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Prof Michael Katz
Chairperson
Specialist Committee on Company Law

Dr SM Masotja
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Dear Prof Katz and Dr Masotja,

SUBMISSION TO THE DEPARTMENT OF TRADE INDUSTRY AND COMPETITION ON THE PUBLIC INTEREST SCORE

1. The South African Institute of Chartered Accountants (SAICA) has identified that the Public Interest Score (PI Score) as set out in the Companies Regulations has been static since the implementation of the Companies Act in 2011

2. Juanita Steenekamp from SAICA presented to the DTIC on 19 September 2019 on issues identified in terms of the Companies Act and Companies Regulations relating to the PI Score.

3. With regards to the PI Score we hereby request that the DTIC

   3.1 consider an increase to the PI Score as the current score has been static since the implementation of the Companies Act in 2011, and

   3.2 consider changes to other aspects such as the definitions and method of calculation of the PI Score.

4. For ease of reference we have set out our main points in **Annexure A**.

Yours sincerely

Freeman Nomvalo
Chief Executive Officer

Juanita Steenekamp
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The South African Institute of Chartered Accountants

Annexure A
SAICA's request to increase and/or change the definition and method of calculation of the Public Interest Score in terms of the Companies Act and Companies Regulations

Contents

A. Background

1. When the Department of Trade and Industry ("the DTI"), now named the Department of Trade Industry and Competition ("the DTIC") initiated the corporate law reform process around 2004, one of the key objectives was to provide flexibility in the formation and management of companies. The objectives were outlined in the DTI policy paper titled, '*South African Company Law for the 21st Century*', and gazetted in May 2004. The DTI policy document stated that the new company law must 'promote flexibility in the formation and management of companies.' Evident from the policy paper is that the new Act, (at that time) questioned the value of some of the statutory requirements in the 1973 Act arguing that, 'a number of the statutory requirements add unnecessary formalities to relatively simple processes…". Ultimately, the aim was to reduce the amount of red tape and lighten the compliance burden on small companies.

The concept of the public interest and the distinction between small business and public interest companies

2. The policy document further stated that the growth of the small business sector created a need for simpler and more accessible laws and that it should be possible for small businesses ("small business owners") and their advisors to understand the administrative requirements, without having to resort to expert advice. The policy recognised and acknowledged the concept of the public interest and the distinction it creates between small business and large corporates that significantly impact the public interest. The Act inter alia imported the concept of the public interest score ("PI score"), which imposes a threshold value that triggers a distinction between requirements that apply statutorily to larger corporates on the one hand and requirements that apply voluntarily to small companies on the other. This distinction between different companies based on their impact on the public interest statutorily determines the appropriate level of accountability and transparency for each such company (public companies are subject to the enhanced accountability and transparency requirements, while the Act adopts a far more lenient approach to small companies). For example, the requirement to have audited financial statements only applies to companies above the statutory PI score threshold with a significant impact on the public interest. Section 30 of the Companies Act, 2008 (the Act) clearly stipulates the criteria to be applied by the Minister when determining which companies (other than public and state owned companies) are required to be audited: the criteria being to "**take into account whether it is desirable in the public interest, having regard to the economic or social significance of the company, as indicated by any relevant factors, including-**

   (aa) its annual turnover;

   (bb) the size of its workforce; or

   (cc) the nature and extent of its activities".

3. The higher the public interest the higher the imposition of requirements on the company or close corporation.

B. Basis for review of the PI Score

4. The PI Score has been in effect from 1 May 2011, being the effective date of the Act.

5. The South African Institute of Chartered Accountants (SAICA), on request from its members, are approaching the DTI to consider a review of the current value of the PI score threshold. The basis of the review is twofold:

   - Review of the threshold value due to inflationary considerations, and
   - Review of the terms used as indicators due to interpretational issues.

6. Regulation 26(2) of the Act requires companies to calculate their public interest score (PI Score) at the end of its financial year, calculated as the sum of the following:

> "*(2) For the purposes of regulations 27 to 30, 43, 127 and 128, every company must calculate its 'public interest score' at the end of each financial year, calculated as the sum of the following:—*
>
> *(a) a number of points equal to the average number of employees of the company during the financial year;*
>
> *(b) one point for every R 1 million (or portion thereof) in third party liability of the company, at the financial year end;*
>
> *(c) one point for every R 1 million (or portion thereof) in turnover during the financial year; and*
>
> *(d) one point for every individual who, at the end of the financial year, is known by the company—*
>
> *(i) in the case of a profit company, to directly or indirectly have a beneficial interest in any of the company's issued securities; or*
>
> *(ii) in the case of a non-profit company, to be a member of the company, or a member of an association that is a member of the company."*

a) **Employees:** A company's employees who are inevitably affected by the activities and success or otherwise of the company, including the broader social impact that companies with many employees have. In terms of regulation 26(2) this is used as a <u>quantitative</u>, <u>non-monetary</u> indicator; i.e. the number of employees.

b) **Third party liabilities:** The extent to which a company is financed, other than by its shareholders, reflecting the interest in the company of creditors and providers of finance. In terms of regulation 26(2) this is used as a <u>quantitative</u>, <u>monetary indicator</u>; i.e. the R-value of third-party liabilities.

c) **Turnover:** The nature and size of the company's business. Various factors, both monetary and non-monetary, could have been considered in this regard, since this is a measure of the broader impact of the activities of a company in financial terms, but also in terms of sustainability, including its economic, social, environmental and governance performance. However, in this instance the legislator decided to use a company's turnover as the sole measure in this regard. As such this is a <u>quantitative</u>, <u>monetary indicator</u>.

d) **Shareholder:** The holders of a company's securities (i.e. shares, debentures or other instruments) representing those stakeholders that have the most direct interest in the company and its performance and sustainability. The broader the base of these stakeholders, the higher the public interest context compared to, for example, a company with a smaller, private group of shareholders. In terms of regulation 26(2) this is used as a quantitative, non-monetary indicator; i.e. the number of individuals that have a beneficial interest in the issued securities of the company.

7. The indicators of public interest used in Regulations 26(2) appear to be all quantitative indicators, which are combined into the determination of a company's PI Score in accordance with the formula set out in the regulation. Two of the indicators (employees and holders of securities) are non-monetary and two indicators (third-party liabilities and turnover) are monetary in nature.
8. The concept of "public interest" is a broad one and not inherently conducive to a common definition; rather what is meant by the term depends on its context. Although various combinations of quantitative and qualitative factors, both monetary and non-monetary, would have been possible for purposes of the Companies Regulations, the legislator decided at the time to implement the specific indicators as discussed above. Whether these are the most appropriate indicators and whether the formula concerned is the most appropriate manner in which relevant factors should be combined in order to determine a certain public interest threshold is not the purpose of this submission, although the paper does touch on other regulators' definitions of public interest. What is important is that the indicators should be clear to the calculators of the PI score of different companies and should be improved to leave no room for interpretation (See below discussion on the interpretation of the terms).
9. The monetary measures of the PI Score are subject to inflation and, currently the Companies Regulations do not provide a mechanism that takes this into account. If such monetary measures are not reassessed at appropriate intervals, this may adversely affect the initial intention of the PI Score in that the bar will over time be set too low, resulting in over regulation of entities that are of minimum interest to the public. This is exacerbated by the fact that the overall threshold has remained constant since 2011, yet entities' turnover is likely to multiplied factorially as compared to 2011
10. The results of the PI Score calculation are used, among other things, to determine whether an entity is required, in terms of the Companies Act, to undergo an audit or alternatively whether its financial statements should be subject to an independent review. Furthermore, companies which are required to be audited in terms of Companies Act or Companies Regulations, which include companies with a certain PI Score, are subject to enhanced accountability and transparency requirements in Chapter 3 of the Companies Act. With the inflationary effect on the monetary measures of the PI Score over a period, smaller companies / close corporations that are owner-managed or had a lower PI Score and therefore in the past could have their annual financial statements either independently reviewed or independently compiled could be moved into the bracket of having their annual financial statements audited, which unintentionally increases the regulatory burden on them. . It is purported that this was not the intention of the original legislator.

