA *Final Report* par 1.27.
[558] CGAA *Final Report* par 6.4.
[559] Hourquebie *Ernst&Young.*
[560] CGAA *Final Report* par 1.5.2; 1.23-1.30.

basis.[561] Substantive compliance to the regulations on the appointment process will have to be required.

3 6 2 3 Conclusion

Despite a dissenting minority, the US, UK and South African regulators seem satisfied to mandate audit partner rotation only. As there was previously no legislation regulating auditor rotation at all, any form of intervention will be welcomed. The question can now be asked whether mere audit partner rotation will be sufficient to address a potential independence conflict. Would the new partner on board not also work for the same firm and further the same cause (that of his audit firm's bottom line) than his predecessor? It is possible that mere partner rotation may only superficially address the perception of auditor independence. It should be remembered that Enron had enough influence over Andersen to dictate who would be on its audit team and who should be removed, regardless of any change in partner.[562]

Auditor rotation is only one aspect of the increased regulation of several other facets of auditor independence. The mandatory regulation of the South African audit partner only can play an important role towards ensuring auditor independence and restoring public trust in the auditor. A rotation period of five years may be too short and difficult to implement in South Africa. Rather, a slightly longer period of seven years is recommended. Audit committees will play a key role in the rotation and reappointment of auditors and should exercise their discretion on this matter with due care.

[561] Cf 3 2 *supra*.
[562] Cf 1 2 2 *supra*.

3 6 3 CROSS-EMPLOYMENT

Auditors are often recruited by their clients to fill senior financial positions with the clients, as they have extensive knowledge of the company and its financial and internal control systems in particular. Placing restrictions on the cross-employment of auditors by client companies can severely limit the company's access to valuable expertise. A lack of regulation on cross-employment could, on the other hand, impede auditor independence. This was well illustrated by Andersen's conduct: Andersen's hiring of the whole internal Enron audit team, as well as the close relationships that Andersen staff had with ex-Andersen staff who switched to Enron without a cooling-off period, have been considered to be substantial factors in the compromising of auditor independence.[563]

South African legislation has not substantively addressed the issue of cross-employment of auditors by their clients and *vice versa*. Section 275 only partially addresses the cross-employment issue by determining that certain employees may not be appointed as auditors.[564] Whether the employee may not *simultaneously* function as both employee and auditor, or whether the employee may not be appointed as auditor after ending employment, is unclear. The Amendment Act only demands a two-year cooling-off period before the company may reappoint the auditor *as auditor*.[565] There is thus no current legislative requirement of a cooling-off period before an auditor is employed by his client.[566]

The strongest authority on cooling-off periods in South Africa is the IRBA Code of Conduct, which prohibits the appointment of certain company employees as auditors in a provision very similar to section 275(1) of the Companies Act.[567] The IRBA Code then determines that employees should not be assigned as auditors and that "the period immediately preceding the assignment should be no less than two years".[568] IRBA thus recommends a two-year period before cross-employment.

The IRBA also determines that an audit partner may, after severing his or her ties with the audit firm by means of resigning or retirement, be employed by one of the firm's audit clients

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[563] Chicago Tribune "Ties to Enron Blinded Andersen" (2002-09-03) <http://www.chicagotribune.com/business/chi-0209030210sep03,0,6882143.story>. *Cf* 1 2 2 *supra.*
[564] Cf 3 2 supra.
[565] S 30 of the Amendment Act inserts s 274A in the Companies Act. *Cf* 3 6 2 *supra.*
[566] The Companies Bill 2008 has not altered the provision as set out in the Amendment Act.
[567] *Cf* 3 2; 3 6 1 *supra.*.
[568] IRBA *Code* par 7.12-7.13.

without necessarily compromising the continuing audit by the firm. According to the IRBA, independence will not necessarily be sacrificed if it can be shown that payments to the former audit partner are merely a result of his past involvement with the audit firm and that the former partner has completely severed his ties with the audit firm.[569]

