THE IMPACT OF MANDATORY AUDIT FIRM ROTATION ON THE STATUTORY DUTIES OF DIRECTORS

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PLAGIARISM DECLARATION

I hereby declare that this thesis, presented for examination for the degree of Master of Philosophy at the University of Cape Town, has not been previously submitted for a degree at this or any other university, that it is my own unaided work both in concept and execution and that all the materials contained herein have been duly acknowledged.

Signed by candidate

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Dale McGregor Date

ABSTRACT

On 5 June 2017, the Independent Regulatory Board for Auditors, the audit regulator in South Africa, implemented mandatory audit firm rotation (MAFR) with effect from 1 April 2023 in response to concerns regarding auditor independence in South Africa.

The introduction of MAFR has been met with criticism from many stakeholders due to the adverse effects many believe the implementation of MAFR will have on audit quality and auditor independence.

To date, there have been limited studies which focus on the impact of audit quality and auditor independence on audit practitioners in South Africa as a result of the implementation of MAFR but, to the best of my knowledge, no studies have assessed how the effects on audit quality and auditor independence will impact the ability of directors to discharge their statutory duties under section 76 of the Companies Act 71 of 2008 ('the Act' or 'Companies Act').

This thesis first provides readers with a brief background of MAFR, followed by an overview of the statutory duties of directors as contained in the Act.

I then subsequently assess how MAFR will affect audit quality and auditor independence before considering the impact this will have on the ability of directors to discharge their duties effectively. One of the duties of the directors is to produce the financial statements which are not false or misleading. Audit quality and auditor independence help directors produce financial statements which are not false or misleading, as determined under section 29 of the Act.

As shown in this thesis, the enforced rotation of auditors results in situations which affect audit quality through the loss of client-specific knowledge which the outgoing auditor has developed over time. Furthermore, the enforced rotation of South African audit firms does create difficulties for multi-national entities which have their various entities audited by the same network of audit firms. These concerns, together with the concerns related to the cost of switching auditors and the threats posed to audit quality and auditor independence related to the initial discounts on audit fees offered by audit firms to new audit clients, poses serious concerns that directors will not be able to comply with section 29 of the Act.

However, the introduction of a new audit team does provide instances which offer improvements to audit quality and auditor independence which may assist directors to produce financial statements which are not false or misleading.

Lastly, I provide recommendations in terms of alternatives to MAFR, examining the existing measures which are already in place in South Africa to promote audit quality and auditor independence.

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Contents

1. Introduction **9**

2. Background **11**

2.1 Objective of mandatory audit firm rotation (MAFR) **11**

2.1.1. Primary objective 11

2.1.2. Ancillary objectives 12

2.2. Entities excluded from the MAFR requirement **12**

2.3 Future area of research **13**

3. Research methodology **15**

4. Existing legislative requirements aimed at promoting auditor independence in South Africa **16**

4.1 Introduction **16**

4.2 Section 90 of the Companies Act **16**

4.2.1 Overview 16

4.2.2 Proposed amendment under South African Companies Amendment Bill, 2018 17

4.2.3 Insight into proposed amendment insofar as it relates to MAFR 17

4.2.4 Rights of shareholders to appoint auditors 19

4.3 Section 92 of the Companies Act **19**

4.3.1 Overview 19

4.3.2 MAFR and the application of section 92 of the Companies Act 20

4.4 Section 94 ..... **20**

4.4.1 Overview 20

5. Standards of directors' conduct (section 76 of the Companies Act) **22**

5.1 Introduction **22**

5.2 Section 76(1) – scope **23**

5.2.1 Overview 23

5.2.2 Conflict between section 76(1) and section 72(2) 23

5.2.3 Do external experts fall within the ambit of section 76(1)? 23

5.2.4 The impact on statutory duties arising from the implementation of MAFR confined to audit committee members 24

5.3 Section 76(2) – duty to not gain an advantage nor knowingly cause harm; duty to disclose material information **24**

5.3.1 Overview 24

5.3.2 Purpose of section 76(2)(a)(i) – duty to not gain an advantage 25

5.3.2.1 Precedent from case law 25

5.3.3 Purpose of section 76(2)(a)(ii) – duty to not knowingly cause harm 25

5.3.3.1 Defining what is meant by 'harm' 26

5.3.3.2 Defining what is meant by 'knowingly' 26

5.3.4 Purpose of section 76(2)(b) – duty to disclose material information 27

5.4 Section 76(3) – duty to act in good faith, in the best interests of the entity with a degree of care and skill 27

5.4.1 Overview 27

5.4.2 Explaining what the statutory duties in section 76(3) entail using case law and common law 28

5.4.2.1 Duty to act in good faith (subsection a) 28

5.4.2.2 Duty to act in the best interest of the entity (subsection b) 29

5.4.2.3 Duty to act for a proper purpose (subsection a) 29

5.4.2.4 Duty to act with a degree of care, skill and diligence (subsection c) 30

5.5 Section 76(4) – discharge of statutory duties and reliance on information provided by others (including external experts) 33

