

# REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC) South Africa

## ACCOUNTING AND AUDITING

April 15, 2003

### Contents

Executive Summary

- I. Introduction
- II. Institutional Framework
- III. Accounting Standards as Designed and as Practiced
- IV. Auditing Standards as Designed and as Practiced
- V. Perception of the Quality of Financial Reporting
- VI. Policy Recommendations

### Executive Summary

This report provides an assessment of accounting and auditing practices in South Africa within the broader context of institutional capacity available for ensuring high-quality financial reporting. National accounting and auditing standards in South Africa are developed on the basis of international standards; but lack of legal backing for accounting standards give rise to problems. South African accountancy professionals play an important role in international standard-setting bodies. The country has many accountants and auditors who are highly skilled and capable of providing world standard services. However, the existing mechanisms for enforcing compliance with accounting and auditing standards seem to be weak. Opportunities exist for undetected accounting manipulation and financial statements misrepresentation and departures from established accounting and auditing requirements.

In the recent past, some high profile cases of corporate failures gave rise to serious discussions about the quality of corporate audit. Enquiry commissions, specifically the Nel Commission, highlighted various problems, including issues related to efficiency and independence of auditors. Ten years of discussions on revision of the legislative framework for accounting and auditing have contributed to uncertainties in the profession. Immediate steps are needed for enactment of the Financial Reporting Bill, amendments to the Companies Act, and the Accountancy Professions' Bill; and to ensure proper enforcement of established statutory requirements. Recognizing the need for reform, the Government is currently in the process of implementing significant changes.

The report provides policy recommendations specifically focusing on strengthening the enforcement mechanisms for ensuring compliance with established accounting and auditing requirements. Moreover, suggestions have been made about some important elements of a regulatory framework for the auditing profession, namely establishing an independent oversight body consisting of eminent persons, and restructuring the statutory regulator of the auditing profession under an effective governance structure and with broader mandate for efficiently regulating the profession.

This report was prepared by a team from the World Bank on the basis of the findings from a diagnostic review carried out in South Africa in December 2001. On the basis of current information provided by the National Treasury, the report was updated in March - April 2003. The World Bank staff team comprised M. Zubaidur Rahman (OPCFM), Iraj Talai (AFTM) and Marius Koen (AFTFM). The review was conducted through a participatory process involving various stakeholders and led by the country authorities

## I. INTRODUCTION

1. This report is based on a review of accounting and auditing practices in South Africa. This is a part of the World Bank and International Monetary Fund joint initiative on Reports on the Observance of Standards and Codes (ROSC). The review process involved an assessment of actual practices and analysis of effectiveness of the mechanisms for ensuring compliance with the formal standards. The review used a diagnostic template developed by the World Bank to facilitate assisted self-assessment by national specialists. The self-assessment results, complemented by the findings of a due diligence exercise conducted by World Bank staff, were used in preparing this report.

2. South Africa is not a typical developing country, having many features of the industrial world. “South Africa is a democracy. It has one of the most progressive constitutions on the planet, and an independent judiciary empowered to uphold it. South Africa has a strong and growing civil society, an increasingly multihued middle class, a free media...and a powerful and vocal business community....South Africa’s economy is growing...it has a budget surplus. It has a debt level that would qualify it for membership in the European Union, today.”<sup>1</sup>

## II. INSTITUTIONAL FRAMEWORK

### A. Statutory Framework

3. **Revision of the legislative framework concerning accounting, financial reporting and accountancy profession has been under discussion for more than ten years.** The delay in revising the current legislative infrastructure has increased uncertainties in the accountancy profession and has resulted in a weak enabling legal environment for high-quality financial reporting. Several drafts of the Accountancy Professions’ Bill have been prepared and widely discussed. Similarly, the initiatives are underway on a draft Financial Reporting Bill for providing legal backing to accounting standards and on proposed Amendments to the Companies Act for taking into account the new developments in corporate financial reporting. The Minister of Finance and the National Treasury recognized that immediate steps needed to be taken to strengthen the legislative environment with regards to the design and enforcement of auditing and accounting standards and the institutional framework governing these professions. In view of the local circumstances and following a large number of corporate failures in many industrialized countries, the Minister of Finance appointed a Panel for the Review of the Accounting Professions’ Bill on December 6, 2002.<sup>2</sup>

4. **The Companies Act requires all companies to prepare annual audited financial statements.**<sup>3</sup> The Companies Act requires that financial statements must be in

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<sup>1</sup> Mabry, Marcus, “South Africa is not Zimbabwe,” *Newsweek*, March 11, 2002, p. 11.

<sup>2</sup> The terms of reference of the Panel can be found in Appendix – A.

<sup>3</sup> All companies registered under the Companies Act, banks supervised by the South African Reserve Bank, financial institutions regulated by the Financial Services Board, and medical schemes regulated by the Registrar of Medical Schemes, are required to have a statutory audit of annual financial statements. In most regulated industries, auditors are required to provide additional assurance to the regulators on certain

conformity with generally accepted accounting practice (henceforth referred to as “gaap”). This is not exactly the same as conformity with the Statements of GAAP (henceforth referred to as “GAAP”), issued by the South African Accounting Practices Board. South African case law defines gaap as “in accordance with certain conventions, which are professionally recognized and reasonably well-known in the world of commerce.” Although paragraph 5 of Schedule 4 of the Companies Act requires disclosure whenever the financial statements of a company depart from any of the GAAP statements issued by the Accounting Practices Board, a reading of the Act shows that companies are under legal obligation to follow the gaap and not the GAAP. The South African Institute of Chartered Accountants (SAICA) issued a circular in December 1999 providing guidance to directors and auditors on compliance with paragraph 5 of Schedule 4 of the Act.