SAICA warns against a blanket prohibition on immediate cross-employment, arguing that the majority of cross-employment situations do not create situations where independence is compromised, and that the application of such a provision will thus be unnecessary. Instead, SAICA suggests that the "revolving door syndrome", as the cross-employment problem is often called, should be only one of many factors that the audit committee has to take into account when deciding on a suitable auditor.[570]

Sarbanes-Oxley requires a one year cooling-off period before an auditor may be employed by a client in any of the senior positions of chief executive, accounting or financial officer or controller or similar positions.[571] Only auditors who have worked more than ten hours on the client's audit will be subject to this restriction.[572] It should also be noted that only the client company is barred from cross-employing within a year: the restriction does not extend to entities affiliated with the client.[573]

The UK Companies Act has provisions similar to section 275 of the South African Companies Act. These UK provisions prohibit an employee, officer or partner of the audited person or an associated undertaking of the audited person to be appointed as auditor.[574] Additionally, the Secretary of State is empowered to define and prohibit any form of special relationship which the Secretary deems close enough to potentially negate independence.[575] If these rules are contravened at any stage, the auditor should resign immediately and disclose to the company its compromised independence as the reason for resignation.[576] The UK, true to its principle-based approach, has not incorporated legislation enforcing a cooling-off period between cross-employment. The CGAA supports the ICAEW recommendation that

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[569] IRBA *Code* par 7.26.
[570] SAICA Comment letter to the Ministerial Panel for the review of the Draft Accountancy Bill <https://www.saica.co.za/documents/commentletter.pdf>.
[571] S 206 of the Sarbanes-Oxley Act.
[572] SEC *Commission adopts rules strengthening auditor independence* (2003-01-22) <http://www.sec.gov/news /press/2003-9.htm>.
[573] Tafara *Speech by SEC Staff* <http://www.sec.gov/news/speech/spch061003et.htm>.
[574] S 1214(1)-(3) of the UK Companies Act.
[575] S 1214(4) of the UK Companies Act .
[576] S 1215(1) of the UK Companies Act.

there should be a two-year cooling off period before an audit partner joins an audit client as "senior employee or director".[577]

All of the abovementioned cooling-off provisions only cover the situation where the auditor is employed by the client. Notably no provision, apart from that of the IRBA, attempts to address the possible independence conflicts that may arise when members of the client company are employed by the audit firm to join the audit team in auditing its previous employer. Familiarity threats in the form of loyalty towards the previous employer and colleagues, for example, may seriously impede independence. SAICA recognises this threat and warns against the self-review and familiarity threats that may arise when the new auditor was a director or officer of the client, or has been in "a position to exert direct and significant influence" over the content of the audited financial information.[578] It is submitted that, when legislating cooling-off periods, this inverse relationship should be afforded the same treatment as the employment of the auditor by the client company.

Although the IRBA Code has provisions on cross-employment in place, it is recommended that a blanket rule mandating at least a one-year cooling-off period should be introduced in legislation. Carefully controlled exceptions to the rule may be introduced in order to allow immediate cross-employment in unique situations. These exceptions may only be invoked if convincing evidence is brought before the audit committee that shows why independence will not be compromised and the audit committee, in exercising their discretion, is persuaded by such evidence. This would give legislative reassurance of independence to the public and investors whilst allowing a certain degree of discretion in the hands of the appointing audit firm or client company. A blanket prohibition in a developing country may put unreasonable strain on the availability of the already limited pool of financial expertise in South Africa.

[577] CGAA *Final Report* 1.5.11; 1.61.
[578] SAICA *Code* par 290.146-290.148.