5.5.1 Overview 33

5.5.2 Conditions to rely on information provided by others (including external experts) 34

5.5.3 Reliance on external experts by audit committee members 35

6. How MAFR may impact the statutory duties of directors as outlined in section 76 of the Companies Act 36

6.1 Acting in the best interest of the entity – section 76(3) 36

6.1.1 Costs associated with changing auditors 36

6.1.2 Enforced rotation of auditors when it is not advisable from a business perspective to do so 37

6.2 Reliance on reports by experts – section 76(4) 38

6.2.1 Requirement to produce financial statements in accordance with applicable financial reporting standards 38

6.2.2 Objectives of an audit 39

6.2.3 How the auditors may assist management to produce financial statements in accordance with the applicable financial reporting standards 39

6.2.4 How MAFR may cause directors to not rely on the work performed by the auditor 40

7. Review of academic literature and statements from relevant stakeholders 41

7.1 Studies defining audit quality 42

7.2 The impact of auditor independence on audit quality 43

7.3 Effects of changing auditors on audit quality 46

7.3.1. Improvements created by new approaches 46

7.3.2 The impact of audit tenure on audit quality 47

7.3.2.1 Threats to independence created by long audit tenure 47

7.3.2.2 Improvements to audit quality as a result of long audit tenure 49

7.3.3 The impact of specialist knowledge gathered over time and its effects on audit quality 51
7.3.4 Access to improved technology and skills 52
7.3.5 Improvements to audit performance and professional scepticism 54
7.3.6 Costs associated with changing auditors 58
7.3.6.1 International findings 58
7.3.6.1.1 Effect on audit fees associated with the introduction of new auditors 58
7.3.6.1.2 The impact of low audit fees on audit quality 59
7.3.6.2 Local findings 62
7.3.5.6.1 Evidence of low-balling in South Africa 62
7.3.6.2.2 Cost concerns associated with MAFR raised by audit practitioners 64
7.3.6.3 Evidence of counter measures to threats created by low-balling 65
7.3.7 Impact on multinational audits 66
7.3.7.1 South African companies with global exposure 66
7.3.7.2 Complexities created for group audits 66
7.3.7.3 The implications for joint audits 68
8. Conclusion & recommendation 70
8.1 Conclusion 70
8.2 Recommendation 72
9. Appendices 73
9.1 Table 1: Audit tenure exceeding 20 years (as at October 2016) 73
9.2 Appendix 1: Eight largest South African companies and the extent of their foreign operations 74
9.3 Figure 1: Tepalagul and Lin 76
9.4 Figure 2: Model of effects (direct and indirect) of partner rotation on audit quality 76
10. Bibliography 77
10.1 Chapters in book 77
10.2 Journals, Conference Proceedings and other articles 77
10.3 Websites and Internet Resources 79
10.4 Legislation and legislative instruments 81

1. Introduction

The audit regulator in South Africa, the Independent Regulatory Board for Auditors (IRBA), published a consultation paper[1] in October 2016 outlining its proposal for the introduction of mandatory audit firm rotation (MAFR)[2] in South Africa. The IRBA then requested all relevant stakeholders to provide a written response to their proposal by 20 January 2017.

Each of the 'Big 4'[3] audit firms provided an official response which was written by one of their members in a key leadership position:
Dion Shango (CEO of PWC Southern Africa);
Lwazi Bam (CEO of Deloitte Africa);
Michael Bourne (EY South Africa Professional Practice Director); and
Michael Oddy (KPMG South Africa Head of Audit).

In their written responses, the 'Big 4' audit firms expressed many concerns regarding the implementation of MAFR. One of those concerns related to the potential impact that MAFR would have on the statutory duties of directors in South Africa. Extracts from their written responses related to the potential impact on directors' statutory duties have been provided below:

> Disenfranchises shareholders and undermines the authority of those charged with corporate governance. By forcing companies to change auditor, audit committees and shareholders are unable to retain the best available firm for the job. The Institute of Directors in South Africa have publicly expressed their views to this effect. This will conflict with directors' duty to act in the best interest of their company if they believe the incumbent will provide a better quality audit than other available firms. Similarly

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[1] IRBA 'Consultation Paper', available at https://www.irba.co.za/upload/IRBA%20Consultation%20Paper%202016.pdf, accessed 14 August 2017.
[2] See Chapter 2, Background, for further detail.
[3] Harber, M. 'An analysis of audit partner perceptions regarding the state of auditor independence in South African audit firms', (2016) *in Proceedings of the September 2016 Southern African Accounting Association Conference* at 6–24.

This refers to the four largest accounting and audit firms globally, namely, PwC, KPMG, Deloitte and EY. This distinction of audit firms is consistent with the distinctions commonly used as follows:

- 'Big four' audit firms refer to the largest four accounting and audit firms globally, namely Deloitte Inc., PwC (previously referred to as PricewaterhouseCoopers Inc.), EY (previously referred to as Ernst & Young Inc.) and KPMG Inc. The 'Big 4' audit firms are also referred to as 'large-tier' firms.
- All other audit firms are either classified as mid-tier or small-tier firms depending on various factors such as their respective global footprint and size and capabilities as an audit firm as judged by the resources available to them.

it will disenfranchise shareholders who are the owners of the company subject to audit. They will not be able to exercise their right to choose the best firm for their audit.[4]

The introduction of MAFR would force the audit committee of a company to change its auditor and would deprive it of its right to make an informed decision in the best interests of the company.[5]

MAFR would undermine the audit committee's ability to choose the best auditor for the job, and determine whether a change in auditor and the timing thereof is in the best interest of the company and its stakeholders.[6]

Given the responses above, it does beg the question whether MAFR will impact the statutory duties of directors.