**5. The Companies Act specifies responsibilities of companies and duties of auditors with regard to annual financial statements.** The secretary of a public company is responsible for timely filing of annual financial statements with the Registrar of Companies; and for sending these financial statements to all the shareholders and debenture holders. Every company that is not a wholly owned subsidiary of another company incorporated in South Africa must submit a directors’ report along with the annual financial statements. Public companies are required to prepare a mid-year interim report, fairly presenting the business and operations of the company (or, if applicable, the group).<sup>4</sup> The Act requires company auditors to perform a number of specific duties, including compliance with the Public Accountants and Auditors Act.

**6. The financial statements do not need to be approved by the shareholders in annual general meeting.** According to the Companies Act, the directors should approve the annual financial statements. In annual general meeting, the shareholders may question the directors on matters related to the annual financial statements.

**7. The Companies Act does not provide for the Registrar of Companies to monitor disclosures in the presentation of companies’ annual financial statements and interim reports.** The Companies Act gives the Registrar of Companies sufficient power to disapprove a company’s prospectus issued for public offering of securities, if it does not comply with the financial reporting requirements. The office of the Registrar of Companies does not have adequate resources with necessary expertise to carry out this function. The new Securities Services Bill authorizes the Financial Services Board to approve the prospectus of publicly listed companies as well as related letters of allocation. The Companies Act will be amended accordingly.

**8. The Public Accountants and Auditors Act provides for statutory regulation of the audit profession.** The Public Accountants and Auditors Board (PAAB), which was

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regulatory matters. As of December 2001, there were 6,730 active public companies (total registered 20,356), of which 547 were listed on the Johannesburg Stock Exchange; 292,462 active private companies (total registered 558,310); and about 16,000 other types of active companies (total registered about 19,000).

<sup>4</sup> An audit is not necessary for interim financial statements, however in the case of listed companies, auditors are required to review unaudited interim reports if the audit opinion on the latest annual financial statements had been qualified, adverse, or disclaimed.

created under the Public Accountants and Auditors Act, is the statutory body responsible for controlling registered accountants and auditors involved in public practice. Members of the Board are appointed by the Minister of Finance from among the State departments, members of the accountancy profession nominated by the provincial societies of chartered accountants, and academics nominated by the Committee of University Principals. The PAAB is funded by fees and levies paid by the registered accountants and auditors. The PAAB reports annually to the Minister of Finance, who then reports to Parliament. The functions of the Board include prescribing syllabuses, setting examinations, prescribing improper conduct by an accountant or auditor, bringing charges relating to improper conduct, and imposing suitable penalty. In addition to registering the qualified individuals who enter the public accountancy profession, the PAAB conducts practice review of individual members at least once in five years. It is the general perception that an inadequate legal mandate and lack of necessary resources within PAAB have constrained its functioning as an effective regulator of the public accountancy profession.

9. **The Financial Services Board, does not have the legal mandate to directly regulate the listed companies and to play a role in corporate financial reporting.** The Financial Services Board is a unique independent institution established by statute to oversee the South African, nonbanking, financial services industry and to supervise the securities markets. The Johannesburg Stock Exchange (JSE), which is a self-regulatory organization established under the Stock Exchanges Control Act of 1985, regulates financial reporting by the listed companies through implementation of its rules and listing requirements. The revised JSE Listings Requirements, which came into effect in October 2000, require a listed company to prepare its annual financial statements and group annual financial statements in accordance with the national law applicable to a listed company (under the Companies Act), and Statements of GAAP or International Accounting Standards (IAS). The reason for allowing either Statements of GAAP or IAS is to facilitate the preparation of financial statements of companies with dual listings on overseas stock exchanges, or listing by overseas companies.<sup>5</sup> The Listings Requirements call for disclosures in financial statements relating to directors' emoluments and specific information relating to the King Report on Corporate Governance.<sup>6</sup> Furthermore, the annual financial statements of listed companies are required to be audited in accordance with the Statements of South African Auditing Standards (SAAS) or, in case of overseas companies, in accordance with company's national auditing standards acceptable to the JSE or International Standards on Auditing (ISA).

10. **In accordance with provisions of the Banks Act, the Registrar of Banks at the South African Reserve Bank plays a key role in financial reporting and appointment of external auditors by banks.** Regulations under the Banks Act include disclosing timely information in financial reports; reporting by external auditors to the Registrar of Banks any material irregularities and other information concerning the audited bank; and enhancing corporate governance practices in banks. The annual financial statements of a

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<sup>5</sup> More than 60 South African listed companies have dual listings in overseas markets.

<sup>6</sup> *King Report on Corporate Governance for South Africa 2001* (and other materials produced by the King Committee on Corporate Governance), Institute of Directors in Southern Africa. Also, *Corporate Governance ROSC for South Africa*, World Bank, 2002.

bank or a bank's controlling company need to be prepared in accordance with Statements of GAAP, with additional disclosures when required (an example of additional disclosure is such information related to corporate governance). Regulation 43 to the Bank's Act provides for the Bank's Act or the Registrar of Banks to override any provisions in Statements of GAAP—in instances of potential systemic risk, it may be appropriate for the Registrar of Banks to override a provision in a Statement of GAAP. Since this override affects general purpose financial statements of banks, it would be prudent to have this override cleared by an independent body which will be responsible for setting and enforcing accounting standards. Regulations require that in the absence of a specific Statement of GAAP or an approved interpretation covering a particular accounting and disclosure area, reference should be made to the pronouncements of the International Accounting Standards Board. The banks are required to submit annual financial statements and interim reports to the Registrar of Banks. Notwithstanding the provisions of the Companies Act, the Banks Act provides that (a) appointment of a bank auditor is not final unless approved by the Registrar of Banks;<sup>7</sup> and (b) a bank of which the total assets as at the close of its preceding financial year exceeded R10 billion (about US\$880 million), shall appoint not less than two auditors who are independent of each other.