3 6 4 COMPETITION

The oligopoly of the Big Four audit firms is the result of several mergers[579] and the fall of Andersen.[580] Smaller firms face significant barriers to entry in the audit market as they simply do not have, or are perceived not to have, the resources necessary to effectively audit the large public listed companies. Currently 78% of US listed companies and 99% of the total sales of US listed companies are being audited by the Big Four.[581] In the UK, the Big Four audit 99% of the FTSE 100 companies, 97% of the FTSE 250 and 93% of all companies listed on UK stock exchanges with the exception of AIM.[582] The global nature of the Big Four has led to a similar situation in South Africa: in the period from 2000 to 2004 the Big Four averaged a total market share of only 68% of public companies listed on the JSE Securities Exchange.[583] Although the smaller South African market share reflects the country's smaller economy, the competition problem is significant enough to merit discussion in a South African context.

The lack of competition is more obvious in certain industry sectors, where the Big Four often audit 90% to 100% of the companies.[584] It has been argued that the Big Four accounting firms limit client choice, and that the choice of auditors for the larger companies in particular, should be expanded.[585] How this should be done, is unclear. There is currently no firm large enough to serve as a fifth largest competitor. To illustrate: the 2002 revenue of KPMG, the smallest of the Big Four, was 60% more than the aggregate of the audit revenues of the next

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[579] In 1989, Deloitte Haskins & Sells merged with Touche Ross to create Deloitte & Touche and Ernst & Whinney merged with Arthur Young to create Ernst & Young. In 1998, Coopers & Lybrand merged with Price Waterhouce to create PWC. The trend of mergers to keep up with the demands of growing global companies, resulted in the Big Eight shrinking to the Big Four by 2002. US GAO *Report to the Senate Committee on Banking, Housing and Urban Affairs: Mandated study on consolidation and competition* 2003 11-12.

[580] Cf 1 2 2 supra.

[581] US GAO Mandated study on consolidation and competition 2003 5-21.

[582] AIM is the listing index for smaller companies. No minimum size is required. London Stock Exchange *About AIM* <http://www.londonstockexchange.com/en-gb/products/companyservices/ourmarkets/aim_new/About +AIM/admissioncritera.htm>; FRC *Discussion paper: choice in the UK audit market* 2006 2 <http://www.frc.org.uk/images/uploaded/documents/Choice%20in%20the%20UK%20Audit%20Market%20Discussion%20Paper4.pdf>.

[583] Firer & Swartz "An empirical analysis of the external audit fee in the 'new' South Africa" *South African Journal of Accounting Research* 1 3-4.

[584] US GAO *Mandated study on consolidation and competition* 2003 110 <http://www.gao.gov/new.items/ d03864.pdf>.

[585] McMeeking "Improving choice in the UK audit market" 2006 *University of Exeter* <http://www.frc.org.uk/documents/pagemanager/poba/Dr%20Kevin%20McMeeking,%20University%20of%20 Exeter.pdf>.

21 largest firms.[586] Even if the fifth and sixth largest accounting firms in the UK were to merge, it would still not result in a viable competitor for the current Big Four.[587] As auditing firms tend to specialise in sector-specific areas, the choice of an auditor is limited even further in certain industries.[588]

The competition in the audit industry creates three different types of problems. Firstly, the large listed companies' choice of an auditor is limited to a member of the Big Four. Secondly, because of the competition between the Big Four and their relatively similar size and resources, it is fairly easy to switch between members of the Big Four. This may result in a form of "opinion shopping" by the client.[589] Thirdly, there is the usual fear of collusive behaviour associated with a cartel.[590]

Competition in the audit industry poses an independence problem when it becomes easy for companies to switch between audit firms in what is often called "opinion shopping". The Cadbury Report recognised the high degree of "competitive pressure" as a factor that influences auditors to comply with the wishes of directors.[591] Fear of replacement when issuing unfavourable opinions may lead to compromised independence. However, most legislations have safeguards in place to ensure that companies cannot merely fire their auditor if they are unhappy with its audit opinion. In South Africa, an auditor may only be removed once any reportable irregularities have been submitted to the proper supervisory authority. The US and UK have similar safety measures in place.[592] It is submitted that this opinion shopping concern has been sufficiently addressed by legislation regulating removal, reappointment and rotation.