In order to answer this question, this thesis sets out to achieve the following:

1) Briefly explain what the statutory duties of directors' entail. As the focus is on the statutory duties, codes of good practice and governance that are not legally binding on directors such as the King IV Report on Corporate Governance for Southern Africa are not considered as part of this thesis.

2) Analyse how MAFR could potentially impact the ability of the directors to discharge their duties. Where necessary, the potential impact of the implementation of MAFR is supported by academic literature and/or statements made by relevant, informed stakeholders such as local and international professional accounting bodies.

The academic literature and statements incorporate technical definitions from the financial reporting and auditing fields. As the intended audience for this thesis are legal professionals and academics, I have explained the technical financial reporting and auditing jargon in a

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[4] Michael Bourne 'Response to Consultation Paper on Mandatory Audit Firm Rotation' at 5, available at *https://www.saica.co.za/portals/0/technical/assurance/IRBA_CONSULTATION_PAPER_COMMENT_LETTER.PDF*, accessed on 14 August 2017.

[5] Lwazi Bam 'Deloitte Response to IRBA Consultation Paper ("the Paper"): Measures to Strengthen Auditor Independence' at 11, available at *https://www.saica.co.za/portals/0/technical/assurance/Deloitte%20response%20to%20the%20IRBA%20Consultation%20Paper%2020%20January%202017.pdf*, accessed on 14 August 2017.

[6] Michael Oddy 'The KPMG response to IRBA's Consultation Paper Issued on 25 October 2016' at 3, available at *https://www.saica.co.za/portals/0/technical/assurance/KPMG%20response%20to%20IRBA%20Consultation%20Paper.pdf*, accessed on 14 August 2017.

simplified manner to allow readers with little to no financial reporting and/or auditing background to understand the terminology being used.

2. Background

This section is provided to enable readers with little to no context of MAFR to understand what MAFR entails.

2.1 Objective of mandatory audit firm rotation (MAFR)

2.1.1. Primary objective

On 5 June 2017, in response to concerns regarding the impact of auditor independence[7] on audit quality, the audit regulator in South Africa, the IRBA, announced[8] the application of s 10(1) of the Auditing Profession Act 26 of 2005 (hereafter referred to as the 'Auditing Profession Act) to publish the ruling to introduce the requirement of MAFR with effect from 1 April 2023.

7 Independent Regulatory Board of Auditors (IRBA) 'The IRBA Rules regarding Improper Conduct and Code of Professional Conduct for Registered Auditors (revised 2014)' available at *https://www.irba.co.za/upload/Rules%20and%20IRBA%20Code%20(Revised%202014)%20Issued%2017%20March%202014.pdf*, accessed 14 August 2018.

The IRBA Rules regarding Improper Conduct and Code of Professional Conduct for Registered Auditors (revised 2014), (hereafter referred to as the 'ÍRBA Code of Professional Conduct') defines independence as:

> Independence of mind – the state of the mind that permits the expression of a conclusion without bring affected by influences that compromise professional judgement, thereby allowing an individual to act with integrity, and exercise objectivity and professional scepticism.
> Independence of appearance – the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a firm's, or a team of the audit or assurance team's, integrity, objectivity or professional scepticism has been compromised.

8 IRBA 'Rule on Mandatory Audit Firm Rotation' available at *https://www.irba.co.za/upload/Government%20Gazette%20with%20Final%20Rule%20-%201%20June%202017.pdf*, accessed on 14 August 2017.

In terms of the MAFR ruling announced by IRBA, the audit firm (including any audit firm in a network[9] of audit firms) may not serve as the auditors of a public interest entity[10] client for more than ten consecutive years. After the completion of ten consecutive years, the audit firm must be rotated and cannot accept re-appointment of the public interest entity for a period of five years.[11]

2.1.2. Ancillary objectives

Before announcing the implementation of MAFR, IRBA issued a consultation paper[12] to various stakeholders affected by the implementation of MAFR. The consultation paper states that the promotion of transformation and the decrease of market concentration by the 'Big 4' audit firms were regarded as additional benefits for the implementation of MAFR.[13]

This thesis does not attempt to consider the rationale for these additional benefits nor whether MAFR will help to accomplish those additional benefits.

2.2. Entities excluded from the MAFR requirement

It is interesting to note that a public interest entity, as defined by IRBA, does not include entities within the public sector.

While this paper does not intend to analyse the reason(s) why, it should be noted that the audits of entities within the public sector fall within the scope of the Auditor General South

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[9] In terms of the definition section of the IRBA Code of Professional Conduct, a network is defined as:

> A larger structure:
> (a) That is aimed at co-operation; and
> (b) That is clearly aimed at profit or cost sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand-name, or a significant part of professional resources.