**11. The draft Financial Reporting Bill focuses on monitoring and enforcement of accounting standards.** The draft Financial Reporting Bill, as prepared in December 2001, seems to have the right focus in all areas, including legal backing for Statements of GAAP, development and implementation of differential financial reporting standards for small and medium enterprises (SMEs), and arrangements for monitoring and enforcement of established accounting standards through a body to be housed in the Financial Services Board. It is necessary to make sure that in the process of finalizing the Financial Reporting Bill, the proposed strict enforcement measures are not diluted. Efforts should be made to overcome any pressure from vested interest groups who might be interested in a Financial Reporting Act “without teeth.”<sup>8</sup> Necessary changes in the 1973 Companies Act for adapting to the provisions of draft Financial Reporting Bill have been proposed in the draft Companies Amendment Bill of 2002.

**12. The draft Accountancy Professions' Bill should take into account current global developments on efforts to protect public interest by introducing independent oversight of the accountancy profession.** The draft Accountancy Professions' Bill envisages that the current PAAB will be replaced by the Regulatory Board of Auditors, under which the Independent Standard-Setting Board for Auditing and Independent Standard Setting Board for Ethics will be established. It seems that more emphasis is needed on establishing an effective enforcement mechanism to ensure compliance with the established auditing and ethical standards, and also to have a strong governance structure where practicing accountants and auditors will not have significant influence over the policies and operations of the Board. The draft Bill needs to take into account the

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<sup>7</sup> The Registrar uses a prescribed form (Form D1 006—in essence a self-assessment by the auditor of the fitness to be the auditor of a bank) to obtain required information to consider the approval of auditor's appointment. One audit firm resigned from the audit of a bank when D1 006 was introduced, realizing it is not able to competently conduct the audit.

<sup>8</sup> A Consultative Forum meeting was held in December 2001 to discuss the draft Financial Reporting Bill. In that meeting, there was an agreement on proposals for improving monitoring and enforcement.

creation of an Oversight Board for independent oversight of the professional conduct of practicing auditors from the point of view of protecting public interest, which was recommended in the Nel Commission Report.<sup>9</sup>

## **B. The Profession**

13. **The accountancy profession in South Africa has a long history, with a highly skilled membership.** There are about 14 national accounting/auditing bodies, including the South African Institute of Chartered Accountants and the Institute of Commercial and Financial Accountants of Southern Africa, which are members of the International Federation of Accountants (IFAC). Only the PAAB members, who hold the designation of registered accountant and auditor, are authorized to act as statutory auditors. At present, most registered accountants and auditors in the country also have membership in the SAICA. The SAICA is a self-regulating body of professional accountants, while the PAAB is the statutory regulator of the auditing profession. South African chartered accountants are highly regarded at home and abroad, and as a result the SAICA has successfully arranged reciprocal membership arrangements with professional accountancy bodies in Australia, Canada, England and Wales, Ireland, Namibia, Scotland, Swaziland, and Zimbabwe.

14. **There is a growing shortage of qualified accounting professionals in the country.** In the recent past, there has been a slow growth in the number of qualified auditors in public practice—at present there are about 4,200 registered accountants and auditors of which about 3,000 are actively in auditing practice. Due to economic downturn in the past years, lack of demand has discouraged entry into the profession. In addition, the high cost of university education has made it difficult for the average South African to train as chartered accountant. Moreover, there has been a large emigration of qualified chartered accountants. By end of 2000, approximately 22 percent of SAICA members were living abroad. The national absenteeism of SAICA members is increasing by 2 percent annually. Research conducted by the Human Sciences Research Council of South Africa shows that if the economy maintains an average annual growth rate of 4 percent, the country would be faced with a shortage of 20,000 qualified professional accountants by 2003. The shortage of qualified accountancy professionals is complicated by slow progress in the transformation of the profession to become representative of the whole South African community.

15. **The members of previously disadvantaged community are yet to enter the profession in a significant scale.** However, the number of qualified chartered accountants belonging to the previously disadvantaged community has increased at a significant rate from 120 in early 1998 to over 250 at the end of 2001.<sup>10</sup> According to various leaders of the profession, the younger generation of the previously disadvantaged community generally still do not have access to high-quality educational system with strong focus on

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<sup>9</sup> The creation of a Public Oversight Board was strongly recommended by the Honorable Mr. Justice H.C. Nel in the *Report of the Commission on Inquiry into the Affairs of the Masterbond Group and Investor Protection in South Africa*.

<sup>10</sup> At present, the total number of qualified chartered accountants (SAICA members) is about 19,000.

mathematics at the school level, which constrains their ability to pursue the higher educational track appropriate for entering the accountancy profession. To overcome this problem, a number of intervention projects have been launched by the profession—a refresher course for failed qualifying examination candidates organized by the University of Cape Town; a refresher course for the candidates sitting the Certificate in the Theory of Accountancy organized by UNISA; an accountancy teachers' development program; a bridging program for black candidates who had failed the Public Practice Examination; and the Chartered Accountants Education Endowment Trust (Eden Trust) formed in 1987 to provide financial assistance to academically deserving black students for pursuing education to become chartered accountant.<sup>11</sup> In order to have a critical mass of black chartered accountants in the foreseeable future, there seems to be an urgent need to address this issue through an intensive program covering all regions of the country.

16. **The larger firms audit most of the publicly traded companies.** The big-5 international accounting firm networks operating under international trade name and 4 national firms with international affiliation audit the vast majority of companies. Of the total number of publicly traded companies, the big-5 firms audit about 67 percent, 4 national firms audit about 19 percent, and 52 other national firms audit about 14 percent.