11. President Ramaphosa mentioned in his 2019 State of the Nation speech: "*We are urgently working on a set of priority reforms to improve the ease of doing business by consolidating and streamlining regulatory processes, automating permit and other applications, and reducing the cost of compliance. If we are to be internationally competitive, if we are to attract investment, we must address the high cost of doing business in South Africa, and complicated and lengthy regulatory processes. We must reach a point where no company should wait more than six months for a permit or licence and new companies should be able to be registered within a day."*

12. The concept of regulatory compliance and the costs thereof is one that affects smaller business.

C. Stakeholder engagement

13. SAICA was invited to present on the PI Score together with other stakeholders on 6 August 2019. Based on these discussions it was noted that the definitions should be clarified and that the method of calculating the PI Score must be simplified.

14. It was further proposed that the requirements for annual financial statements either being audited or independently reviewed for companies with a PI Score between 100 and 350 with financial statements either internally or independently compiled must be removed as this creates confusion. Annual financial statements should either be audited, independently reviewed or compiled. The issue of owner-managed companies was also raised as there are various companies that are owner-managed but due to their ownership structure do not meet the definition of owner-managed, such as trusts.

15. The combination of the four factors was also discussed and an option to rather use only two or three of the indicators was proposed.

16. The Companies Regulations' requirements that require:

    a. that independent reviews for companies with a PI Score between 100 and 350 must be performed by a registered auditor or chartered accountant; and

    b. that independent reviews for companies with a PI Score below 100 can be performed by all accountants that qualify to act as an accounting officers as stated in the Close Corporations Act (including registered auditors and chartered accountants)

    are also viewed as confusing and should be removed.

D. Issues presented

17. Over the last ten years various interpretational issues with regard to the calculation of the PI Score have been raised which necessitate the clarification of the definitions contained in the Act and Companies Regulations.
18. These definitions used to measure public interest are unclear with the general public also battling with the interpretation thereof. Should this be revisited, the information as set out needs to be taken into account.

- ## Employees

19. Regulation 26 states that an “employee” has the meaning set out in the Labour Relations Act 66 of 1995. In this Act, an employee is defined as:

    “(a) any person, excluding an independent contractor, who works for another person or for the State and who receives, or is entitled to receive, any remuneration; and

    (b) any other person who in any manner assists in carrying on or conducting the business of an employer,

    and ‘employed’ and ‘employment’ have meanings corresponding to that of ‘employee’.”

20. Further guidance in Section 200A of the Labour Relations Act 66 of 1995 include:

    “Until the contrary is proved, a person who works for, or renders services to, any other person is presumed, regardless of the form of the contract, to be an employee, if any one or more of the following factors are present:

    (a) the manner in which the person works is subject to the control or direction of another person;

    (b) the person’s hours of work are subject to the control or direction of another person;

    (c) in the case of a person who works for an organisation, the person forms part of that organisation;

    (d) the person has worked for that other person for an average of at least 40 hours per month over the last three months;

    e) the person is economically dependent on the other person for whom he or she works or renders services;

    (f) the person is provided with tools of trade or work equipment by the other person; or

    (g) the person only works for or renders services to one person.”

21. The question that is posed is how seasonal employees, temporary employees and part-time employees should be treated for purposes of the PI score calculation.

22. The Constitutional Court ruling in favour of the National Union of Metalworkers of SA (Numsa) states "that an employee who earns less than the stipulated threshold (R205,000 per annum and less) contracted through a labour broker to a client firm for more than three months becomes an employee of the firm, “employed on the same terms and conditions of similar employees, with the same employment benefits, the same prospect of internal growth and the same job security” also impacts the calculation.

23. The ruling further states that where a company / close corporation makes use of the services of a labour broker, the number of employees would need to be adjusted after the employees meets the three months deadline and only applicable to employees earning less than R205 000. The labour broker would therefore need to reduce its PI score where employees are contracted to a client for more than three months, otherwise this will result in the same employees being counted twice. When these employees are no longer employed by the client, the labour broker can include them in the labour broker’s calculation.

24. Farmers often raise this issue where part-time employees are required for seasonal work, resulting in an increase in their PI Score - above the 100 or 350 points. This leads to their farming operation registered as a company to have to follow the additional requirements as per the Act, including having a social and ethics committee and audited financial statements.

- ### Third party liabilities

25. "Third party liabilities" is not defined in the Act. The questions that are raised include whether subordinated loans, intercompany loans, provisions and credit provided are included in the definition.

26. SAICA provides the following guidance in the SAICA Guide to the Companies Act:

   - items should meet the definition of a "liability" and involve a "third party";
   - it is proposed that liabilities (including subordinated loans) relating to direct shareholders are seen to be with a directly related party of the company and should be excluded from the PI Score calculation;
   - loans from directors should be excluded from the PI Score calculation;
   - provisions recognised in terms of the prescribed Financial Reporting Standard ("FRS") should be included only if reasonably deemed to be payable and the third party can be clearly identified (for example, deferred tax would be excluded);
   - when calculating the PI Score, the company should be considered and not the group, and therefore loans from other companies within a group should be included in the calculation of the PI Score. For example, intercompany creditors should be included in the calculation.

27. Changes to the International Financial Reporting Standards, IFRS 16 on leases also impact third party liabilities. These changes require companies leasing assets to include both the asset and liability of the lease in the annual financial statements. This is just an example of how financial reporting standards changes affect a company's PI Score.

- ### Beneficial interest in the company's securities

28. For the purposes of the PI Score calculation, "beneficial interest" is defined as follows:

"*when used in relation to a company's securities, means the right or entitlement of a person, through ownership, agreement, relationship or otherwise, alone or together with another person to –*

(a) receive or participate in any distribution in respect of the company's securities;

(b) exercise or cause to be exercised, in the ordinary course, any or all of the rights attaching to the company's securities; or

(c) dispose or direct the disposition of the company's securities, or any part of a distribution in respect of the securities,

but does not include any interest held by a person in a unit trust or collective investment scheme in terms of the Collective Investment Schemes Act, 2002 (Act 45 of 2002)."

29. A person is also regarded as having a beneficial interest in a security if the security is held *nomine officii* by another person on the first person's behalf.

30. Regulation 26 of the Act requires one PI point to be allocated for each individual known to the company that has a direct or indirect beneficial interest. The reference to "indirect beneficial interest" could imply that a subsidiary of a holding company is required to include the individuals with a beneficial interest in the holding company in its PI Score, as these individuals could be seen as having an indirect interest through their shareholding in the subsidiary.

