01 November 2017

The Board
Independent Regulatory Board for Auditors (IRBA)
Building 2
Greenstone Hill Office Park
Emerald Boulevard
Modderfontein
Johannesburg

THE CFO FORUM SUBMISSION TO THE IRBA POST THE GAZETTING OF MANDATORY AUDIT FIRM ROTATION (MAFR)

Dear IRBA Board Members

The CFO Forum ("The Forum") is a high-level discussion group formed and attended by the Chief Financial Officers of major JSE listed and larger state-owned companies with broad sectorial coverage which includes financial services, mining, retail, media, telecoms, medical services, agriculture and paper & packaging. Its aim is to contribute positively to the development of South Africa's policy and practice on financial matters that affect business, for example in the areas of: government regulatory issues and initiatives, taxation, financial reporting, corporate law and governance, capital market regulation and stakeholder communications for enterprises on behalf of its members, who represent a significant part of South African business. The Forum was created in 2011.

The CFO Forum would like to make the following submissions to the IRBA in respect of the gazetting of the MAFR Rule in June 2017. Our submission covers the following three issues:

- Joint audit (longer rotation period);
- Alignment with the Companies Act; and
- Additional market concentration that may result from MAFR.

Joint audit (longer rotation period)

We would like to submit to the IRBA that, when considering section 90 of the Companies Act, in conjunction with the recently IRBA published rule on MAFR, a number of compliance challenges are posed by the simultaneous operation of both these requirements. The challenges are exacerbated by the additional requirements set out in the IRBA Code of Conduct applicable to auditors ("the Code").

Companies Act

Section 90(2) (b) of the Companies Act provides for specific disqualification of an individual auditor / firm for a period of 5 years where the auditor provided certain prohibited services. A company must therefore consider these facts when it considers the appointment of the auditor / firm. In addition, Section 92 of the Companies Act requires the rotation of the individual auditor of the firm every 5 years.

Mandatory audit firm rotation

MAFR requires a public interest entity ("PIE") as defined in the Code to rotate audit firms after a period of 10 consecutive financial years. Thereafter, the audit firm will only be eligible for reappointment as the auditor after the expiry of at least five financial years. If the audit firm has served as the appointed auditor of a public interest entity for 10 or more consecutive financial years before the financial year commencing on or after 1 April 2023, then the audit firm shall not accept re-appointment and will be required to rotate.

IRBA Code of Professional Conduct

The Code, which is aligned with the international code published by the International Ethics Standards Board for Accountants, comprehensively deals with the independence of auditors when performing audits and other services. The Code sets out the risks relating to independence and self-review threats and has clear guidance on the provision of non-assurance services to clients by audit firms.

Possible impact of the above provisions

The combination of the above provisions could lead to a company's limitation of choice of auditor.

- The joint impact of all of the above requirements could be quite onerous and time-consuming for companies and could lead to difficulty in obtaining the services of an auditor / audit firm who meets the combined requirements.
- Section 90(2) of the Companies Act and MAFR requires an audit firm to undergo a "cooling-in" period of five years where it has rendered specific services to a prospective audit client. This is unprecedented in legislation, especially in so far as the introduction of MAFR, as no other jurisdiction in the world has similar requirements.

  In many cases, multiple audit firms may have performed an array of services that may fall into section 90(2) during a five year period for the prospective audit client. In this

scenario a significant portion of the audit firms are unable to propose for the audit, should the audit committee (or similar governing body) determine that a new auditor needs to be appointed. The specific services are typically rendered by persons who do not form part of the audit team, and would not ordinarily impact the independence of the audit team if those services were performed in the previous five years. In South Africa, there are already professional and regulatory rules that safeguard the independence of audit teams and audit firms. With MAFR being effective for financial years of companies commencing on or after 1 April 2023, boards of directors and their audit committees are required to already commence considering rotation and the limitations of section 90 will create a number of complexities as well as impede an entity from being able to engage with many audit firms for non-audit related services. The reference here is to more than one audit firm since an entity will be required to consider the selection of a new audit firm from a pool of audit firms – i.e. the entity will request a proposal from a number of audit firms and all those firms will be required to have met the criteria of section 90 in order to qualify for selection as auditor of that entity.

- The primary concern is therefore one of choice and whereby the choice of which audit firms and which professional service firms a company is able to use is severely limited as a result of Section 90(2)(b) in the context of MAFR.
- The above-mentioned issue is exacerbated for entities that are jointly audited, since the restrictions would be greater in terms of selecting audit firms in terms of the requirements of MAFR.