The Sarbanes-Oxley Act does not attempt to regulate competition amongst the accounting firms, but it did order a study to be done by the Comptroller General on the effects of

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[586] Cox The oligopolistic gatekeeper: the US accounting profession in Armour & McCahery (eds) After Enron (2006) 271-272.
[587] Bruce "Apathy rules: competition in the audit industry" *AccountancyAge* (2006-10-26). <http://www.accountancyage.com/financial-director/comment/2167220/apathy-rules>.
[588] Cox The oligopolistic gatekeeper 272.
[589] Beattie & Fearnly "Audit market competition: auditor changes and the impact of tendering" 1998 *The British Accounting Review* 261-289.
[590] Cox warns about the impact that an oligopoly has on any industry: "collusion is more likely to be successful within concentrated industries than those that are competitively structured. Industry concentration, therefore, always raises concerns that there will be either overt collusion or conscious parallel behaviour that yields the same effects as an agreement". Cox *The oligopolistic gatekeeper* 273.
[591] Cadbury Report par 2.1.
[592] *Cf* 3 5 *supra*.

competition in the accounting industry.[593] Sarbanes-Oxley identified particular problems that arise from the current competitive situation that should be assessed in this study. These potential problems include higher audit costs, lower quality of services, compromised auditor independence and a lack of consumer choice.[594] The study also had to explore the extent to which federal and state legislation affected competition, and propose solutions to, *inter alia*, ways to increase competition. The Comptroller General concluded that no conclusive link could be found between audit quality or audit independence and the current oligopoly of the Big Four. The study also concluded that market forces will not change the current composition of firms, and that no merger of any two smaller audit firms will result in a fifth large competitor. The report's final conclusion was that it is not clear what, if anything, could be done by the legislator to rectify, address or change the current audit market composition.[595]

In the UK, the CGAA recommended that the matter of competition among audit firms should be investigated.[596] The Office for Fair Trading ("OFT") conducted a study and, although the OFT acknowledged concerns regarding the overconcentration of the audit market, it concluded that the matter need not be referred to the competition commission nor legislated at national level. The OFT gave the global nature of the competition problem as the reason for not acting, and committed to keep the audit profession under review by the continuous monitoring of the problem.[597]

As a possible solution, the CGAA suggested that audit firm rotation will encourage audit firm competition.[598] It is also argued that competition will be encouraged by adopting mandatory audit firm rotation. Changing auditors on a regular basis will force the industry-specific expertise of the audit firms to spread out more evenly.[599] As mandatory firm rotation is not popular on regulatory level and remains a voluntary practice, any competitive advantages brought about by this rotation will also be lost on the industry. It is submitted that the advantages of improved competition will not outweigh the disadvantages brought about by mandatory audit firm rotation.

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[593] S 701(a)(2) of the Sarbanes-Oxley Act.
[594] S 701(a)(2) of the Sarbanes-Oxley Act.
[595] US GAO Mandated study on consolidation and competition 6.
[596] CGAA *Interim Report* 2002 par 1.12(a).
[597] OFT "Competition in audit and accountancy services" *Statement by the OFT* (2002-11-02) <http://www.oft.gov.uk/shared_oft/press_release_attachments/accountancy.pdf>.
[598] CGAA *Final Report* par 1.26.
[599] Cox The oligopolistic gatekeeper 309-310.

As an alternative solution the OFT supports compulsory retendering as a potential means by which to encourage competition. The OFT argues that the increased transparency of the auditor appointment process brought about by a retendering process, will encourage competition between firms and might give smaller firms a foot in the door, provided the costs of bidding does not become too high.[600] It has been previously submitted that the introduction of retendering is not recommended.[601] The tendering process encourages "aggressive fee renegotiation"[602] which often leads to low-balling[603] by audit firms and only further limits choice in the audit market.