17. **The audit profession is under attack for some high profile corporate failures in the recent past.** Recently, there have been a number of corporate failures in South Africa, which provoked questioning of the professional conduct of auditors. The audit profession has been criticized for not disclosing in audit reports any forewarnings of problems. Auditor independence has also raised questions of concern.<sup>12</sup>

“The issue of corporate governance and in particular the role of the auditing firms has once again dominated the headlines. The Enron debacle has brought into sharp relief a number of key issues—weak or nonexistent governance structures, the fiduciary responsibility of directors, negligent and sometimes reckless management, ineffective auditing, independence of auditors, and conflicts of interest arising from inadequate separation between auditing and consultancy. Closer to home, a number of corporate failures—Macmed, Leisurennet, Regal Treasury, and Unifer, to name but a few—have raised a similar set of issues. Many of these weaknesses were highlighted in the Nel Commission Report.”

Following the collapse of Masterbond Group in the early 1990s, the Government of South Africa established an inquiry commission led by Honorable Mr. Justice H. C. Nel. The Nel Commission ended its work in late 2001. In course of investigation, the Commission documented many examples of auditors' failure to protect investors' interests. It cited a number of cases where auditors of various failed companies compromised the independence of the auditing profession, departed from minimum norms of professional conduct, and disregarded any code of professional ethics.

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<sup>11</sup> The Eden Trust, up to the end of 2001, has helped 124 black chartered accountants to qualify.

<sup>12</sup> From the budget speech of South Africa's Finance Minister delivered February 20, 2002.

18. **The practicing auditors are required to follow Codes of Professional Ethics issued by their professional body and the PAAB.** Every registered practitioner needs to comply with the Code of Ethics issued by the PAAB and respective professional body. The PAAB Code is a condensed version of the SAICA-issued Code for observance by its members. The SAICA Code is in line with the Code of Ethics issued by the IFAC, as of January 1998. Recent improvements in the IFAC Code have not been incorporated in SAICA Code. In practice, compliance with all requirements of the Code of Professional Ethics depends on the individual auditor.

19. **South Africa has not yet experienced large-scale litigation against audit practitioners.** There are very few reported court cases against auditors. Professional indemnity insurance is not compulsory, however the PAAB recommends that auditors take out such insurance. Currently partners in an audit firm are subject to liability jointly and severally. For incorporated practices, there is a form of proportionate liability with regard to delicts. However, in contract law, they would still be jointly and severally liable. As an amendment to the current regime, the draft Accountancy Profession Bill proposes that proportionate liability also be applicable in the case of contract law, and professional indemnity insurance for auditors will become mandatory.

### **C. Professional Education and Training**

20. **The professional education and training arrangements for audit practitioners are of high quality and in some cases surpass IFAC educational guidelines.** Since 1956, the PAAB has set the qualifying examination, a prerequisite for becoming a registered accountant and auditor. From 1999, the regulatory function of the PAAB with respect to education and training was changed to a process of recognition and monitoring. The academic training and Part 1 Assessment of SAICA is recognized, with the PAAB conducting the final qualifying examination related to auditing, known as the public practice examination. The PAAB is considering revising its recognition and accreditation model for meeting admission requirements to the public practice examination, which could lead to other professional accounting bodies in the country receiving accreditation. In 1999 the structure and prerequisite of the public practice examination was changed. The change required the completion of a practical training period of 18 months and a specialist course in auditing. As successful completion of an academic program, which is a prerequisite of taking the public practice examination, the PAAB recognizes the SAICA-approved Certificate in the Theory of Accounting (or equivalent), which requires completion of a 3-year university degree and a 1-year post-graduate degree or diploma from a SAICA-approved university.

21. **In order to gain necessary practical knowledge before entering into the auditing profession, a candidate spends at least three years with a PAAB-approved training provider.** When a candidate enters into a training contract with the training provider, the contract is registered with the PAAB and supervised by SAICA. The PAAB requires SAICA to ensure that the minimum duration of a training contract is not less than the required minimum contract term, allowing for the minimum period of work attendance and the minimum period of chargeable-work hours in core experience areas as shown below:



<i>Entrance requirement category</i>	<i>Minimum contract term (months)</i>	<i>Minimum hours</i>	
		<i>Work attendance</i>	<i>Core experience</i>
Holder of a university degree (relevant or non-relevant)	36	4,500	3,600
Holder of a technical diploma (relevant or non-relevant)	48	6,000	4,800
Holder of a matriculation (exemption certificate)	60	7,500	6,000

22. **Neither PAAB nor SAICA prescribe requirements for continuing professional education.** As a self-regulatory body, SAICA believes that the purpose of continuing professional education is to achieve an outcome of professional competence, but that structured learning (or any other type of learning) is no automatic guarantor of professional competence. Consequently, SAICA has decided that it is not appropriate to require its members to undertake any structured learning activities, or to require that members and associates keep a record of the extent of structured learning. Members and associates are to use their own discretion regarding the effectiveness and extent of their continuing education. SAICA issued guidance in March 2001 in the form of a competence self-appraisal. All SAICA members and associates are required to sign an annual declaration that they are committed to continuing their professional education and to remain competent and relevant in their work. SAICA is researching issues in continuing professional education; the results will feed into the process of turning IFAC Educational Guidelines into Standards.

23. **At present, ethics is not taught as a separate subject.** The syllabus for auditing courses includes the Professional Code of Conduct and Improper Conduct defined by the PAAB. SAICA has established a research unit to examine various aspects of teaching business ethics as a separate subject in higher education institutions. The unit is also exploring the possibility of including as a stand-alone course, “accountant’s professional ethics,” in the professional examination to be implemented by 2003.

#### **D. Setting Accounting and Auditing Standards**

24. **The Accounting Practices Board, an independently constituted body of preparers, users, and auditors, issues Statements of GAAP, which are harmonized with International Accounting Standards.** In 1993, SAICA launched the Harmonization and Improvements Project, which revised existing Statements of GAAP in line with IAS and issued new standards in all areas where IASs existed, but without equivalent South African standards. Currently there is a local Statement of GAAP for every IAS. The last statement in this regard (Agriculture) was issued in October 2001. South African policy does not permit differences with IASs on fundamental issues, but does allow for elimination of allowed alternative treatments, additional disclosures, and additional guidance and departure from IAS, if IAS requirement is in conflict with national law or legislation.