Consequences for public interest entities (PIEs)

- The companies affected by MAFR, i.e. PIEs, are listed and other large, usually complex, companies. In that context there are additional requirements that an audit firm will need to meet to be able to audit the company in the timeframe required by both the JSE and the Companies Act with the degree of quality required by International Standards on Auditing. We provide some context to those requirements below by clarifying some of the characteristics of PIEs.
    - *Public Interest Entity (PIE) companies:*
        - are usually large, complex operations and many are structured with multiple subsidiary / divisional entities reporting into the holding company requiring multiple on-site audit teams to complete fieldwork. (This requires audit firm with sufficient available resources to audit all of the locations timely).
        - often have geographically spread operations which in some cases are across various foreign countries. This requires the auditor to be able to audit the financial information of those operations in those jurisdictions. (This requires an audit firm with geographical spread and/or access to resources across geographies to be able to audit all locations timely).
        - have operations which may need a degree of specialist expertise to be involved in the audit. This is either from the context that the company is in a specialised industry requiring an auditor with experience in that industry and/or the company may have complex accounting or auditing

matters requiring the input of specialists such as actuaries, valuation experts, engineers or special IT audit capabilities. (This requires an audit firm with audit partners and staff with specific industry experience and/or access to in-house or external experts familiar with reporting on specialised audit matters).

- As a result of the above, a company will therefore usually require an audit firm which has some or all of the requirements noted above. This usually limits the entity in choosing between the larger firms; often referred to as "large and medium sized firms". Furthermore companies also have a preference for the majority if not all of the entities in a group to be audited by the same auditor to ensure accountability of consistent service and to ensure the understanding of the group is complete. Related to this are the auditor's considerations where an auditor signing off a consolidated entity would usually be required to be the auditor of the majority of the entity's consolidated revenues, assets and profits to ensure the auditor is able to manage the risk of providing an opinion on the group. In a group that has operations in several geographies this may also result in further complexity where those other operations have their own specific MAFR requirements. This issue is also further exacerbated for entities that are jointly audited where there is a need to maintain consistency between the group and the geographical operation's auditors.

Impact on quality of the audit

- Large corporates in South Africa also often engage smaller audit firms (particularly those with BBEEE credentials) to provide services outside statutory audits, including those prohibited by Section 90(2). This makes such smaller firms unable to compete to be appointed as statutory auditors for bigger corporates.
- Choosing a firm that does not have the necessary skills, competence and available resources could impact on the quality of the audit, the ability to meet regulatory deadlines and ultimately could impact the reliability of the audit. This in turn could have severe ramifications for the shareholders and the economy as a whole.
- It is for this reason that boards of directors and audit committees are tasked with carefully considering which auditors to recommend for appointment. Similarly when it comes to providing "other services" in relation to tax, advisory and transactional support it is usually these firms that also have the capabilities to provide those services to the companies. Companies require these other services as they often require specific services for which it is not practical to have those expertise or skills "in-house" as they are required "ad-hoc" and are often urgent.
- Different firms also have different levels of experiences with different industries in each of those services and have different levels of expertise for the various sub-services within those services. As a result companies will often be required to utilise more than one of the larger firms to ensure they choose the most competitive and competent offering to suit their needs. This may result in many of the firms potentially being unable to tender for an audit as a result of a fair number of these services potentially being within the ambit of Section 90(2)(b). If an audit firm or its advisory associate company performs a service in the scope of Section 90(2)(b) it would preclude that audit firm from being able to accept appointment as auditor for 5 years from performing the service.

- Whilst we acknowledge the intention of Section 90(2)(b) is likely to prevent the auditor from being in a position of reviewing his/her own work we note that this is already well governed by the IRBA Code.