The FRC and DTI's official conclusion on the competition problem is that any form of regulation, by for example splitting up the Big Four in the UK, forcing clients to change their auditor to a non-Big Four audit firm, or the creation of a state audit firm, is by no means an economically viable solution. [604]

It is thus submitted that little can be done from by the regulator to address the Big Four oligopoly. As market forces and increased globalisation of client companies encouraged the merging of audit firms to keep up with their clients, the market should be allowed to rectify itself. In the meantime, the industry is being closely monitored. There is no way of changing this unless market forces change. Government intervention to hasten this process would be unwise. The UK DTI argues that smaller audit firms will only be able to successfully participate in the audit market if the audit client's audit committees and management are willing to encourage the inclusion of smaller firms.[605] The problem will, however, only be resolved if the smaller companies are able to compete with the Big Four in terms of fees and resources, which is highly unlikely to happen in the foreseeable future. It is submitted that

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[600] CCGA *Final Report* par 6.4.
[601] Cf 3 6 2 supra.
[602] Beatty & Fearnly in Firer & Swartz 2006 *South African Journal of Accounting Research* 9.
[603] Low-balling, also known as strategic misrepresentation, occurs when the audit firm intentionally underestimates its future fees in the initial tendering or budgeting process. This is done to create barriers of entry for the smaller firms which often do not have the resource capacity to compete with the underestimated price. The large audit firm employs low-balling to receive or retain their appointment as auditor. Upon completion of the audit, the client is then billed for a much higher fee than originally tendered. This ensures a profitable venture for the auditor despite initial projected losses. Although audit firms vehemently deny using this tactic, observers of the industry have often concluded otherwise and remain sceptical. Williams "Accounting: Playing Low-Ball" *AccountancyAge* (2007-07-12) <http://www.accountancyage.com/financial-director/comment /2193827/playing-low-ball>; Simons "Independence, low balling and learning effects" 2007 *SSRN* <http://ssrn.com/abstract=1010429>; Mainelli "United Kingdom: Anti-dumping measures and inflation accounting" (2003-06-19) *Z/Yen Limited* <http://www.mondaq.com/article.asp?articleid=21647>.
[604] FRC *Discussion paper: choice in the UK audit market* 2006 6.
[605] FRC *Discussion paper: choice in the UK audit market* 2006 6.

increased disclosure by both the auditors and the clients on auditing matters may encourage the audit committee to consider smaller firms more regularly. Increased transparency can boost the public image and reliability of smaller audit firms and lower the risks and costs associated with the appointment of such smaller firms.[606]

The FRC also rightly warned that, if a Big Four audit firm should leave the market, it would have a serious debilitating effect on the industry, and should be avoided at all costs.[607] It is submitted that the legislator should consider legislative intervention only to prevent the situation from worsening. Choice will be limited unreasonably if the Big Four were to become the Big Three.

In South Africa, the legislator has predictably not addressed the competition problem. The Big Four's smaller market share in South Africa indicate that audit choice is not as limited in South Africa as in the US and UK. This can probably be partly ascribed to the smaller size of South Africa's listed companies and South Africa's status as a developing economy. Both of these factors make it easier for medium sized audit firms to be appointed. It is submitted that, although regulatory intervention is not recommended, the legislator should closely observe the local competition situation. Although increased disclosure by audit firms is supported to improve transparency in the audit industry, the role of the audit committee in increasing competition is not supported. It is not the audit committee's task to help regulate the audit market. Audit committees should act in the best interest of the investors, not the best interests of the audit industry. There is thus little that can be done from a regulatory point of view to encourage competition in the industry.

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[606] *Cf* 3 6 5 *infra.*
[607] FRC *Discussion paper: choice in the UK audit market* 2006 6.

3 6 5 ADDITIONAL ASPECTS OF INDEPENDENCE

Although the independence factors discussed *supra* can play a significant role in the possible restriction of independence, there are many other factors that can compromise independence. Most of these fall under the umbrella term "conflicts of interest". Increased disclosure of audit fees and transparency of the audit process can influence auditor independence by improving perceived independence and ensuring more informed investors and public.