25. **The proposed Financial Reporting Bill and the Amendments to the Companies Act, if passed, will introduce a new accounting standard-setting arrangement.** The Amendment to the Companies Act will recognize the Financial

Reporting Standards Council, as the authorized body to set and monitor compliance with accounting standards for all companies registered under the Companies Act. In order to fulfill the responsibilities of the Standards Council in terms of the new Financial Reporting Act, the following committees will be formed:

- Financial Reporting Standards Development Committee, responsible for developing accounting standards for general purpose financial statements;
- Small Enterprises Financial Reporting Committee, responsible for identifying/developing another comprehensive basis of accounting for private companies for limited purpose financial statements; and
- Committees responsible for monitoring compliance with established accounting standards; and for taking enforcement actions against violators on the basis of recommendations from the compliance committee.

26. **The PAAB, as the statutory body of the auditing profession, issues South African Auditing Standards that are comparable with International Standards on Auditing.** Until the beginning of 2002, the PAAB authorized the Auditing Standards Committee of SAICA to issue auditing standards on its behalf. The PAAB has recently established an Auditing Standards Board as a committee of the PAAB. In 1994, the Auditing Standards Committee started its Harmonization and Improvements Project. The objective was to align SAASs with ISAs issued by the IFAC, but with improvements and adaptations relevant to the South African context. That project was completed toward the end of 2000. Until recently, the Auditing Standards Committee locally issued the international exposure drafts on ISAs as South African exposure drafts. The comment date of local exposure drafts normally coincided with the international comment date to enable a comment to be submitted to the International Auditing Practices Committee of the IFAC. Recently, it has been agreed not to issue local exposure drafts, but to request members to comment on the international exposure drafts.

#### **E. Ensuring Compliance with Accounting and Auditing Standards**

27. **Hardly any enforcement mechanism for ensuring compliance with accounting standards exists either within the statutory regulatory bodies, such as the Registrar of Companies, the Financial Services Board or the South African Reserve Bank; or the self-regulatory organizations, such as SAICA.** The capacity of the Registrar of Companies is inadequate, with no capacity to enforce penalties. The Financial Services Board is the statutory regulator and in comparison with the Security and Exchange Commission in the United States, there is no statutory regulation for enforcement of accounting and disclosure requirements. An interim measure to establish a GAAP Monitoring Panel has been adopted as a joint initiative between SAICA and the Johannesburg Stock Exchange. The Financial Reporting Bill, which has been drafted but not yet enacted, will address legal backing and also monitoring and enforcement.

28. **The Johannesburg Stock Exchange does not have the resources to effectively monitor compliance with GAAP or IAS by every publicly traded company.** The self-regulatory Johannesburg Stock Exchange, under the oversight of the Financial Services Board, has the legal mandate to regulate financial reporting by the listed companies. The

Stock Exchanges Control Act provides several sanctions at JSE disposal. The listed companies are in a “contractual” relationship with the JSE, whereby the JSE penalizes the companies that do not comply with the rules and listings requirements. The JSE monitors and enforces timely submission of financial statements. Qualified audit opinions are annotated on the listings board. With regard to compliance with the accounting standards in annual, interim, or provisional financial reports, JSE monitors to some extent, but lacks the capacity to cope with the quantity of these reports and the resources to effectively monitor compliance with GAAP or IAS by every publicly traded company.<sup>13</sup> Since the beginning of 2002, the JSE has joined forces with SAICA to establish a monitoring function until the proposals in the Financial Reporting Bill are passed and enacted. Under this arrangement, a panel of experts will investigate the specific cases of violation, decide upon the materiality, occurrence, and magnitude of the noncompliance and issue a report on their findings and recommendations. The JSE will utilize its existing structures (i.e., the Appeals Committee) and its own code and regulations and consider action to be taken against directors of the companies concerned.

29. **For ensuring that the regulated banks comply with accounting and financial reporting requirements, the South African Reserve Bank relies fully on the bank auditors.** The Registrar of Banks believes that it has a partnership with bank auditors where mutual trust and respect motivates the auditor to enforce accounting and reporting requirements. Representatives of the Registrar of Banks indicated that most problems dealt with by banking supervision were management issues and not accounting and auditing issues. Measures taken to review compliance with accounting and auditing standards include the approval of the audit firm by the Registrar of Banks; bi-lateral meetings between the auditor and the banking supervision staff responsible for the bank prior to the commencement of the audit; and tri-lateral meetings between bank supervision, the bank’s audit committee, and the external auditor. The external auditor of a bank is required to report to the Reserve Bank any information regarding violations of established standards, rules, regulations, and laws. Regulation 65 under the Banks Act gives the Registrar wide powers. There has been a recent example where the Registrar has refused to permit a bank to publish a qualified audit report and the bank was forced to restate its financial results.

30. **All registered accountants and auditors performing the attest function are subject to practice review by the PAAB.** However, it appears from the findings of Nel Commission Inquiry on Masterbond affairs and the results of due diligence carried out in connection with the Accounting and Auditing ROSC, that in many occasions corporate auditors failed to comply with the established auditing standards and codes, and this noncompliance remained undetected by any self-regulatory or statutory regulatory body. Individual practitioners, but not the audit firm as a whole, are subject to the PAAB practice review. Reviews are performed by qualified chartered accountants employed full-time by the PAAB (staff presently include four full-time practice reviewers and one practice review director). Every audit practitioner is reviewed once in a 5-year cycle. When a practitioner fails a review, a second review a year later is required to determine

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<sup>13</sup> According to the JSE listing requirements, publicly traded companies may apply either GAAP or IASs.

whether corrective action has been taken. If the practitioner fails the second review, they are referred to the PAAB Investigation Committee.

