

REF# 768773

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Submitted electronically at: Kuben.Naidoo@resbank.co.za

Dear Kuben

SAICA's COMMENT LETTER ON THE PRUDENTIAL AUTHORITY'S DRAFT GUIDANCE: SECTION 252 OF THE FINANCIAL SECTOR REGULATION ACT, 2017

In response to your *Draft Guidance on Section 252 of the Financial Sector Regulation Act* (Draft Guidance), please find included the comments prepared by SAICA.

We thank you for the opportunity to provide comments on this Draft Guidance. Our comments have been provided under the overall comments section below.

Please do not hesitate to contact us should you wish to discuss any of our comments. You are welcome to contact Thandokuhle Myoli (thandokuhlem@saica.co.za).

Yours sincerely

Signed electronically

Thandokuhle Myoli
Project Director: Audit and Assurance

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Project Director: Members in Business

A. Overall comments

1. SAICA welcomes the opportunity to comment on the Draft Guidance. This comment letter is based on consultations within the various divisions at SAICA.

Section 252(1) of the Financial Services Regulation Act (S252 (1))

2. With reference to the term auditor as utilised throughout the document, we assume this refers to the industry accredited auditors or partners. We suggest that the term be referenced to the relevant legislation.
3. While the term “financially unsound” may be undefined, it is important that a comprehensive set of indicators is given or a decision tree to be followed to ensure that auditors have sufficient guidance to enable them to make the conclusion that a financial institution may be financially unsound. Other possible indicators of financially unsound financial institutions may include (not an exhaustive list):
 - a. Inadequate capital reserves.
 - b. Inadequate provisions to non-performing loans.
 - c. The quality of the assets held by the financial institutions e.g. significant exposure to unsecured loans.
 - d. High exposure to risky or non-performing sectors of the economy.
 - e. The impact of fluctuations in interest and exchange rates and other macroeconomic policies adopted by government.
4. Given that there is no specific definition for “financially unsound”, the guidance should emphasise that the auditor needs to apply professional judgement, using the indicators, understanding of the entity and its operations as well as industry knowledge in order to conclude on whether a matter is reportable to the Prudential Authority (PA) or not.
5. The PA should consider expanding the guidance with illustrative examples of cases where financial institutions may potentially be “financially unsound.” These examples should not necessarily focus on conclusions reached by the auditor but on the thought process and issues that the auditor should consider in making a determination as to the financial soundness of a financial institution.
6. Paragraph 2.1.4 states that materiality can be taken into account when considering reporting the matter to the PA. The guidance focused on financial unsound and not the other factors, we suggest that there should be more guidance on materiality consideration to avoid inconsistencies in interpretation of the section and guidance. An example, the pension fund contributions that are paid after the 7th of the following month say on the 8th – this is a non-compliance matter as per 252 (1)(a)(ii)(bb) however, this could potentially be seen as not material and not reported and guidance will ensure industry aligned interpretation.
7. Paragraph 2.1.5 of the Draft Guidance states, “*In some cases, a matter identified as a reportable matter for the purposes of section 252 of the Act may result in a modification of the audit opinion of the financial institution.*” SAICA suggests that this paragraph needs to be expanded on to clarify that the disclosure of the matter in the auditor’s report does not preclude the auditor from reporting in terms of S252 (1).
8. The Draft Guidance does not give clarity on whether the auditor has a responsibility to disclose to the financial institution that a matter has been reported to the PA in terms of S252 (1). In order to prevent inconsistent practices amongst auditors, it is important that there is clarity in this regard. SAICA is of the opinion that there should be a requirement for the auditor to issue a written report to members of the management board of the financial institution, thereby notifying them, that a matter has been reported to the PA. This written notice should be accompanied by a copy of the report submitted to the PA.

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9. A reportable matter in terms S252 (1) may also be a reportable irregularity in terms of Section 45 of the Auditing Profession Act, No. 26 of 2005, (the APA), section 45 – *Duty to report on irregularities*.

In the APA, a reportable irregularity is defined 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, shareholder, creditor or investor of the entity in respect of his, her or its dealings with the entity; or*
- (b) *is fraudulent or 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.”¹*

In terms of S45(4) of the APA, the Independent Regulatory Board of Auditors (IRBA), must as soon as possible after receipt of a reportable irregularity from an auditor, notify any appropriate regulator in writing of the details of the reportable irregularity to which the report relates and provide that regulator with the report. As the APA is the primary legislation governing the activities of registered auditors, its requirements may be understood to supersede the requirements of the Financial Sector Regulation Act (FSRA) where a reportable matter is also a reportable irregularity in term of the APA. SAICA encourages the PA to collaborate with the IRBA in this regard to ensure that there is clear guidance with regards to how auditors should act in these circumstances. A recommendation is for both regulators to issue joint communication to address this.

10. Paragraph 2.1.12 of the Draft Guidance states, “*If the auditor has submitted written reports or representations on the same matter to a different authority or institution, the auditor may include such reports or representations as an appendix to the report.*” With regards to reportable irregularities reported to the IRBA, this could cause confusion for auditors given the requirements in section 45(4) of the APA. Refer to the recommendation provided in paragraph 9 above.
11. The Draft Guidance does not deal with consequences in the instances where the auditor fails to report a matter in terms of S252 (1). The consequences should be clearly documented for both the individual auditor and the firm, particularly in those instances where the auditor knew or ought to have known of a reportable matter but failed to report to the PA. Failure to report a matter to the PA could be a case of the auditor failing to conduct their duties with the necessary professional competence and due care which may be a breach of the IRBA Code of Professional Conduct for Registered Auditors. Incorporating this element in the Draft Guidance may enforce the seriousness of the requirements of S252 (1).

Section 252 (2) of the Financial Services Regulation Act

12. Section 252(2)(b) of the FSRA states, “*An auditor of a licensed financial institution or of a holding company of a financial conglomerate who resigns or whose appointment is terminated must submit to the Prudential Authority... (b) any report contemplated in section 45(1)(a) and (3)(c) of the Auditing Profession Act, 2005 (Act No. 26 of 2005), that the auditor would, but for the resignation or termination, have had reason to submit.* “
13. Section 45(1)(a) of the APA, however, states that “*An individual registered auditor referred to in section 44 (1)(a) of an entity that is satisfied or has reason to believe that a reportable irregularity has taken place or is taking place in respect of that entity **must**, without delay, send a written report to the Regulatory Board.*” (own emphasis added)

¹ Auditing Profession Act No. 26 of 2005, Section 1, Definitions

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Section 45(3) of the APA also states that, “*the registered auditor **must** as soon as reasonably possible but no later than 30 days from the date on which the report referred to in subsection (1) was sent to the Regulatory Board...*” (own emphasis added)

The APA, therefore, places all responsibilities with regard to section 45 on the auditor who identifies the reportable irregularity. The auditor must complete the reporting of a reportable irregularity before resigning from an audit. The report process is completed once the auditor has submitted the second report to the IRBA as required by section 45(3). The auditor cannot resign from the engagement without satisfying the requirements of that section. SAICA, therefore, is of the view that the wording in section 252 (2)(b) creates the false impression that an auditor who identifies a reportable irregularity may withdraw from the engagement without satisfying the requirements of section 45 of the APA. The Draft Guidance should clarify this situation by prescribing that the auditor needs to satisfy the requirements of section 45 of the APA where a reportable irregularity is identified.

Addendum 1, Informal Consultation

14. Refer to Addendum A, *Informal consultation*, for proposed changes to the illustrative written report.