3 6 5 1 Conflicts of interest and disclosure by the auditor

Section 44(6) of the Auditing Profession Act prohibits any auditor to conduct an audit if the auditor has "a conflict of interest in respect of that entity, as determined by the Regulatory Board [IRBA]".[608] Although legislation is silent on the detail of this aspect, IRBA's code of conduct determines that any conflict of interest should be disclosed by the auditor. If the conflict is material, the auditor should turn down the appointment. If the conflict is not material, the situation should still be fully explained to the client and both the client and the auditor should consent in writing that the conflict is allowed.[609]

Potential conflicts of interest as outlined by the IRBA include direct or indirect financial interest in the client, personal and family relationships, the receipt of goods, services or "undue hospitality" as well as when the auditor takes an advocate role when litigating on behalf of its client.[610] Pending litigation by the client against the auditor may especially compromise independence, as this may adversely influence the client's willingness to disclose information necessary to conduct an audit.[611]

Economic dependence also poses a threat to auditor independence. If an audit firm is too dependent on the income from a single audit client, the fear of losing that client may place the auditor under undue pressure to issue a favourable opinion. The CGAA Report addresses this problem by recommending that an audit firm should disclose the fees received from their

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[608] S 44(6) of the Auditing Profession Act.
[609] IRBA *Code* par 6.1-6.4.
[610] IRBA *Code* par 6-7. SAICA and the IRBA elaborate comprehensively on these topics in their codes of conduct. *Cf* SAICA *Code* par 290; IRBA *Code* par 7.1-7.12; 7. 19-7.21.
[611] IRBA *Code* par 7.27-7.28.

audit clients if the income from a single client comprises five percent or more of the auditor's total audit fee income.[612] The CGAA also recommends that audit firms should disclose their internal policies and procedures that have been followed during the auditing process, as well as what the audit firm did in order to promote or ensure auditor independence.[613]

3 6 5 2 Disclosure by the client

Accurate and complete disclosure of matters regarding the company auditor can considerably enhance perceived independence.[614] Disclosures by the client would include the report of the audit committee on the auditor.[615] Section 283(2) of the South African Companies Act requires the separate disclosure of audit and non-audit services and auditor expenses and payments. This section also determines that the nature of non-audit services should be specified. The Companies Act reflects the provisions of King II, which recommended that the amount paid for audit and non-audit services respectively should be disclosed separately, and advised that detailed information on the nature, scope and amount of each non-audit service received should be undertaken in the notes to the annual financial statements.[616] It has also been recommended by King II that additional disclosure should be made of the decisions taken with regard to non-audit services by the audit committee, and consequently implemented by the board.[617]

The 2006 UK Companies Act now confers a new discretion on the Secretary of State in terms of which the Secretary may require any company to disclose the terms on which they appointed their auditor in the annual company account, directors' report or auditors' report. The terms of engagement may include detail regarding duties, appointment and remuneration.[618] This move is welcomed, as it may lead to increased transparency, permitted

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[612] CGAA par 1.5.13.
[613] CGAA par 1.5.15.
[614] It has been argued that increased perceived independence will, in turn, help to narrow the expectations gap. Moizer *Independence* in Sherer and Turley (eds) *Current issues in auditing* 55. The term "expectations gap" is used to refer to the gap between society's understanding of what the auditor should be doing and what the auditor is perceived to be doing. For more background on this well-researched concept and its relationship with perceived auditor independence, see Humphrey *Debating audit expectations* in Sherer and Turley (eds) *Current issues in auditing* 3; Pierce & Kilcommins "The audit expectation gap: the role of auditing education" *Research Paper Dublin City University Business School* <http://www.dcu.ie/dcubs/research_papers/no13.htm>.
[615] Cf 2 3 1 supra.
[616] King II par 11.
[617] King II par 12.
[618] S 493 of the UK Companies Act.

the discretion is exercised properly. Furthermore, section 494 restates the 1989 position by confirming the Secretary's power to require the company to disclose the nature of all services rendered by their auditors. This provision is similar to section 283(2) of the South African Companies Act as explained *supra,* the main difference being the degree of compliance: separate disclosure is compulsory in South Africa, whereas the Secretary of State merely has a discretion to invoke such requirements.