31. **The voluntary work performed by the Board members and various Committee members of the PAAB affect efficient execution of its responsibilities.** When reviewing the performance of individual auditors working for a large audit firm (particularly one of the local members of big-5 international network), which requires additional co-reviewers, the PAAB practice review team uses individuals from foreign offices of the same firm being reviewed—the conflict of interest issue is not considered. The practice review mainly focuses on audit documentation; only individual auditors are subject to review, and quality assurance arrangements of the audit firm are not reviewed. The draft Accountancy Profession Bill needs to provide clear direction about setting up an adequately resourced “independent practice review arrangement” mainly focusing on the audit firms, as a means of monitoring and enforcing compliance with the established auditing standards and ethical code. A suggested arrangement can be found in the policy recommendation section of this report.

32. **The nontransparent disciplinary process at the PAAB diminishes enforcement effectiveness.** The PAAB is occasionally criticized for the lack of effective regulation of the audit profession. Understaffing in PAAB has required several technical personnel in its Investigation and Disciplinary Committees to work on a voluntary basis. Contributing to the weak disciplinary process at PAAB are the slowness and non-transparency of the decision making process, and the influence of large audit firms over decisions taken by various committees of the PAAB. In order to ensure independence of the Disciplinary Committee, majority of its members should not be drawn from the practicing audit professionals. The draft Accountancy Profession Bill should include provision(s) to enhance the effectiveness and transparency of disciplinary process of the statutory regulator of the audit profession.

### III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

33. **The South African Statements of GAAP are comparable with the IASs.** Some minor inconsistencies do exist between the Statements of GAAP and IASs. However, efforts are underway for ensuring full adoption of all accounting standards and related interpretations issued by the International Accounting Standards Board (IASB).

34. **The absence of effective regulatory enforcement mechanisms facilitates uncontrolled manipulation of accounting policies and a mere appearance of compliance, rather than one of substance.** Many companies have the availability of highly skilled accountants and auditors who seem to use sophisticated accounting manipulations that may not be evident from a reading of financial statements. As a result, in many cases noncompliance of the established accounting standards takes place, yet giving the appearance of full compliance. In the course of the ROSC review, it was revealed that many South African companies perform off-balance-sheet transactions using “special purpose entities” created at home and abroad—huge amounts of liabilities and risk exposures remain hidden from stakeholders. In December 1999, the SAICA issued an Interpretation of Statements of GAAP in conformity with the interpretation of the

International Accounting Standards Board under SIC 12, *Consolidation—Special Purpose Entity*. Under the existing accounting requirements in South Africa, “an SPE should be consolidated when the substance of the relationship between an enterprise and the SPE indicates that the SPE is controlled by that enterprise.”

**35. Review indicates several cases of noncompliance with important accounting requirements.** From interviews for the A&A ROSC with a cross section of practicing auditors, corporate accountants, academics, investment analysts, and financial journalists, information on a number of cases of noncompliance was collected. On the basis of these information, some conclusions were reached. In the financial statements of many companies, significant related-party transactions remain undisclosed; many controlled entities do not get consolidated; and recognition, measurement, and disclosure of financial instruments are not in full compliance with the substance of the established rules. Another commonly applied manipulation in South African corporate accounting is the misclassification of leases. These leases that are essentially finance leases, are treated as operating leases. This misclassification improves the liability side of the balance sheet and creates more favorable borrowing capacity. Experienced practitioners also reported that manipulation of revenue source is a common practice in many companies. An example of misleading revenue source can be found in the case of the recently failed Regal Bank. Regal invested in related enterprises while showing bogus revenues that ultimately helped the bank to inflate reported earnings in its consolidated financial statements. An inquiry commission report on Regal Bank affairs, published in March 2002, provided detailed description of manipulations and criticized the Registrar of Banks and Regal Bank’s auditor (local member of one of the big-5 international network of accounting firms).

**36. From a reading of the most recent financial statements of 30 top-listed companies in the Johannesburg Stock Exchange, it appeared that the sample companies generally complied with most of the disclosure requirements.** Within the scope of ROSC review exercise, it was not possible to carry out a review of accounting records and/or working papers of the corporate auditors; therefore, the results shown below may not reflect the kind of noncompliances mentioned earlier. Moreover, noncompliances regarding recognition and measurement of accounting items, if not disclosed, are not detectable through a reading of financial statements. A checklist of selected disclosure requirements under South African GAAP was used to identify compliance/noncompliance by each of the 30 sample companies. Some noncompliances were observed. One sample company deducted cash and cash equivalents from interest bearing debt. A bank having subsidiaries did not consolidate all of them. For segment reporting, in a few instances details were not provided for each of revenue, operating profit, total assets, and total liabilities of different segments. A number of companies did not disclose within profits and losses the exchange rate differences for the period. Although required, a many companies do not disclose information on related-party relationships, and five companies that reported related-party transactions failed to provide required detailed information. Three companies did not provide required detailed information on revalued land and building.; although there is a requirement for all companies to undertake impairment test of assets every year, half of the sample companies disclosed no such information. Companies that disclosed information as lessor or lessee of finance leases, failed to disclose all required information. Regarding financial

instruments, about half of the sample companies did not disclose details on maximum credit risk exposure and information on concentrations of credit risk, also a number of companies did not provide information on fair values.

37. **The sample companies generally failed to comply with the requirement on disclosure of audit fees and fees for other services paid to the auditor.** Most of the 30 sample companies did not comply with the requirement to specify the nature of other services carried out by its auditors. Section 283 (2) of the Companies Act requires all payments made or to be made by the company to its auditor—specifying the remuneration for the audit, the remuneration for other specified services, the auditor’s expenses and payments in respect of the audit, and any other matters—be shown under a separate heading in the income statement.

#### IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

38. **South African Auditing Standards are in line with the International Standards on Auditing.** However, the SAAS 550, *Related Parties*, does not include a local measure that requires predecessor auditors to provide knowledge of additional related parties. At present, there is no local equivalent of ISA 501, *Audit Evidence—Additional Considerations for Specific Items*; an exposure draft is awaiting issuance. Also, there is no local equivalent of ISA 402, *Audit Considerations Relating to Entities Using Service Organizations*.