31. SAICA is of the view that shareholders of a holding company do not have the right or entitlement to distributions of the subsidiary. Neither do they have the right to dispose of securities of the subsidiary directly or to direct the voting/ in respect of these securities. In other words, they are unable to control or influence the cash flow activities of the subsidiary and would not be considered as control in accordance with International Financial Reporting Standard (IFRS) 10. Therefore, SAICA is thus of the view that they should not be regarded as having a beneficial interest. The holding company's shareholders should therefore be excluded from the calculation of the PI Score of the subsidiary, unless an agreement or similar instrument is in place that "creates" beneficial ownership in respect of the subsidiaries' shares.

32. With regard to calculating the beneficial interest in a company whose securities are held by a trust, the CIPC's non-binding opinion, dated 30 June 2011, expresses the view that individual beneficiaries of the trust should be counted as the individual beneficial interest holders. (This may depend, however, on the specific provisions of the relevant trust deed.)

Turnover

33. Turnover is not defined for purposes of Regulations 28 of the Act. Turnover" is however defined in Regulation 164(4) of the Act as follows:

"*At any particular time, the annual turnover of –*

> *(a) a company other than a holding company is the gross revenue of that company from income in, into or from the Republic, arising from the following transactions or events, as recorded on the company's most recent annual financial statements:*
> *(i) the sale of goods;*
> *(ii) the rendering of services; or*
> *(iii) the use by other persons of the company's assets yielding interest, royalties, or dividends; or...*"

34. Further Regulation 164(1) of the Act states:

"*For purposes of section 175 of the Act, the assets and turnover of a company at any particular time must be calculated in accordance with –*

> *(a) the financial reporting standards applicable to that company, as set out in regulation 27; or*
>
> *(b) SA GAAP, as defined in regulation 26(1)(f), in the case of a company in respect of which no financial reporting standards have been prescribed.*"

35. While Regulation 164(4) of the Act defines the term “turnover”, it states that this definition is only provided for the purpose of the calculation of administrative fines and is not extended for the use of calculating the PI Score.

36. The definition provided, however, is the same as the previous definition provided for “revenue” in the prescribed FRS, whereas “turnover” is not defined in the FRS. As general practice, turnover is determined as the revenue generated from the primary activities of a company. It would, however, be more conservative to include all revenue generated by a company for the calculation of the PI Score, as this definition is more in line with the guidance provided in Regulation 164 of the Act. CIPC released Practice note 1 of 2016, which states that entities should declare the correct turnover on the annual return.

37. According to a presentation previously presented by a CIPC representative (Mr C. Zwane, minuted in the Companies Liaison Committee meeting of 12 May 2016) the Revenue amount in the annual financial statements (AFS) submitted to the CIPC should be the same as the turnover amount when filing the Annual Return. SAICA raised the issue that if you were to file the 2015 annual return, you will include your 2015 turnover but your 2014 year’s AFS would be submitted as the current year’s (2015) AFS would not yet have been completed when the annual return is due. Therefore, the revenue on the AFS and the turnover amount on the annual return will never be the same. With the change in IFRS there is also confusion on whether the legislation intend for companies to submit their revenue as per IFRS or IFRS for SMEs or turnover as defined for the purposes of Regulation 175 of the Act.

38. This leads to further interpretational issues, as there has been a change in IFRS 15 which now defines revenue as “*Income arising in the course of an entity’s ordinary activities”*. IFRS 15 however provides in its scope section that its recognition and measurement criteria do not apply to financial instruments and other contractual rights or obligations within the scope of IFRS 9 *Financial Instruments*, IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements*, IAS 27 *Separate Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures* which will be the likely source of any income that comes in the form of dividends. IFRS 15 also stipulates that ‘revenue’ only be recognised upon the satisfaction of ‘performance obligations, which, in certain service related industries would differ from traditional turnover as reported

39. Guidance provided in IFRS 9 addresses the same application requirements included in other standards which is that dividends are recognised in profit or loss only when the entity’s right to receive payment of the dividend is established; it is probable that the economic benefits associated with the dividend will flow to the entity; and the amount of the dividend can be measured reliably.

40. In the case where a holding company whose business is to hold investments, the earning of dividends and/ or capital appreciation would form part of the ordinary activities of the entity and therefore, in spite of the recognition and measurement of the income being dealt with in other standards, it would meet the definition of revenue in the books of the holding company.

41. Therefore there is no clarity on whether turnover should be turnover as defined in Regulation 164 of the Act or as per revenue defined in IFRS.

42. In the case of non-profit companies the question arises as to whether donations received by a non-profit company would be viewed as turnover.

Timing of the calculation of the PI Score

43. Regulation 26 of the Act requires every company to calculate its PI Score at the end of each financial year. This could, however, cause a practical problem for the audit or review process applicable to the company. If it is discovered that a company is required to be audited in terms of its PI Score calculation at the end of the financial year without any preparation in this regard, certain procedures, such as a stock count that should have been conducted on the last day of the financial year, would not have been performed.

44. Management should therefore consider calculating an indicative PI Score, based on the forecasted financial results of the company, to ensure that a likely result of the calculation is appropriately planned for.

45. The PI Score calculated before audit adjustments may change substantially after the audit adjustments are made. This can have a material impact on whether an audit or independent review is required and what IFRS should be applied.

46. In terms of the Act, the PI Score, which determines the audit/independent review requirements, should reflect the results of a company after the audit adjustments are processed and, therefore, could impact on the requirement to be independently reviewed or audited.

47. Again, management should consider when a company is close to a relevant threshold (that is 100 or 350) whether to implement a conservative approach (based on the assumption that the company will exceed the threshold) .

Significance of the 100/350 threshold

48. It bears emphasising that the audit threshold is when a PI Score is above 100. Only if the financial statements are “independently compiled and reported” does the audit threshold increase to 350.

49. In order to be “independently compiled and reported”, the financial statements must be prepared by an independent accounting professional (IAP) as defined in Regulation 26 of the Act. The definition of “independent accounting professional”, in SAICA’s view, excludes all people who are employed by the company or the group. Therefore, the higher threshold of 350 will only apply if the company’s financial statements are prepared by someone who is truly independent of (external to) the company.

Fiduciary capacity

50. In addition to the issues already mentioned there is also confusion with regards to the interpretation of Regulation 28(2)(a) of the Act which states that any company that falls within the following category must have their annual financial statements audited:

    “Any profit or non-profit company if, in the ordinary course of its primary activities it holds assets in a fiduciary capacity for persons who are not related to the company, and the aggregate value of such assets held at any time during the financial year exceeds R5 million. “

51. The CIPC released a non-binding opinion in 2013 which was withdrawn in 2020 on the interpretation of “fiduciary capacity”

52. The issue that arose was whether legal practitioners practicing in personal liability companies have to have their annual financial statements audited if they have a trust account of more than R5 million at any given time. The contentious element is whether such assets are held 'in the ordinary course of the legal practitioners firm's primary activities'. The two opposing views are:

    a. The operation of the trust account, per se, is not in the ordinary course of the legal practitioner's primary activities; or

    b. The operation of the trust account, being a legal requirement, is part of the business activities of the legal practitioner's firm and cannot be regarded as merely incidental.

53. This interpretation of whether a legal practitioner practicing in a personal liability company holds assets in a fiduciary capacity also impacts the use of the prescribed financial reporting standards.