The SEC has published several rules with regard to Sarbanes-Oxley's regulation of auditor independence. In particular, it expanded the disclosure requirement for fees paid by a company to its external auditor: before Sarbanes-Oxley, public companies only had to distinguish between audit and audit-related fees paid and did not have to disclose the amount of each non-audit service if that service constituted less than $50 000 or ten percent of total audit fees paid, whichever is the lesser.[619] The SEC issued a new directive in 2003 to give further effect to the provisions in Sarbanes-Oxley, whereby companies now have to disclose the *quantum* of four categories of audit services: audit fees, audit-related fees, tax fees and other fees. The company also has to disclose the audit committee's policies and procedures that have been followed in the approval of non-audit services, as well as the percentage of non-audit fees paid that is excluded from audit committee approval on account of falling under the *de minimis* exception in Sarbanes-Oxley.[620] Section 202(i)(2) of Sarbanes-Oxley also provides that the audit committee's approval of non-audit services has to be disclosed in regular reports to investors.[621]

A statement by the company on how the independence of its auditor has been ensured is welcomed, as this will force the company to proactively focus on ensuring independence by developing and implementing some form of independence policy. This should improve the transparency and accountability of the company with regard to its relationship with its auditor. The Combined Code and Smith Report determine that, in cases where non-audit services were rendered by the auditor, there should be disclosure in the client's financial statements as to how auditor independence was safeguarded throughout the financial year.[622]

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[619] SEC Final Rule: Revision of the Commission's Auditor Independence requirements.
[620] SEC *Commission adopts rules strengthening auditor independence*.(2003-01-23) <http://www.sec.gov/news/press/2003-9.htm>; S 202(i)(1)(B) of the Sarbanes-Oxley Act.
[621] S 202(i)(2) of the Sarbanes-Oxley Act.
[622] Combined Code par C.3.7; Smith Report par 5.30.

South African companies are encouraged to implement statements of independence. Yet it is submitted that disclosure, especially that of a non-financial kind, will only be of value if there is a determined effort by the client to comply, not only to the letter of the law or rules, but to its spirit as well. Mere superficial compliance to the letter of the law will not be enough.

CHAPTER 4

CONCLUSION

The need for legislative reform of the auditing industry is clear when one takes the sheer scope of corporate failures of large companies like Enron and WorldCom into account. As the external company auditor often contributes to such failure, there is clearly scope for the legislative reform of the auditing industry. The biggest problem of company auditors in corporate failures has been a sharp decrease in auditor independence, previously mostly unregulated terrain. Although outright fraud is also a large contributing factor to corporate failures, and the preventative power of prohibitive legislation in this regard, is not a surefire cure for corporate malfeasance, it is submitted that legislative intervention in increasing auditor independence in South Africa, has been long overdue.

South Africa has promulgated both auditing and company law legislation over the past few years as part of corporate law reform. As both sets of laws regulate the external company auditor at least in part, it is imperative for these laws to be aligned to provide a coherent approach. Whilst the Auditing Profession Act has been generally welcomed, the Corporate Laws Amendment Act presents more difficulty with the manner with which it attempts to address and reform issues regarding the auditor. What makes the Amendment act more problematic, *inter alia,* is that a lot of the Amendment Act's attempted reforms have been roughly based on similar provisions in the American Sarbanes-Oxley Act. Whether these provisions are the best for the South African environment, is arguable.

Another problem with the Amendment Act, is that it has a high cost of compliance, as it introduced a new categorisation of companies, separate from the traditional public-private distinction. However, the Companies Bill, expected to be operational by 2012, is set to abolish this new distinction again. This means that a lot of companies have an unnecessarily high compliance cost to the Amendment Act for only a few years before the Companies Bill takes effect.