39. **The degree of compliance with the established auditing standards differs among audit firms of different sizes.** In order to assess actual auditing practices, interviews by the ROSC team were held with practicing auditors and the leaders of the PAAB audit practice review team. Moreover, facilitated discussion was conducted with a group of partners representing nine of the biggest audit firms in the country. Auditors generally follow auditing standards, however, in some cases—due to the difference of opinion about the spirit of certain auditing standards—audit firms implement these standards differently from each other. Some of these practices of compliance/noncompliance with selected auditing standards were revealed in the interviews. With respect to the standard on *materiality*, the auditors often find it difficult to get the client to make adjustments to correct mistakes; and as a result there may be departures from the norms. Regarding implementation of the standard on *going concern*, it seems that the shortcomings in effective compliance with this standard have improved only recently. In some instances of risk assessments and internal control, there is a tendency not to check whether the controls were functioning throughout the review period, and at times test of controls and substantive tests are incorrectly combined. It seems that in general there is a lack of awareness of the existence of the local auditing standard, which is comparable to ISA 510, *Initial Engagements—Opening Balances*. It is widely believed in the profession that the auditing standard regarding *related parties* does not receive the attention it deserves, taking into account that most of the listed companies have related-party relationships with various other entities.

40. **Auditors seldom report material irregularities.**<sup>14</sup> The provisions of section 20(5) of the Public Accountants and Auditors Act, which require an auditor to report to the PAAB any material irregularities, seem to lack clarity and appear to be difficult to monitor and enforce. Proof of noncompliance with the provisions of section 20(5) would generate an insignificant penalty—maximum R4,000 (equivalent to about US\$350).

## V. PERCEPTION OF THE QUALITY OF FINANCIAL REPORTING

41. **The investors generally do not have high opinion about the quality of information available in the published financial statements.** Interviews and discussions with the representatives of several institutional investors revealed serious concerns about the quality of financial reporting—many corporate failures have given rise to investors' dissatisfaction with auditor's performance. There seems to be a consensus that the companies with dual listings in JSE and foreign stock markets generally present relatively high-quality financial statements. In most other cases, the investors generally express their reservations about reliability of information contained in the audited financial statements. When the investors were asked to rate corporate financial statements on the basis of consistency (consistent in presentation from period to period) and comparability (comparable from one enterprise to another), the responses were either "fair" or "poor." In response to a question regarding the need for improving actual accounting practices in selected areas, most of the interviewees identified the following areas: related-party transactions, impairment of assets, pension accounting, segment reporting, and accounting for leases and financial instruments. All the interviewees shared a strong view that the quality of financial reporting would not be improved unless there is a strong regulatory regime and there are effective enforcement mechanisms for ensuring compliance with accounting and auditing standards and the requirements on auditor's professional ethics.

## VI. POLICY RECOMMENDATIONS

42. **The policy recommendations presented in this section emerge from the review of accounting and auditing practices.** The policy recommendations include valuable inputs received from various parties interviewed by Bank staff conducting the due diligence exercise. These recommendations are aimed toward creating an environment for high-quality corporate financial reporting and delivery of auditing services. It is expected that the recommendations in specific areas presented in this section would be used as inputs for preparing and implementing the action plan for accounting and auditing reform in South Africa.

43. **Efforts need to be made to strengthen the enforcement mechanism.** High-quality financial reporting depends not only on having appropriate accounting and auditing standards, but also on proper enforcement of these standards. There are three important links in the enforcement chain: (a) the preparers of financial statements need to comply with established standards; (b) the auditors need to act independently to assure financial statements are prepared in compliance with the established standards and they

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<sup>14</sup> *Inquiry into the Affairs of the Masterbond Group and Investor Protection in South Africa*, Nel Commission Report, volume 1, p. 69.

fairly present enterprise's financial conditions; and (c) the regulators, both self-regulatory organizations and statutory regulatory bodies, need to put in place proper arrangements for efficient monitoring of compliance/noncompliance, and taking effective actions against those responsible for violating established standards, rules and regulations.

44. **Financial Reporting Bill and amendments to the Companies Act .** Take necessary steps for enactment of the *Financial Reporting Bill* which includes provisions on legal backing for accounting standards and arrangements for setting accounting standards—separate financial reporting standards for small and medium enterprises and other companies. The standard-setting objective should be the adoption of International Accounting Standards and International Financial Reporting Standards issued by the International Accounting Standards Board, and issuance of implementation guidelines on individual standards. Ensure that the Financial Reporting Bill, in the process of being turned into an Act, does not lose the provisions dealing with arrangements for taking effective punitive measures against violators of the established accounting and reporting standards. Necessary amendments in the Companies Act are needed to accommodate the provisions of the proposed Financial Reporting Bill. Moreover, the Companies Act should address what role the Office of the Registrar of Companies plays with regard to the annual financial statements submitted by companies.

45. **Financial Services Board.** The JSE, a self-regulatory organization, has the legal mandate to enforce listing requirements. Steps may be taken to include in the scope of work of the Financial Services Board, specific role with regard to financial reporting by the publicly traded companies. This may be achieved by linking the financial reporting monitoring and enforcement arrangements proposed in the Financial Reporting Bill, with Financial Services Board's enhanced role to directly regulate the issuers.

46. **Accountancy Profession Bill.** The draft Accountancy Profession Bill needs to include provisions specifically focusing on setting up an efficient and effective regulatory framework for ensuring that the practicing auditors discharge their responsibilities properly to protect public interest. The following aspects of a regulatory framework may be considered.