54. The CIPC in June 2021 submitted a view to SAICA "*that a legal practitioner's business hold assets in a fiduciary capacity for a broad group of outsiders and cannot apply the IFRS for SME framework. In 2019, CIPC withdrew the legal opinion where it rebutted the fact that the Legal practitioners in holding assets in a fiduciary capacity for a broad group of outsiders is incidental to the legal practitioners business and that their primary business is to provide legal services.*

55. *Therefore, the legal practitioners hold assets in a fiduciary capacity for a broad group of outsiders as one of its primary business and hence cannot use the IFRS for SME as its financial Reporting Framework. Companies Regulations 27 (3) is clear in that entities can utilize either IFRS or IFRS for SME, provided the entity meets the scoping requirements outlined in the IFRS for SME. In this case there is no issue in interpretation of Companies Act versus interpretation of IFRS for SME's."*

56. The prohibition of the use of IFRS for SMEs as the financial reporting standard and the audit of the annual financial statements of these personal liability companies increases the difficulty and the cost of compliance.

E. Impact / use of PI Score

57. The results of the PI Score calculation are used, among other things, to determine whether an entity is required, in terms of the Companies Act to undergo an audit or alternatively whether its financial statements should be subject to an independent review. Furthermore, companies which are required to be ***audited in terms of Companies Act or Companies Regulations,*** which include

    - companies with a certain PI Score,
    - companies keeping assets in a fiduciary capacity of more than R5m

    are subject to the following:

    - Section 10(2)d) which states that following provisions, Parts B and D of Chapter 3, does not apply to NPCs unless the obligation arises in terms of a requirement in the company's **Memorandum of Incorporation** (**MOI)** as contemplated in section 34(2) or the regulations as contemplated in 30(7) (*the categories of any profit or non-profit* *companies that are required to have their respective annual financial statements audited, as contemplated in subsection (2) (b) (i));*

- Section 30(2A)(a) which states that the audit exemption does not apply to a company if it falls into a class if company that is required to have its annual financial statements audited in terms of the regulations contemplated in subsection (7)(a);
- Section 30(4) which states that the AFS of each company that is required to be audited in terms of this Act must disclose certain director's remuneration requirements;
- Section 30(7)(a) which states that the Minister may make regulations including different requirements for different categories of companies prescribing the categories of any profit or non-profit companies that are required to have their respective annual financial statements audited, as contemplated in subsection (2)(b)(i);
- Section 33(1) which states that a copy of its annual financial statement must submitted to CIPC with the annual return, if it is required to have such statements audited in terms of section 30(2) or the regulations contemplated in section 30 (7);
- Regulation 30 which states that a company that is required by the Act or regulation 28 to have its annual financial statements audited must file a copy of the latest approved audited financial statements on the date that it files its annual return;
- Section 34(2) which states that a private company, personal liability company or non-profit company is not required to comply with the extended accountability requirements set out in Chapter 3, except to the extent contemplated in section 84(1)(c), or as required by the company's **MOI;**
- Section 56 (7) which states that a company that falls within the meaning of **"regulated company"** as set out in section 117(1)(i) must-

  (a) establish and maintain a register of the disclosures made in terms of this section; and

  (b) publish in its annual financial statements, if it is required to have such statements audited in terms of section 30(2), a list of the persons who hold beneficial interests equal to or in excess of 5 percent of the total number of securities of that class issued by the company, together with the extent of those beneficial interests;
- Section 84 which states that Chapter 3 would apply to companies that is required by this Act or the regulations to have its AFS audited or otherwise only to the extent that the MOI so requires.

  (c) a private company, a personal liability company or a non-profit company-

    (i) if the company is required by this Act or the regulations to have its annual financial statements audited every year: Provided that the provisions of Parts B and D of this Chapter will not apply to any such company; or

    (ii) otherwise, only to the extent that the company's Memorandum of Incorporation so requires, as contemplated in section 34(2);

- Section 90(1A) which state that a company referred to in section 84(1)(c)(i), or a company that is required only in terms of its MOI to have its annual financial statements audited as contemplated in section 34(2) and 84(1)(c)(ii), must appoint an auditor-
  - (a) in accordance with subsection (1), if the requirement to have its annual financial statements audited applies to that company when it is incorporated; or
  - (b) at the annual general meeting at which the requirement first applies to the company, and each annual general meeting thereafter; and
- Section 58 "(2A) Section 30(2)(b), and (3) to (6) of the Companies Act, read with the changes required by the context, apply to a corporation that is required by the **regulations made in terms of section 30(7)** of the Companies Act, to have its annual financial statements audited."

58. With the inflationary effect on the monetary measures of the PI Score over a period of time, smaller companies / close corporations that are owner-managed or had a lower PI Score and therefore in the past could have their annual financial statements either independently reviewed or independently compiled could be moved into the bracket of having their annual financial statements audited, which unintentionally increases the regulatory burden on them.

59. In terms of Regulation 27 other the Act the requirement to use the financial reporting framework is also linked to the PI Score:

Category of Companies	**Financial Reporting Standard**
Profit companies, other than state-owned or public companies, whose public interest score for the particular financial year is at least 350.	One of— (a) IFRS; or (b) IFRS for SMEs, provided that the company meets the scoping requirements outlined in the IFRS for SMEs.
Profit companies, other than state-owned or public companies– (a) whose public interest score for the particular financial year is at least 100 but less than 350; or (b) whose public interest score for the particular financial year is less than 100, and whose statements are independently compiled.	One of— (a) IFRS; or (b) IFRS for SMEs, provided that the company meets the scoping requirements outlined in the IFRS for SMEs; or (c) SA GAAP (withdrawn).
Profit companies, other than state-owned or public companies, whose public interest score for the particular financial year is less than 100, and whose statements are internally compiled.	The Financial Reporting Standard as determined by the company for as long as no Financial Reporting Standard is prescribed.
Non-profit companies, other than those contemplated in Regulation 28(1)(b), whose public interest score for the particular financial year is at least 350.	One of— (a) IFRS; or (b) IFRS for SMEs, provided that the company meets the scoping requirements outlined in the IFRS for SMEs.

Non-profit companies, other than those contemplated in the first row above— (a) whose public interest score for the particular financial year is at least 100, but less than 350; or (b) whose public interest score for the particular financial year is at less than 100, and whose financial statements are independently compiled.	One of— (a) IFRS; or (b) IFRS for SMEs, provided that the company meets the scoping requirements outlined in the IFRS for SMEs; or (c) SA GAAP (withdrawn)
Non-profit companies, other than those contemplated in the first row above, whose public interest score for the particular financial year is less than 100, and whose financial statements are internally compiled.	The Financial Reporting Standard as determined by the company for as long as no Financial Reporting Standard is prescribed.

F. Voluntary audits

60. The Companies Act states in section 30(2)(b)(ii) of the Act that companies' annual financial statements, if they do not meet the requirements to be audited, can be voluntarily audited as set out in the MOI, by shareholders resolution or board decision or the annual financial statements should be independently reviewed, unless exempted.

61. The CIPC released a communication named: Voluntary Audits Mandate[1] that states:

    "*Pursuant to the afore-stated provisions, it is clear that since The Companies Act requires that a company be voluntary audited, should its Memorandum of Incorporation, a shareholders resolution, or the board of directors so determines same, this is then a requirement in terms of the Act. Hence, moving on to subsection 4, it is stated that if the Act requires this, then the audit must include the disclosure of remuneration, and other amounts (specified above) in respect of each director.*

    All requirements relevant to a mandatory audit will then also include a "voluntary audit" as per the afore-stated provisions. The criteria must remain the same for both types of audit.