Important aspects of the regulation of the auditor have been addressed in earlier legislation. These include the appointment, remuneration, rights and duties and removal and resignation of the external company auditor. Although the Companies Act of 1973 regulated detail provisions regarding these aspects, it was not enough to ensure adequate independence

according to today's international standards. As the focus of the reform of auditing legislation has largely been on increasing auditor independence, the Amendment Act sought to improve the independence underlay of the appointment and remuneration, and resignation of the external auditor. The Amendment Act has introduced some welcome innovation with regard to perceived auditor independence, although these are not without criticism.

The introduction of the use of the audit committee by the Amendment Act is welcomed. This new regulation has effectively increased auditor independence by requiring that the audit committee, not the board of directors, is now in charge of approving the appointment and determining the remuneration of the external auditor. Although the mere delegation of responsibility is no guarantee against corporate mismanagement, the audit committee, if functioning correctly and seeking to create an environment of integrity and transparency that goes beyond mere legislation, can significantly improve corporate governance of the auditor.

The threat of non-audit services to auditor independence has been widely acknowledged by Sarbanes-Oxley, King II and the CGAA. Particular independence concerns arise when an audit firm receives more income in non-audit fees from a client, than from audit fees from the same client. The US intervened by prohibiting a list of non-audit services, while the UK, true to form, recommended a more principle based approach. The Amendment Act has rightly avoided a prescriptive approach, and provides a more flexible framework by delegating the prohibition of non-audit services to the IRBA. With the conflicting results of studies on the effects of non-audit services in mind, it is submitted that South African legislation should not regulate non-audit services. Instead, the discretion of the audit committee, combined with effective adherence to the audit committee terms of reference and comprehensive disclosure, should provide enough assurance to investors and the public that auditor independence is not materially affected by a non-audit appointment.

With regard to audit partner rotation, the introduction of partner rotation, as opposed to entire firm rotation, is supported. However, the current five year compulsory rotation period is submitted to be too short. A longer period of at least seven years is recommended. Alternative means of rotation are dismissed as not practical for South Africa. In particular, the skills shortage in South Africa will not allow whole audit firm rotation to take place effectively. Another alternative to audit partner rotation, compulsory retendering, is also

dismissed as it will hamper the effective functioning of both the audit committee and the auditor.

South African legislation does furthermore not have a provision that properly regulates or prohibits cross-employment. The legislator has not used the opportunity to change this situation in the text of the Companies Bill. It is submitted that it may be valuable to add a legislative provision requiring at least a one-year cooling-off period, as long as the provision allows some flexibility in determining that the audit committee has some influence in the decision-making process, or even has the power to override the cooling-off period provision entirely, should there be sufficient reason to do so. Also, a cooling-off provision should preclude both the immediate appointment of the auditor by his client and *vice versa*. Current legislative trends only provide for the former situation. A blanket prohibition will be unnecessarily restrictive.

Although the lack of competition in the auditing industry is clear, there is not much that can be done by the legislator to change this unfavourable situation. Although compulsory audit firm rotation can encourage competition, the possible advantages of this in the South African context are limited and do not justify the disadvantages brought about by the audit firm rotation system. Government intervention in this regard is discouraged, as well as audit committee intervention. It is not the role of the audit committee to regulate the audit market. Improved disclosure by audit firms may lead to an increase in the appointment of smaller firms and in turn, improve the competition situation in South Africa.

Finally, increased disclosure on all audit-related matters by both the auditor and client can contribute to increased transparency and thus improve auditor independence. To legislatively require the audit client to disclose a statement on how it ensured the independence of its auditor is recommended. This will only be effective if there is a genuine commitment by the client to adhere to the principles underlying the legislation.

When determining auditor independence in general, a strong reliance on the subjective discretion and good judgment on the part of the audit committee which should function with strict adherence to legislatively determined terms of reference and with integrity, is supported.

Although the general increased awareness of auditor independence by legislation is welcomed, care should be taken to not overlegislate each contributing aspect of independence on its own, as this may hamper the effective functioning of the external company auditor. A customised approach is needed. It is submitted that the South African legislator should take due regard of the South African context when increasing auditor independence regulation.

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