- ***Establish an Oversight Body.*** This independent body should be charged with oversight of the public-interest activities undertaken by practicing auditors and various relevant organizations—self-regulatory organizations of accountants and statutory regulatory body of public accountants and auditors. The oversight body should assess whether the auditing profession is appropriately serving the interests of users of audited financial statements and the wider public. It will publish assessment reports for bringing to light the problems and prospects of the auditing profession. Moreover, the body should advise from time to time professional self-regulatory organizations and statutory regulators for taking actions to ensure that the accountability and monitoring mechanisms on audits and auditors are consistent with international best practices. The oversight body shall consist of eminent persons who need not work on a full-time basis. The practicing public accountants and auditors will not be eligible for membership of the oversight body.



- **Create a Regulatory Board of Auditors.** The draft Accountancy Profession Bill contains provisions for creation of a Regulatory Board of Auditors. This seems to be the right step. As a means of creating a strong entity, majority members of the Regulatory Board, including the Chairperson, should not be practicing public accountants and auditors. At least half of the members should work on a full-time basis. Membership of the Regulatory Board should include representatives of stakeholder groups, including investor community, academia, professional bodies, and relevant government agencies and departments. The Regulatory Board should have a strong governance structure to ensure that any vested interest groups cannot influence enforcement actions. One important function of the Regulatory Board will be to conduct independent practice review of audit firms and auditors.<sup>15</sup> There should be an efficient and effective mechanism for taking disciplinary actions on a transparent basis against the violators of auditing standards and code of professional ethics.

47. **Enforcement Mechanism at the South African Reserve Bank.** The banking supervision department needs to put in place a mechanism or actively coordinate with the initiatives mentioned in paragraph 25, for systematic monitoring of compliance with accounting and disclosure requirements by banks. It is also necessary to assess the quality of audited financial statements of banks and take appropriate actions against those banks, top management of banks, audit firms, and auditors who fail to comply with the established accounting and financial reporting standards, rules, and regulations.

48. **Education and Training.** Although South Africa has high-quality educational system, the following steps need to be taken with regard to professional education and training:

- **Continuing Professional Education.** The professional accountancy bodies should introduce requirements for continuing professional education in conformity with IFAC guidelines. And the Regulatory Board of Auditors should assess arrangements in professional bodies regarding enforcement of these requirements—provisions of the draft Accountancy Profession Bill dealing with continuing professional education may be enhanced.
- **Teaching Business Ethics.** Business ethics should be taught as a separate subject in undergraduate business/accounting programs. Moreover, the professional qualification examinations given by SAICA and similar organizations should have extended emphasis on testing candidates' knowledge about practical aspects of professional ethics.

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<sup>15</sup> The practice review group should have experienced reviewers and it should follow a transparently established review methodology. The practice review group is not expected to have a large number of experienced reviewers as full-time staff. Depending on the need for additional human resources, the practice review group will borrow competent individuals from audit firms other than those subject to review in a particular year. After completion of the practice review, the Regulatory Board of Auditors will submit a bill to the reviewed audit firm for the number of hours worked on the review. The employers of borrowed human resources will also send bills to the Regulatory Board for the level of efforts provided by their staff for practice review purposes.

## Appendix – A

(Excerpts from comments on the draft Accounting and Auditing ROSC prepared by the National Treasury of South Africa, on February 27, 2003)

There is general agreement with the overview provided by the World Bank on the current institutional and regulatory framework regarding auditing, financial reporting and accounting in South Africa.....As a result of local circumstances and the wave of international corporate failures, most notably in the US, the Minister appointed a Panel for the Review of the Accounting Professions' Bill on the 6<sup>th</sup> of December 2002. The Terms of Reference for the Panel are as follows:

***To make recommendations to the Minister of Finance on:***

1. The appropriateness of the structure of the regulatory framework for auditors and accountants that is currently envisaged in the Bill in the light of international developments and the debate around self-regulation;
2. The desirability of separating the consulting and statutory auditing function within a firm;
3. The introduction of term limits for auditors and audit rotation;
4. A system of accountability between an auditor and their clients that addresses the issue of fees and the relationship between an auditor and directors and the board of a client entity;
5. An appropriate set of liabilities and disciplinary procedures for auditors that fail to properly disclose the true financial health of an entity;
6. An appropriate set of liabilities and disciplinary procedures for executive management of companies that fail to properly disclose the true financial health of a company to the auditors;
7. The usefulness and appropriateness of accounting standards and disclosure rules and the feasibility of implementing a system of 'current disclosures';
8. The feasibility and appropriateness of incorporating the regulation of internal auditing, audit committees and their relationships to external auditors in the legislative framework; and
9. The inter-relationships between the Accounting Professions Bill, the Financial Reporting Bill and the Companies Act, 1973.

The Panel of experts, that includes senior Treasury officials, representatives from the Financial Services Board, Banking Supervision, the Office of the Registrar of Companies and professionals is to provide a final report containing recommendations to the Minister by 31 July 2003.

The Minister and the National Treasury will then review the recommendations and draft amendments to the Accounting Professions' Bill, Financial Reporting Bill and the Companies Act as may be appropriate. It is anticipated that the two Bills and amendments to the Companies Act will be presented to the Cabinet of South Africa by December 2003. Thereafter, it is expected that Parliament will adopt this legislation by the middle of 2004.

We believe that this is the first initiative of its kind amongst emerging market jurisdictions and it is anticipated that South Africa will be in a position to provide guidance and leadership to other such jurisdictions on these matters. Although it is always correctly emphasised that international standards and codes must be adopted unilaterally, South Africa is in the process of trying to understand the uniqueness of its emerging market status underpinned by a keenness to attract investment. Term of Reference number seven is testimony to this. We want to understand if there are useful and practical measures that we can put in place that will in fact go beyond the current standard in terms of disclosures and timeliness thereof.

The Treasury has planned to have this entirely modernized and strengthened system of regulating the accounting professions' implemented by the end of 2004. The Treasury believes that this addresses majority of the issues raised in the ROSC.