[10] Op cit note 8

As defined in section 290.25 to 290.26 of the IRBA Code of Professional Conduct, a public interest entity is:

> (a) A listed entity; and
> (b) Any entity:
> i. defined by regulation or legislation as a public interest entity; or
> ii. for which an audit is required by regulation or legislation to be conducted in compliance with the same independence requirements that apply to the audit of listed entities. Such regulation may be promulgated by any relevant regulator, including an audit regulator.

[11] Op cit note 9.
[12] Op cit note 1.
[13] IRBA 'Consultation Paper' ibid para 2.2.3 and 5.10.

Africa (AGSA). The mandate and functions of the AGSA are established through Chapter 9 of Constitution of the Republic of South Africa 1996 (hereafter referred to as 'The Constitution'). Through the Constitution[14], the AGSA is the only institution established to audit and report on entities within the public sector. Subsection 2 of section 181 also provides that all Chapter 9 institutions are independent.

Therefore, in order for the IRBA to include public sector entities within the definition of 'public interest entities' this would need to entail a change to The Constitution to allow other entities, besides the AGSA, to audit the entities within the public sector. The power to impose a change to The Constitution extends far beyond the powers of IRBA and would need to be made through a two-thirds[15] majority vote by the National Assembly. Any amendment to the Constitution would undoubtedly be a difficult and time-consuming process for the audit regulator.

2.3 Future area of research

It is interesting to note that a change to MAFR was made through the Auditing Profession Act and not the Companies Act 71 of 2008 (hereafter referred to as the 'Companies Act' or 'the Act').

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14 Section 188 of Chapter 9 of The Constitution states:

(1) The Auditor-General must audit and report on the accounts, financial statements and financial management of—

(a) all national and provincial state departments and administrations;

(b) all municipalities; and

(c) any other institution or accounting entity required by national or provincial legislation to be audited by the Auditor-General.

15 Section 74 of the Constitution states:

(1) Section 1 and this subsection may be amended by a Bill passed by—
(a) the National Assembly, with a supporting vote of at least 75 per cent of its members; and
(b) the National Council of Provinces, with a supporting vote of at least six provinces.

(2) Chapter 2 may be amended by a Bill passed by—
(a) the National Assembly, with a supporting vote of at least two thirds of its members; and
(b) the National Council of Provinces, with a supporting vote of at least six provinces.

(3) Any other provision of the Constitution may be amended by a Bill passed—
(a) **by the National Assembly, with a supporting vote of at least two thirds of its members [Emphasis added]**; and
(b) also by the National Council of Provinces, with a supporting vote of at least six provinces, if the amendment—
(i) relates to a matter that affects the Council;
(ii) alters provincial boundaries, powers, functions or institutions; or
(iii) amends a provision that deals specifically with a provincial matter.

Another respondent to IRBA's consultation paper, the Association of Savings & Investment South Africa (ASISA), a non-profit company operating under a mandate of entities managing R8.7 trillion worth of assets, noted the following in their response to IRBA:

> The objects of the Auditing Professions Act, among others, include regulating audits performed by registered auditors and to develop and maintain auditing standards for auditors. IRBA's statutory functions, in broad terms, include regulating the quality within the auditing profession. It is submitted that any requirements in respect of companies should be formulated and proposed by the Department of Trade and Industry's Specialist Committee on Company Law and/or the financial sector regulators, after policy analysis and a regulatory impact assessment as well as public consultation as required in terms of the Promotion of Administrative Justice Act.[16]

> Before implementation can be considered, the Department of Trade and Industry's Specialist Committee on Company Law and the financial sector regulators would have to formulate proposals and engage in a public consultation process. A detailed regulatory impact analysis (potentially a pilot test with willing participants) should be conducted. Such impact analysis should include both the supply side (audit firms and auditors) and the demand side (users of audit services, including companies/other entities that have mandatory or voluntary audits and different classes of investors).[17]

This thesis does not attempt to assess why the change was not made through the Companies Act, although this could be an area for future research. A change of this nature, impacts, whether directly or indirectly, various stakeholders, including but especially, the directors of the public interest entities and the performance and fulfilment of their statutory duties imposed in terms of the Companies Act.

[16] Leon Campher, Sunette Mulder, Adri Messerschmidt 'IRBA Consultation Paper on Mandatory Audit Firm Rotation (MAFR)' at 2, received directly from CEO, Leon Campher, available on request.
[17] Ibid at 5.

3. Research methodology

The research for this thesis was conducted by performing a desktop research and literature review. The initial idea for this thesis was obtained through research performed with other accounting academics in the area of MAFR. The research typically looked at MAFR from an accounting perspective but, to the best of my knowledge, no studies have attempted to consider the impact of the implementation of MAFR from a legal perspective.

I then reviewed the Companies Act to identify sections which may be applicable to my thesis.

In order to expand upon my thesis and address the purpose of the thesis, I was able to access a wide variety of sources via online searches to obtain information from accredited journals, websites, articles, professional and ethical standards, case law and textbooks. I considered whether these sources provided sufficient and appropriate evidence to support the findings of this thesis. In order to present a balanced argument, different views have been considered and presented in this thesis.

At the time of writing this thesis, I am fortunate to have and to have been able to draw upon a combined seven years of practical and theoretical auditing experience developed through work experience (during and after the completion of my articles) in the field of commerce and teaching auditing at a final year undergraduate and postgraduate level.