62. The CIPC therefore requires that all requirements applicable to a mandatory audit, will also apply to companies which choose to have a voluntary audit. Therefore, companies that choose an audit, even though voluntarily, need to also comply with the requirements of the Act, including the following:

    - Disclosure of directors' remuneration;
    - Submitting audited annual financial statements to the CIPC;
    - Submitting of these annual financial statements using iXBRL; and
    - other requirements applicable to companies that have to have their annual financial statements audited in terms of the Act.

63. In our view this creates an additional burden for small to medium sized companies who are required or chose to have their annual financial statements audited for other reasons.

[1] Information notice: Voluntary audits dated 8 August 2018

64. Literature research performed by Elsabé Kilian also shows the following:
    64.1 "The need for audits came about as a result of the increased separation between ownership and control and grew into the complex world of auditing we know today. Audit is seen as a "public good" in companies as it provides an external check on the financial statements. Auditors provide an external verification on the financial statements of a company thereby giving assurance to external parties that the financial statements are fairly presented. Studies have found that in instances where the financial statements underwent an audit, management of the company is automatically perceived as being more honest by lenders which then results in reduced interest rates on loans.
    64.2 There is a range of factors why companies choose to undergo an audit, even when exempt according to law. The likelihood that the company will choose to undergo an audit increases with the size of the company, the level of debt, complexity of the company, loss of control, number of risks, intention to raise capital and longer chains of command.
    64.3 There are many arguments against mandatory audits in private companies and these researchers find common ground that the very small company, where the owners have access to the information within the company on a more regular basis, does not have the same need for an auditor as the bigger more complex entities with increased agency costs.
    64.4 Regulators across the world have also come to the conclusion that in many instances the costs associated with an audit are too burdensome for the small company. Especially in companies where there are a limited number of shareholders who can easily obtain access to the financial records of the entity. The basis for audit exemption in the EU was as a result of support which the EU wanted to provide to the growing number of Small to Medium Sized Enterprises. In 2010 the EU had 23 million SMEs which makes up approximately 99% of all businesses in the EU and provide more than 100 million jobs. The EU fourth directive sets out the requirements to meet the definition of a small company (the same definition used for audit exemption) and once this definition is met the company qualifies for a range of exemptions including an exemption to prepare a full set of financial statements and exemption from filing a full set of financial statements.
    64.5 Audit is only one of the many costs which these countries have tried to limit for their small companies. Studies have shown that the compliance costs needed in businesses carry a much higher weight as a percentage of all costs in these small companies compared to larger companies. It is for this reason that countries reduce the burden on SMEs to encourage growth in these companies."

G. South African legislation

65. Research done by Elsabe Killian states that, in South African legislation, there are currently five different definitions for a small and medium company.

Table 4: Definitions classifying companies as "small"

	Previous National Small Enterprise Act[2]	National Small Enterprise Act	Income Tax Act 58 of 1962	Broad-Based Economic Empowerment Act 53 of 2003	Regulations to the Companies Act 127(2)(b)	Stats SA
Turnover	>R0.2m - <R32m	>R5 m - <R75m	<R20 m	>R10m and < R50m	-	>R13.5m - <R69m
Employees	>5 and <50	0 and <50	-	-	-	-
Total assets	>R0.1m - <R6m	N/A	-	-	-	-
Third party liabilities	-	-	-	-	-	-
PI Score	5.3 to 87	1 to 130	1-20	10 to 50	<100[3]	14 to 69

Table 5: Definitions classifying companies as "medium"

	Previous NSBA definition	NSBA	Regulations to the Companies Act 127(2)(b)	Stats SA
Turnover	>R5m - <R64m	<R35m - <R220m	-	>R81m - >R432m
Employees	>100 - <200	>51 to <250	-	-
Total assets	>R3m - <R23m	-	-	-
Third party liabilities	-	-	-	-
PI Score	108 to 287	86 to 470	100 to 500[4]	81 to 432

66. The National Small Enterprise Act thresholds for defining enterprise size classes by sector uses two proxies. The third proxy of "Total gross asset value" was removed as it was difficult to calculate and define.

67. Stats SA further utilises the National Small Enterprise Act thresholds in calculating inflation and only make us of one category of turnover.

[2] National Small Enterprises Act 102 of 1996 (NSME)

[3]Regulation 127(2) defines a **small company- "**(iii) **"small companies"** being any company, other than a state owned or public company, whose most recent public interest score, as calculated in terms of regulation 26 (2), is less than 100; and"

[4] Regulation 128 defines a **medium companies"** being— (aa) any public company whose most recent public interest score, as calculated in terms of regulation 26 (2), is less than 500; or (bb) any other company, other than a state owned company, whose most recent public interest score, as calculated in terms of regulation 26 (2), is at least 100 but less than 500"

68. The Competition Act 89 of 1998 implemented the National Small /Enterprise Act thresholds for the definition of a small and medium business for the use of the Competition Act from 6 July 2019.

69. Some South African laws make use of one or two of the categories to determine whether a company is classified as small or medium. The Companies Act uses four categories.

70. The fact that the Companies Act make use of four categories compared to other legislation, which only uses two categories, probably indicates that the Companies Act score is too low in comparison with the other legislation only using two categories.

71. Therefore in terms of the National Small Business Act a medium-sized company's PI Score would be between 86 to 470 using two indicators. The Companies Act uses four categories to classify a company as medium with a PI Score between 100 to 500.

72. This supports the argument that the PI Score should be increased. When using two categories the legislation seemingly comes to the conclusion that a medium-sized company's score is between 87 to 470.

H. SAICA research

73. SAICA conducted research through a survey to members during July 2019 via its committee structures, social media platforms and general communications platforms and also received varied comments.

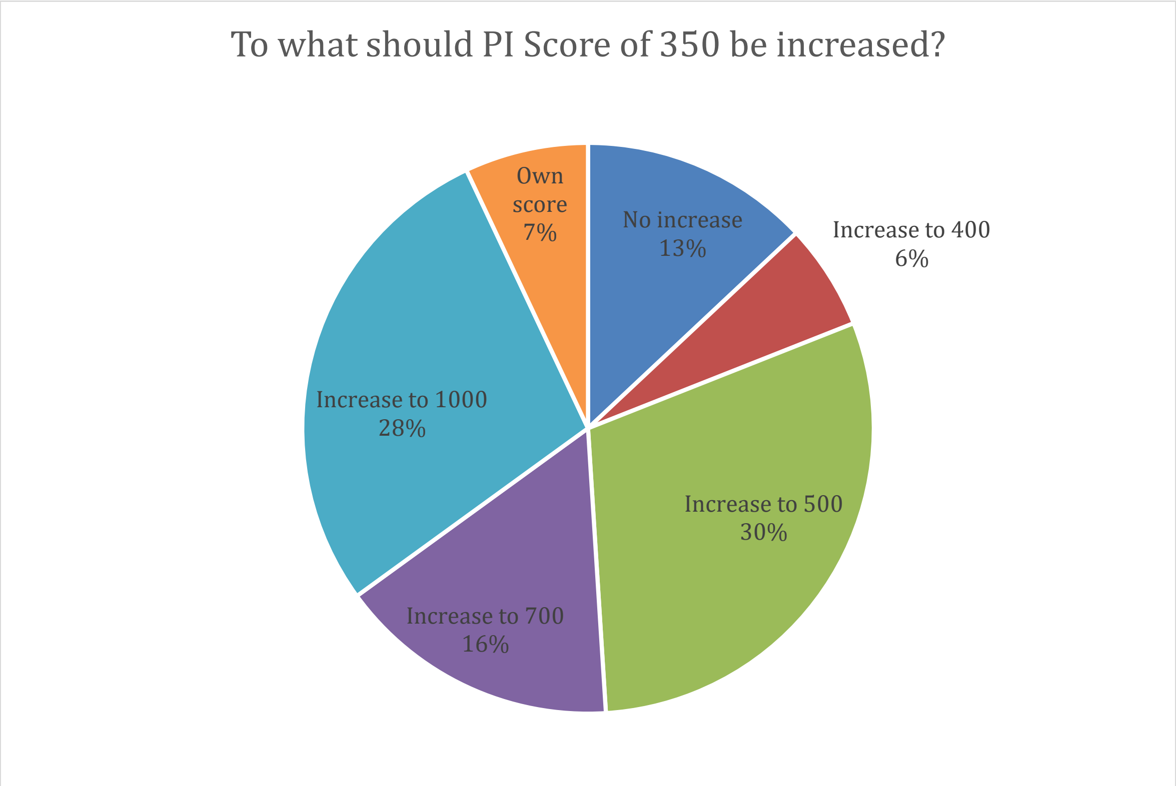
74. 371 comments were received. Thirty-five respondents were commenting on behalf of members in public practice. 94% of the respondents were SAICA members and 58% are registered with the Independent Regulatory Board for Auditors (IRBA). The demographics of the 79% of respondents who were classified as members in public practice were as follows:

- Sole Proprietor – 23%
- Small firm – 40%
- Medium firm -16%
- Large firm - 21 %

75. 21% of the respondents were not in public practice and were classified as:

- External users -13%
- Members of boards of directors - 17%
- Regulators -2%
- Academia - 4%
- Preparers - 41%
- Members of audit committee - 5%
- Profession accountancy organisation - 11%
- Other 7%

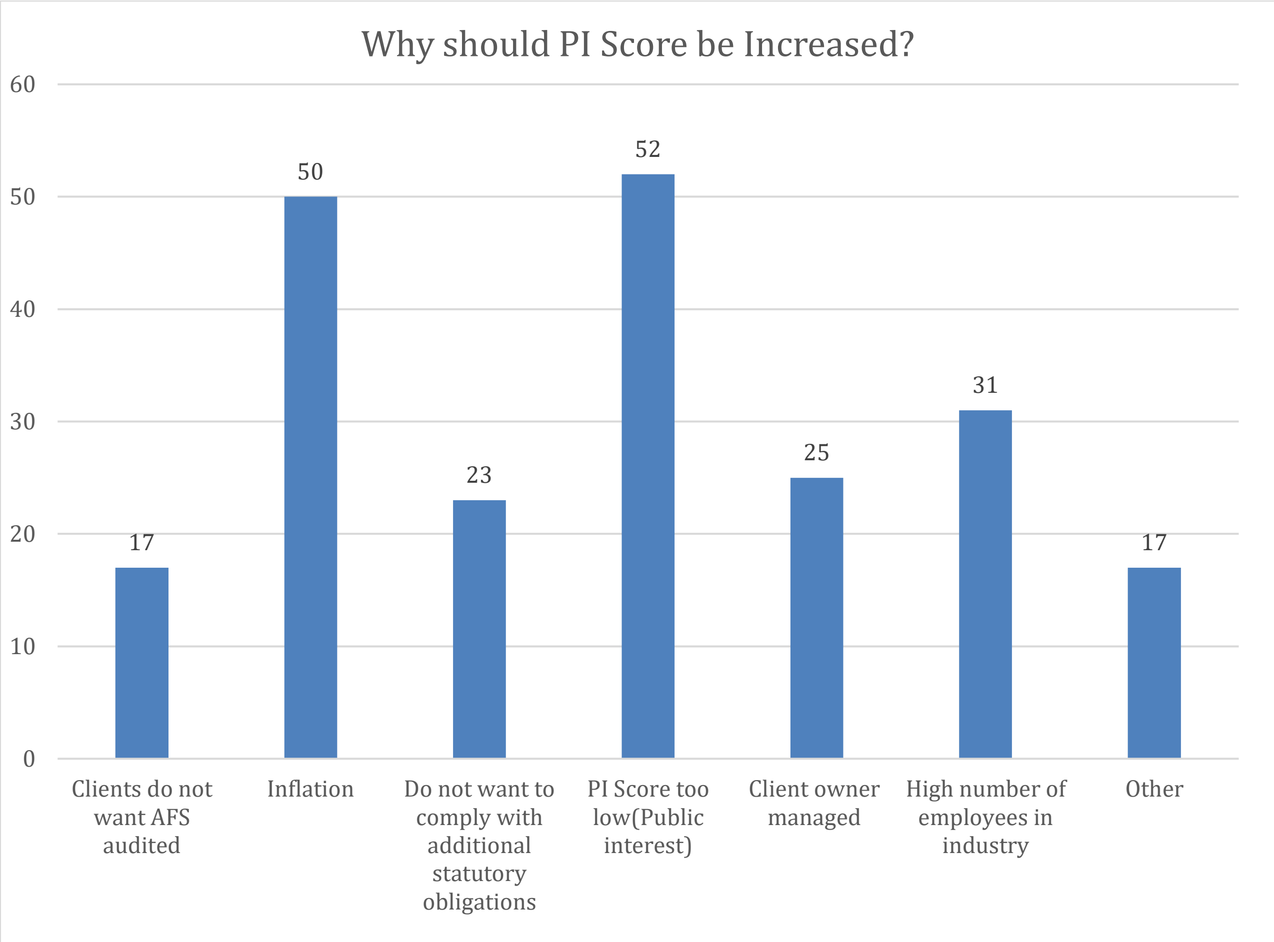
Figure 2: Questions asked of the respondents.



76. Members were asked whether the PI Score should be increased and if they were supportive of the increase, various options were provided.

77. General comments included that certain respondents felt that the current method of calculation does not protect the public interest, for example where exporters of foodstuffs with a yearly turnover of R500M, with only 5 staff members, 1 shareholder and no debt; the turnover does not indicate public interest, and thus suggest that the PI Score to be reviewed.

Figure 3: Responses to why the PI Score should be increased



78. Various reasons were provided for requesting an increase in the PI Score which for example included seasonal workers in industries such as farming, construction, security and certain industries can result in a high PI Score due to the number of employees and the nature of certain businesses such as petrol stations, importing companies, wholesalers, labour brokers, supermarkets and Fast Moving Consumer Goods companies. In many of these cases the company is owner managed but due to the nature of the business there is a large number of employees.