Competition considerations

- Section 90(2) reduces the number of audit firms that are available to a company to select as its auditor, where an audit firm has performed the services described in Section 90(2) in the preceding five years. This restriction is further exacerbated by the IRBA Rule on MAFR, which further precludes certain firms from being appointed as auditors.
- In addition, certain firms that intend on proposing for the audit of a company will not be able to provide the services under Section 90(2) to the company, thereby resulting in fewer options available to the company to choose from, to perform these services.
- Large corporates in South Africa also often engage smaller audit firms (particularly those with BBEEE credentials) to provide services outside statutory audits, including those prohibited by Section 90(2). Therefore using such firms would preclude the firm from being the entity's statutory auditors for bigger corporates. This could work against the objective of transforming the South African auditing or accounting industry.
- The simultaneous provisions of Section 90 and the MAFR rule as issued by the IRBA may not promote improved market competition and also could take away the freedom of choice of companies to select the best auditors and advisors. In a market the size of South Africa's, this has the effect of shrinking an already small pool of eligible audit firms and stunting the growth of small- and medium-sized firms.
- In addition to the independence requirements of the Code we note that there is another factor to consider in relation to the self-review threat. When the service provider firm (audit / advisory firm) provides non-audit services that firm is not doing so in a vacuum. That is to say there is a different firm / individual acting as auditor for the company during the period in which such non-audit services were provided. Therefore if the non-audit services impact the financial statements or the accounting records in any way, it will be subject to the procedures of the audit (provided by a different auditor/firm). This is quite an effective control to provide additional oversight over the other services which also reduces the subsequent self-review threat. This is because it has already been subjected to scrutiny by a different auditor. It is in this context that we believe that the provisions of Section 90(2)(b) overly limit the acceptability of an auditor appointment beyond international norms and in doing so primarily limit the choice which is available to audit committees when appointing an auditor. It also prevents the company from being able to choose from a wide pool of suppliers for other services. This is because audit firms will be less willing to offer other services if they believe it would impact their ability to tender for the audit in the future.
- We note that as audit firms compete and they know they cannot win each tender that they submit, they are likely to "steer clear" of a larger pool of potential audit clients to be able to successfully win tenders on a sufficient number of tenders. This is a practical response to ensure sustainability but further reduces the number of firms a company can utilise for "other services".
    - In the next few years as we approach the first round of MAFR rotations, companies will discover that many audit firms may not be eligible to tender for an audit even though are independent in term of The Code and international

guidelines. Similarly many audit firms or their associate advisory firms may also be unwilling to accept an offer for other services. In respect of the latter it would be due to those firms not wanting to taint their ability to tender for an annuity service. This is likely to recur each time the company enters the 5 year period preceding each required rotation.

- We therefore note that this will reduce the likelihood that a company will be able to select an appropriate audit firm from a wide range of firms. The company thus may not be able to obtain the required service (audit or other) from their preferred providers or the provider which is best placed and/or suited to provide the service. It may even affect the ability of the company to obtain the service at all. In turn, this may also result in a reduced number of firms to compete.
- In turn this may also result in a reduced number of firms competing for the audit services.
- Certain regulatory, covenants or contractual requirements may be at risk of being contravened or companies may not be able to raise capital, i.e.
  - In some instances, local and global regulators prescribe and certain global capital markets expect that to perform specific audits, auditors must meet certain requirements. An example of such a requirement exists in the banking environment and, as a result, audit firms meeting those requirements are limited. Should any of them be excluded by the provisions of Section 90(2), a situation may arise that no auditor would be capable of accepting the appointment. In addition, contracts, such as loan agreements or conditions of approval for the provision of capital, may also require specific auditors to be appointed.
  - Companies may be in breach of loan agreements or may not be able to raise capital if they are unable, due to Section 90(2), to appoint a specific auditor as a result of services provided in the previous five years.

- There also unintended consequences (of the current interpretation) on non-South African Companies. Where a multinational company has a subsidiary in South Africa, and the multinational company intends to appoint a new global auditor, the multinational may be precluded from appointing its audit firm of choice, not only in South Africa, but also globally, if that firm performed any of the activities described in Section 90(2) during the preceding 5 years on any of the South African companies. This is particularly the case where South African operations are significant. Taking Section 90(2) into account, together with the International Standard on Auditing, ISA 600, *Special considerations – Audits of Group financial statement (including the work of component auditors)*, it is imperative that a group engagement partner or firm gains sufficient audit evidence to enable him/her to express an audit opinion on the group results as a whole. Where the group auditor is not able to use its network firm in South Africa, it may result in the auditor not being able to express an opinion on the group, without the multinational incurring significant costs to have the South African business(es) re-audited by the group auditor.

Conclusion

We recognise that constructive debate around the implementation of MAFR remains essential.

We consider the provisions of Section 90(2) to be unnecessary when one considers that the IRBA Code of Professional Conduct for Auditors already contains extensive and adequate provisions for monitoring and safeguarding independence. In addition, the audit committee plays an important role in ensuring that external auditors are sufficiently independent, which includes considering which advisory services may be performed by the company auditor. This role is guided by the King Code of Corporate Practices and Conduct, which is a further source of provisions which guide and strengthen auditor independence. There are also proposed updates to the JSE Listing Requirements recently published for public comment that further strengthens auditor independence.

Our recommendation is that Section 90(2)(b) should be removed from the Companies Act as the matter it intends to regulate is adequately regulated by the IRBA. Alternatively the section should be altered to a 1 year "cooling in" period to be in line with the Code and other international norms.

The CFO Forum would further like to request a meeting with the IRBA, to further discuss the transitional arrangements in order to assist and communicate with it's the forum members on the implementation of the MAFR rule.

Yours sincerely

KC Ramon
Chairperson of the CFO Forum