I am also a registered member with the South African Institute of Chartered Accountants (SAICA), a professional accounting body in South Africa with over 40 000 members[18] in 2018. Many would regard chartered accountants to have specialised knowledge in the field of accounting.

Where relevant, I have used my experience and knowledge to add pertinent insights to this thesis. These insights are informed by my experiences and the reader should be aware that the

[18] South African Institute of Chartered Accountants (SAICA) 'Constituencies 2018' available at *https://www.saica.co.za/Portals/0/Members/About%20members/Constit2018b.pdf*, accessed on 7 December 2018.

insights may be subject to anchoring bias[19] but have been included as my accounting background allows me to add a different perspective to this legal thesis.

4. Existing legislative requirements aimed at promoting auditor independence in South Africa

4.1 Introduction

The Companies Act has a number of requirements aimed at promoting auditor independence by providing prohibitions against the appointment of a person/audit firm as auditor (s 90), providing for mandatory audit partner rotation (s 92) and providing oversight by the audit committees to ensure that independence of the auditor is assessed prior to appointment (s 94).

An overview of each of the legislative requirements is provided below and then discussed insofar as it relates to MAFR.

4.2 Section 90 of the Companies Act

4.2.1 Overview

Section 90 is a legislative requirement aimed at promoting auditor independence. Under section 90, a company is required to appoint an auditor subject to certain prohibitions. Section 90 prohibits a person being appointed as the auditor if they had a close working relationship with the company within a period of five years prior to their appointment as auditor.

[19] Gretchen B. Chapman & Eric J. Johnson 'The limits of anchoring' (1994) 7 *Journal of Behavioral Decision Making* available at https://onlinelibrary.wiley.com/doi/abs/10.1002/bdm.3960070402, accessed on 20 November 2018.
'Anchoring and adjustment is a pervasive bias in which decision makers are influenced by random or uninformative numbers or starting points.'

4.2.2 Proposed amendment under South African Companies Amendment Bill, 2018

Since being passed in 2011, the Companies Act has not undergone any substantive amendments. The Department of Trade and Industry have proposed a handful of amendments to try and align the Companies Act with international best practices and trends, reduce the burden placed on many companies with the application of some of its sections, while also improving investor confidence.[20]

On 21 September 2018, the Department of Trade and Industry published the South African Companies Amendment Bill 2018 (hereafter referred to as the 'Bill') and invited comments from relevant stakeholders.[21] The Bill has proposed that the five year 'cooling off' period in s 90 be reduced to two years.[22]

At the time of writing this thesis, the Bill has not been enacted. Upon review of the Bill, there are no proposed amendments to provisions which may alter the statutory duties of directors.

4.2.3 Insight into proposed amendment insofar as it relates to MAFR

It is interesting that a change has been proposed to s 90.[23]

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[20] CliffDekkerHofmeyr 'Newly-published Companies Amendment Bill: Closing the gaps and clearing the air' available at https://www.cliffedekkerhofmeyr.com/en/news/publications/2018/Corporate/corporate-and-commercial-alert-1-october-newly-published-companies-amendment-bill-closing-the-gaps-and-clearing-the-air.html, accessed on 20 November 2018.

[21] NortonRoseFulbright 'The South African Companies Amendment Bill 2018' available at https://www.financialinstitutionslegalsnapshot.com/2018/09/the-south-african-companies-amendment-bill-2018/, accessed on 20 November 2018.

[22] Ibid

[23] Section 90 of the Companies Act states:

> (1) Upon its incorporation, and each year at its annual general meeting, a public company or state-owned company must appoint an auditor.
> (2) To be appointed as an auditor of a company, whether as required by subsection (1) or as contemplated in section 34(2), a person or firm—
> (a) must be a registered auditor;
> (b) in addition to the prohibition contemplated in section 84(5), must not be—
> (i) a director or prescribed officer of the company;
> (ii) an employee or consultant of the company who was or has been engaged for more than one year in the maintenance of any of the company's financial records or the preparation of any of its financial statements;
> (iii) a director, officer or employee of a person appointed as company secretary in terms of Part B of this Chapter;
> (iv) a person who, alone or with a partner or employees, habitually or regularly performs the duties of accountant or bookkeeper, or performs related secretarial work, for the company;
> (v) a person who, at any time during the five financial years immediately preceding the date of appointment, was a person contemplated in any of subparagraphs (i) to (iv); or

One of the arguments put forward in favour of this amendment is that it will allow individuals who are still familiar with the operations of the entity to be able to audit the entity.[24] Being familiar with the entity allows the auditor to more easily identify instances which may pose a threat to the financial statements being free from material misstatement.[25] However, a 'cooling off' period is still imposed, although decreased, which reinforces the importance of the potential auditor remaining independent.

It is interesting to note that the Department of Trade and Industry has decided to reduce the 'cooling off' rather than increase it, particularly in light of the independence concerns raised by the IRBA. If the Department of Trade and Industry perceived there to be a problem with the independence of the auditors and the quality of audits in South Africa, this would have undoubtedly prompted more stringent regulations to be imposed rather than relaxing the existing statutory measures which are already in place to promote auditor independence. Although the purpose of the thesis is to not consider why the introduction of MAFR was not made through the Companies Act, it does also pose the question, based on the proposed amendment to relax legislative measures in place to promote auditor independence, whether an amendment for MAFR through the Companies Act would have had the support of the Department of Trade and Industry.