79. Industries identified with high employee numbers:

- Medical
- Farming
- Construction
- Security
- Cleaning
- Property developer
- Estate agent

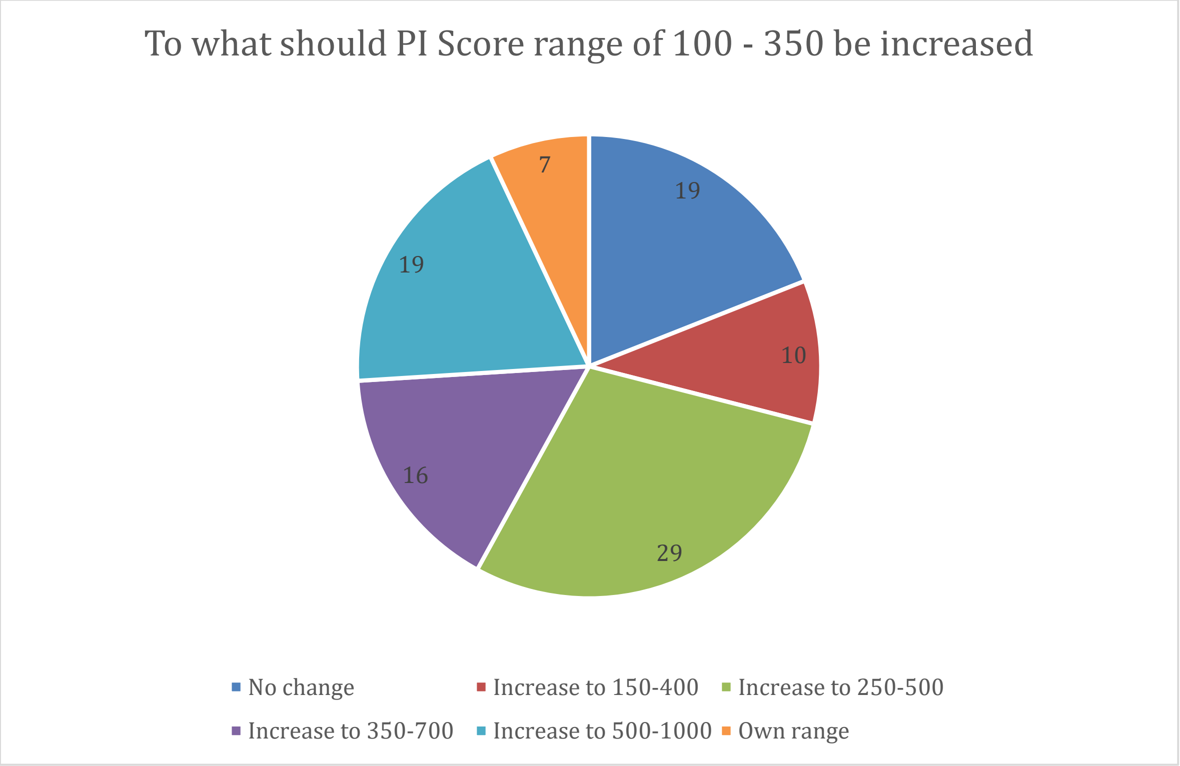
- Manufacturing
- Petrol
- Textile
- Forestry

80. The respondents who answered on behalf of companies further stated that their companies would not want to be audited if they can prevent it due to them being:
    a. owner managed,
    b. the cost implication,
    c. no value added by an audit, and
    d. users do not understand different levels of assurance.

81. In some cases clients would like to have the annual financial statements audited voluntarily for the following reasons but would not want to have the additional compliance requirements:

- Clients prefer the assurance
- Good governance
- Audits required by other stakeholders, e.g banks
- Peace of mind

Figure 4: Suggestion to what PI Score range of 100 to 350 should be increased to



82. Comments further included that members felt that entities owned for example by family trusts should be able to be owner managed. Respondents also requested that all companies within this range be treated the same and that the requirements for internally compiled versus independently compiled should be removed. Respondents also suggested that the points system to be changed e.g. 1 point for R2m turnover or 1 point for R10m third party liabilities.

83. Respondents were also asked on suggestions on how the PI Score should be increased in future.

84. Comments / suggestions included:

- Annual review
- Link to Gross Domestic Product (GDP)
- Inflation
- Review every 5 years
- Linked to Consumer Price Index (CPI)
- Allow formulae to be weighted, as to why would turnover receive the same weighting as 3rd party liabilities
- Annual increase of 5%
- Data from annual returns should be used
- Industry trends
- 50 points every year
- Annual increase with budget speech
- Increase every three years, with inflation every year,

85. Some respondents requested that employees should be removed, especially temporary employees, from the calculation of the PI Score.

I. Reasons for voluntary audit of financial statements

86. In South Africa, companies / close corporations require audits of their annual financial statements for various other reasons including:

- Banks / other credit providers require assurance when providing loans / credit;
- Minority shareholder might require additional assurance; or
- MOI requirement.

87. Respondents indicated that companies / close corporations believe that the decision to have their annual financial statements voluntarily audited should not require them to apply other sections in the Companies Act due to them choosing additional governance or assurance. For example section 15(2)(a)(iii) of the Act states that the company's MOI may impose a higher standard or more onerous requirement on the company that otherwise would not apply to the company.

J. SAICA's proposal

88. Based on our research SAICA would like to propose the following:

- an increase in the PI Score as soon as possible,
- that within the current legal framework the PI Score of 100 is increased to 350 and the PI Score of 350 increased to 700, and
- following the changes to the PI Score that the requirements of when companies require a social and ethics committee in terms of Companies Regulation 43 and the application of the PI Score business rescue as set out in Regulation 127 should similarly be updated.

89. Further to the above, SAICA would like to propose the following in addition to the increase in PI Score:

- Definitions and clarification of the indicators to calculate the PI Score.
- Financial statements to be prepared internally or independently with no further consequence, thereby removing the current requirement that annual financial statements to be audited if the annual financial statements were internally compiled and when the PI Score is between 100 and 349 (current PI Score).
- The PI Score going forward should no longer require all four indicators but the DTIC should investigate a combination of any three of the four indicators. This will assist company owners with a high number of seasonal workers, to exclude the number of employees in the calculation of PI Score.
- Companies with PI Score above 700 must have their annual financial statements audited.
- Companies with a PI Score below 700 must have their annual financial statements independently reviewed unless they are owner-managed, in which case their annual financial statements need only be compiled.
- Independent reviews to be performed by all persons who are qualified to act as accounting officers in terms of the Close Corporations Act.
- Clarification that where companies decide to have their annual financial statements audited in terms of their MOI, shareholder's resolution or board decision that this is voluntary and that the sections of the Companies Act applicable to companies audited in terms of their PI Score (mandatory) does not apply.
- Refine the owner-managed definition to assist smaller companies being owned by structures such as a trust.

Annexure 1: International research

1. Audit exemption in other countries (extract from research by Elsabé Kilian[5])

Audit exemption in other countries

2. In the early 1990s audit exemption was implemented in the European Union. The European Union suggests the use revenue, total assets and employees as qualifiers for audit exemption in the European Union Fourth Company Law Directive (78/660/EEC). A private company is exempted from audit if it meets two of the three qualifiers. The European Union revised their audit exemption threshold on several occasions since the initial implementation. The table below summarises the increases in audit exemption thresholds over the years in the European Union.

Table 1: Summary of increases in audit exemption threshold from 1994 to 2016 in EU

	1994	1999	2003	2008	2016
Net turnover	≤€4m	≤€5m	≤€7.3m	≤€8.8m	≤€12m
Balance sheet total	≤€2m	≤€2.5m	≤€3.65m	≤€4.4m	≤€6m
Average employees	≤50	≤50	≤50	≤50	≤50
Companies are classified as small if on their balance sheet date for two consecutive years, they do not exceed the limits of at least two of the three above criteria.					

3. Out of the 28 member states of the European Union, only three have adopted the maximum audit exemption thresholds and all other member states have lower thresholds which result in more audits. The European Union argued that the members who opted for lower thresholds continue to see the value of statutory audits and the public interest function it serves.