(vi) a person related to a person contemplated in subparagraphs (i) to (v); and
(c) must be acceptable to the company's audit committee as being independent of the company, having regard to the matters enumerated in section 94(8), in the case of a company that has appointed an audit committee, whether as required by section 94, or voluntarily as contemplated in section 34(2).

[24] Op cit note 23
[25] A misstatement is a difference between what management has recognised compared to what should have been recognised in terms of the applicable financial and legal reporting frameworks.

A misstatement is considered to be material if it will affect a user of the financial statements economic decision making.

Auditors therefore do not provide assurance that the financial statements are free from all misstatements but rather that the financial statements are free from all material misstatements. Where the financial statements are not free from material misstatement, the auditor will modify the opinion he/she expresses in the auditor's report.

4.2.4 Rights of shareholders to appoint auditors

One of the measures that remains is that s 90 requires the shareholders to appoint the auditor at the annual general meeting. The shareholders are one of the many users of the financial statements and when choosing to re-appoint the auditors, the shareholders have the power to exercise their minds and not appoint an auditor who they believe is not independent. This however does require shareholders to be cognisant of the requirements of s 90 and to be actively engaged in matters which may threaten the independence of the auditor. This thesis does not attempt to consider how the introduction of MAFR will impact the rights of shareholders to appoint the auditor. This could be an area for future research.

4.3 Section 92 of the Companies Act

4.3.1 Overview

Section 92 is another one of the current legislative measures which is aimed at promoting auditor independence.[26]

In terms of s 92[27] of the Companies Act, an individual (not the audit firm) may not serve as the registered auditor for more than five consecutive years. In terms of s 92, you could have the situation where an audit firm may audit the same company for several years while the individual audit partner is rotated after a five-year period. A new individual audit partner within the same audit firm can then replace the outgoing individual audit partner for the next five-year period and so on and so forth.

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27 In terms of s 92 of the Companies Act:

> (1) The same individual may not serve as the auditor or designated auditor of a company for more than five consecutive financial years.
>
> (2) If an individual has served as the auditor or designated auditor of a company for two or more consecutive financial years and then ceases to be the auditor or designated auditor, the individual may not be appointed again as the auditor or designated auditor of that company until after the expiry of at least two further financial years.
>
> (3) If a company has appointed two or more persons as joint auditors, the company must manage the rotation required by this section in such a manner that all of the joint auditors do not relinquish office in the same year.

4.3.2 MAFR and the application of section 92 of the Companies Act

MAFR should not be confused with s 92.

However, once MAFR becomes effective, the audit firm may only audit a public interest entity for a maximum period of ten years after which there will be an enforced rotation to another audit firm. The implementation of MAFR does not change the maximum period the individual may serve as the registered auditor of an audit client in terms of s 92 of the Companies Act.

The existence of s 92 is aimed at promoting rotation of the auditor and does not abdicate any of the directors from discharging their statutory responsibilities.

4.4 Section 94

4.4.1 Overview

The final legislative requirement aimed at promoting auditor independence are the performance of certain duties by the audit committee as required by s 94 of the Companies Act. In their written response to the IRBA, one of the 'Big 4' audit firms eluded to the importance of the role of the audit committee:

'Every public and state owned company has to have an audit committee. This is designed to underpin auditor independence.'[28]

One of the duties of the audit committee under s 94(7)(a) is the requirement for the audit committee to nominate an independent auditor for appointment by the shareholders.

The audit committee is required in terms of s 94(8)[29] to apply their minds and consider various factors in deciding whether the auditor is independent of the company. As MAFR

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[28] Op cit note 4 at 3.

[29] Per sec 94(8):

In considering whether, for the purposes of this Part, a registered auditor is independent of a company, the audit committee of that company must –

(a) Ascertain that the auditor does not receive any direct or indirect remuneration or other benefit from the company, except-

(i) As auditors; or

(ii) For rendering other services to the company, to the extent permitted in terms of subsection 7(d)

applies to the auditors of public interest entities,[30] many of those entities will have to abide by the requirements of s 94 read with s 84 of the Companies Act. Apart from private companies, personal liability or non-profit companies who are required to be audited in terms of the Companies Act or the regulations,[31] all other public interest entities will have to establish audit committees in terms of s 94 of the Companies Act.[32]

Section 94 is not applicable to private, personal liability or non-profit companies in terms of s 84[33] of the Companies Act unless the company is required to appoint an audit committee in terms of its Memorandum of Incorporation or is required to be audited in terms of the regulations to the Companies Act as a matter of being in the best interest of the public, as determined by the entity's public interest score.

4.4.2 Requirement for audit committee members to carry out their duties in accordance with section 76

(b) Consider whether the auditor's independence has been prejudiced –
  (i) As a result of a previous appointment as auditor, or
  (ii) Having regard to the extent of any consultancy, advisory other work undertaken by the auditor for the company
(c) Consider compliance with other criteria to independence or conflict of interest as prescribed by the Independent Regulatory Board for Auditors established by the Auditing Profession Act

[30] Op cit note 8.
As defined in section 290.25 to 290.26 of the amended IRBA Code of Professional Conduct.

[31] In terms of Regulation 28(2) of the Companies Regulations. 2011 GNR.351 of 26 April 2011:
In addition to public companies and state-owned companies, any company that falls within any of the following categories in any particular financial year must have its annual financial statements for that financial year audited:
(a) 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 R 5 million;
(b) any non-profit company, if it was incorporated—
  (i) directly or indirectly by the state, an organ of state, a state-owned company, an international entity, a foreign state entity or a foreign company; or
  (ii) (ii) primarily to perform a statutory or regulatory function in terms of any legislation, or to carry out a public function at the direct or indirect initiation or direction of an organ of the state, a state-owned company, an international entity, or a foreign state entity, or for a purpose ancillary to any such function; or
(c) any other company whose public interest score in that financial year, as calculated in accordance with regulation 26 (2)—
  (i) is 350 or more; or
  (ii) is at least 100, if its annual financial statements for that year were internally compiled.

[32] In terms of s 94(7) of the Companies Act.

[33] In terms of Section 84(1)(c):
This chapter [reference to chapter 3 which contains section 94] applies to private, personal liability or a non-profit company-
  (i) If the company is required to be audited by this Act or the regulations to have its annual financial statements audited every year: Provided Part B [Company Secretary] and D [Audit Committees] will not apply to any such company; or
  (ii) Otherwise, only to the extent that the company's Memorandum of Incorporation so requires.

In performing their statutory duties, as required by s 94, of the Companies Act, the members of the audit committee are required to exhibit certain standards of conduct as outlined by s 76 of the Companies Act.

5. Standards of directors' conduct (section 76 of the Companies Act)

5.1 Introduction

Before we can consider whether the implementation of the MAFR will inhibit the directors from discharging their duties in accordance with s 76 of the Companies Act, it is important to first understand what the standards of directors' conduct entail.

With the implementation of the New Companies Act in May 2011, directors' duties have undergone a process of codification. Under its predecessor, the Companies Act 61 of 1973, many of the directors' duties were partially codified and established through common law and precedent set by case law.

This thesis will focus on the statutory duties established under the Companies Act 71 of 2008. The Companies Act does not clearly explain what each of the duties entail and therefore, it will be necessary to make use of the common law and case law in order to understand what the duties, as described in the Companies Act, entail.

The directors' duties have been a focus of many academic literature and case law over the years. Understanding the directors' duties is one aspect of this study that is necessary to understand how the introduction of MAFR will impact the ability of the directors to discharge their statutory duties. However, understanding the directors' duties is by no means the primary focus of this thesis. As such, an overview of s 76 is provided and a brief explanation, with precedent from case law and common law, of each of the subsections within s 76 is provided in section 5.2 of this thesis.

5.2 Section 76(1) – scope

5.2.1 Overview

> (1) In this section, 'director' includes an alternate director, and—
> (a) a prescribed officer; or
> (b) a person who is a member of a committee of a board of a company, or of the audit committee of a company,
> irrespective of whether or not the person is also a member of the company's board.

5.2.2 Conflict between section 76(1) and section 72(2)

It is interesting to note that the definition of 'director' includes 'a person who is a member of the audit committee of a company.' This part of the definition almost seems redundant given the requirements of s 94(4)(a) which states:

'Each member of an audit committee of a company must be a director of a company…'

The above requirement seems to be in direct conflict with s 72(2) which states:

> Except to the extent that the Memorandum of Incorporation provides otherwise, the board of a company may –
>
> (2) Except to the extent that the Memorandum of Incorporation of a company, or a resolution establishing a committee, provides otherwise, the committee—
> (a) may include persons who are not directors of the company, but—
> (i) any such person must not be ineligible or disqualified to be a director in terms of section 69;

It would be advisable for the Companies Act to clear up the conflict between s 72 and s 94.

5.2.3 Do external experts fall within the ambit of section 76(1)?

The audit committee may encounter issues which are beyond the scope of their area of expertise[34] in which case, they will rely on external experts for advice. Given the

[34] In terms of s 42 of the Regulations to the Companies Act:

> For the purposes contemplated in section 94(5), at least one third of the members of a company's audit committee at any particular time must have qualifications, or experience, in economics, law, corporate governance, finance, accounting, commerce, industry, public affairs or human resource management.

requirements of s 94(4), those external experts will not qualify for membership to the audit committee given that they are not directors of the company.

The question arises as to whether those external experts would also be subject to the requirements of s 76. Further research is required in this area. If the intention of s 76 was to include external experts, this would be unfortunate as those external experts would be subject to the onerous requirements of s 76 without the compensation of remuneration as a director.

5.2.4 The impact on statutory duties arising from the implementation of MAFR confined to audit committee members

It is also interesting to note that any impact on the statutory duties imposed by s 76 because of the implementation of MAFR will only be confined to the members of the audit committee in terms of the requirement of s 94(10):

> Neither the appointment nor the duties of an audit committee reduce the functions and duties of the board or the directors of the company, except with respect to the appointment, fees and terms of engagement of the auditor.