4. Australia also makes use of audit exemption as set out in the Corporations Act No. 50 of 2001. Small companies in Australia are subject to reduced reporting requirements and are exempt from audit if they fall below two of the three thresholds. The government of Australia recently updated the thresholds to audit exemption by doubling.

Table 2: Australian government increase of thresholds for audit exemption

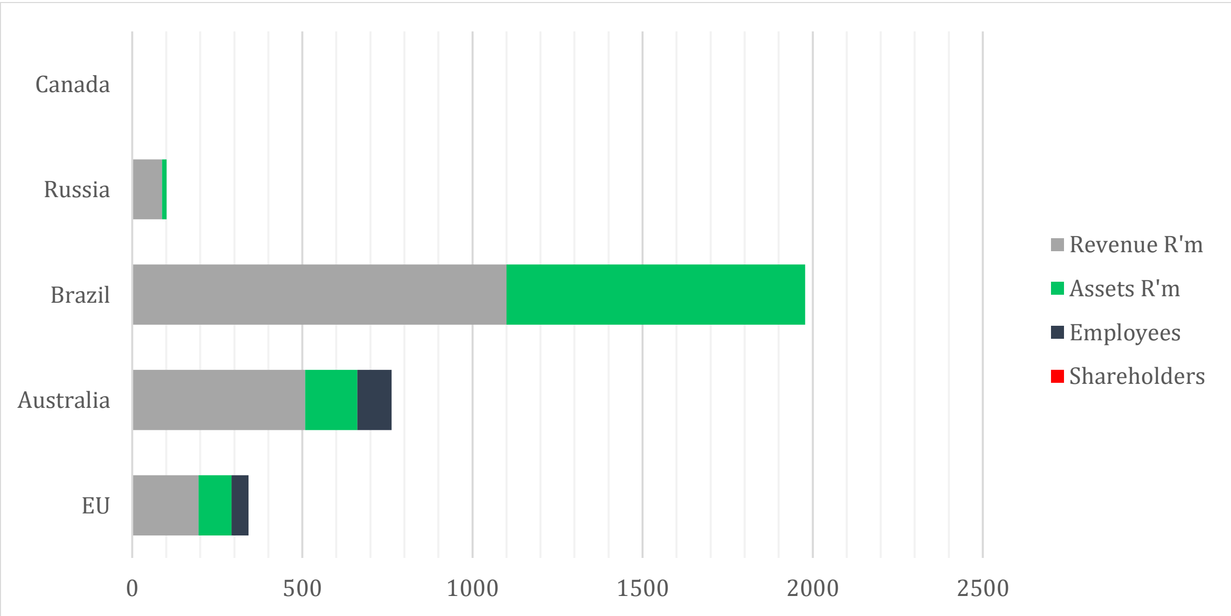
	Financial years ending on or before 30 June 2019	Financial years beginning on or after 1 July 2019

[5] Elsabé Kilian, North West University Masters student, 2019

Revenue	≤$25m	≤$50m
Gross assets	≤$12.5m	≤$25m
Employees at the end of the year	≤50	≤100

5. Brazil and Russia make use of revenue and total assets as their qualifiers for audit exemption. A company is considered large and is required to undergo an audit if the company has a threshold higher than either of the two qualifiers. Federally incorporated companies in Canada can make use of audit exemption if all their shareholders unanimously vote to forego an audit; in effect, this results in a "Public Interest Score" of one. There are private companies in the United States of America significantly bigger than their listed counterparts who are legally not required to undergo an audit. Studies have found that many of these companies voluntarily choose an audit as audited financial statements result in lower interest rates by financiers due to more reliance placed on the correctness of the financial statements. If a private company has more than $10 million in assets and more than 2000 shareholders, then only are private companies required to disclose their financial statements publicly. The chart below sets out the various thresholds in Rand value for the different countries.

Figure 1: Audit thresholds in Rand value



6. In order to better compare the Rand values for each countries threshold above to the South African Public Interest score, a "Score" was calculated for each country depending on which combinations would trigger an audit. For Australia and the EU combinations were identified between Revenue, Employees and Assets. However, for Brazil and

Russia only one of the qualifiers have to be met in order to be classified as large and undergo an audit.

Table 3: Score calculated for countries relating to South African PI Score

Country	"Public Interest score"
Brazil (Revenue)	1100
Brazil (Assets)	878
Australia (Revenue and Assets)	662
Australia (Revenue and Employees)	608
South Africa (Revenue, Employees, Shareholders and Third party liabilities)	350
EU (Revenue and Assets)	292
EU (Revenue and Employees) and Australia (Employees and Assets)	254
EU (Employees and Assets)	147
South Africa (Internal AFS) (Revenue, Employees, Shareholders and Third party liabilities)	100
Russia (Revenue)	88
Russia (Assets)	13
Canada	1

7. The South African "Public Interest Score" is not completely comparable with other countries since other countries do not include Third party liabilities and Shareholders into their calculation and we do not include assets into our calculations, however it still gives an idea of where on the scale we find ourselves.
8. Internationally there has been changes to the legislation of companies requiring an audit of their annual financial statements.
9. In Europe the 2013 Accounting Directive required that a small undertaking would be for two consecutive years not exceeding the limits of at least two of the three criteria:
    - Balance sheet total: €4 000 000
    - Net turnover: €8 000 000
    - Average number of employees during the financial year: 50
10. Member states are permitted to increase their thresholds to a level not exceeding:
    - Balance sheet total: €6 000 000
    - Net turnover: €12 000 000

11. Accountancy Europe published survey results in April 2020[6]: Audit exemption thresholds in Europe, 2020 Update which included the following conclusions that various countries amended the thresholds during 2019:

- Cyprus requires all companies to be audited
- Estonia decreased number of employees from 60 to 50
- Italy lowered all three thresholds
- Romania lowered balance sheet total from €3 650 000 to €3 500 000 and turnover from €7 300 000 to €7 000 000
- Turkey lowered balance sheet total from €6 250 000 to €5 500 000 and turnover from €12 500 000 to €11 000 000 and employees from 200 to 175
- Denmark increased balance sheet total from €4 837 000 to EUR6 000 000 and turnover from €9 674 000 to €12 000 000
- France has increased the balance sheet thresholds to €1 000 000 and €1 550 000 to €4 000 000 and turnover from €2 000 000 and €3 100 000 to €8 000 000
- Ireland increased balance sheet total from €4 400 000 to EUR6 000 000 and turnover from €8 800 000 to €12 000 000

12. Smaller entities are allowed to have their annual financial statements audited and the survey refers to the diverse needs of SMMEs such as:

- Assurance on the reliability of financial information reported
- Getting more confidence on going concern
- Ensuring appropriate disclosures
- Assurance on risk coverage

13. SAICA wishes to also refer to the recent publication by the Department for Business, Energy & Industrial Strategy in the United Kingdom, *Restoring trust in audit and corporate governance*[7] where the UK Government proposes that large private companies with both 750+ employees and annual turnover of £750m+ would be viewed as public interest entities. These companies would be required to adhere to higher standards of corporate governance, given their importance for employees, shareholders and the country.

14. The UK is therefore defining companies as public interest when they have 750+ employees and R14 437,5m (£750m x R19,25) turnover.

[6] Accountancy-Europe_Audit-exemption-thresholds-in-Europe_2020_survey-update.pdf (accountancyeurope.eu)
[7] Restoring trust in audit and corporate governance