As the audit committee is responsible for nominating the auditor for appointment,[35] only members of the audit committee could potentially have their statutory duties impacted by the implementation of MAFR.

5.3 Section 76(2) – duty to not gain an advantage nor knowingly cause harm; duty to disclose material information

5.3.1 Overview

> (2) A director of a company must—
>
> (a) not use the position of director, or any information obtained while acting in the capacity of a director—
>
> > (i) to gain an advantage for the director, or for another person other than the company or a wholly-owned subsidiary of the company; or
> > (ii) to knowingly cause harm to the company or a subsidiary of the company; and

[35] Section 94(7)(a) of the Companies Act.

(b) communicate to the board at the earliest practicable opportunity any information that comes to the director's attention, unless the director—

(i) reasonably believes that the information is—

(aa) immaterial to the company; or

(bb) generally available to the public, or known to the other directors; or

(ii) is bound not to disclose that information by a legal or ethical obligation of confidentiality.

5.3.2 Purpose of section 76(2)(a)(i) – duty to not gain an advantage

Section 76(2)(a)(i) is aimed at deterring individuals from using information or opportunities which they became aware of in their capacity as directors to generate gains (financial or otherwise) in their personal capacity or that of another person (referred to as the common law no-profit rule) or to divert the corporate opportunity for themselves thereby depriving the company of the opportunity (known as the common law corporate opportunity rule). Section 76(2)(a)(i) also imposes the duty on directors to avoid a conflict of interest in which the individuals should not let their personal interests' conflict with their duties as a director.[36]

5.3.2.1 Precedent from case law

The application of the no-profit rule and the duty to avoid a conflict of interest is best encapsulated in the rulings for Regal (Hastings) v Gulliver,[37] Robinson v Randfontein Gold Mining Co Ltd[38]and Da Silva v CH Chemicals (Pty) Ltd.[39] The latter two cases reinforce the legal principle of the corporate opportunity rule.

5.3.3 Purpose of section 76(2)(a)(ii) – duty to not knowingly cause harm

Section 76(2)(a)(ii) requires a director to not knowingly cause harm to a company. The term 'harm' is not defined in s 1 of the Companies Act.

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[36] Farouk HI Casiem 'The duties and the liability of directors' in Farouk HI Casiem (ed) Contemporary Company Law 2 ed (2012) 507-63.

[37] [1942] 1 All ER 378 (HL); [1967] AC 134

[38] 1921 AD 168

[39] 2008 (6) SA 620 (SCA)

5.3.3.1 Defining what is meant by 'harm'

As no definition of 'harm' is provided in the Companies Act, other relevant sources for a definition are considered.

The Oxford Dictionary[40] defines 'harm' as:

> Noun:
> 1. Physical injury, especially that which is deliberately inflicted.
>   1.1 Material damage.
>   1.2 Actual or potential ill effects or danger.
>
> Verb:
> 1. Physically injure.
>   1.1 Damage the health of.
>   1.2 Have an adverse effect on.

Using the definition above and the reading of s 77 of the Companies Act[41] and applying it within the context of a company, 'harm' would mean any loss, damage or costs suffered by the company because of the director breaching their fiduciary duties.

5.3.3.2 Defining what is meant by 'knowingly'

Attention must be drawn to the word 'knowingly' in s 76(2)(a)(ii). 'Knowingly' is defined in s 1 of the Companies Act*:*

> 'Knowingly' when used with respect to a person, and in relation to a particular matter, means that the person either-
> (a) Had actual knowledge of the matter; or
> (b) Was in a position in which the person reasonably ought to have –
>   i. Had actual knowledge
>   ii. Investigated the matter to an extent that would have provided the person with actual knowledge; or
>   iii. Taken other measures which, if taken, would presumably be expected to have provided the person with actual knowledge of the matter.

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[40] Oxford Living Dictionaries 'Harm' available at *https://en.oxforddictionaries.com/definition/harm*, accessed on 8 September 2018.

[41] Section 77(2)(a) of the Act states

> A director must be held liable in accordance with the principles of the common law relating to breach of a fiduciary duty, for any loss, damage or costs sustained by the company as a consequence of any breach by the director of a duty contemplated in section 75, 76(2) or 76(3) (a) or (b).

The definition above implies that the director must be aware of their actions and the nature of their conduct. Any acts of harm because of ignorance or mistake would not necessarily fall outside the scope of s 76(2)(a)(ii) as the use of 'was in a position in which the person reasonably ought to have…' implies an objective rather than a subjective test.[42] Given the high degree of skill and expertise required of directors, acts of ignorance or mistake do not necessarily fall outside the scope of s 76 if the mistake would not necessarily be expected of directors in general.

5.3.4 Purpose of section 76(2)(b) – duty to disclose material information

Subsection 2(b) requires directors to disclose any material information to the company as directors are required in terms of the common law principles to take care of and protect sensitive corporate information.

This subsection is not impacted by the introduction of MAFR as an enforced rotation of auditors will not create any instances whereby directors may be put in situations whereby they may potentially have material information which they do not disclose to the company.

As such, this statutory duty will not be expanded on for the purposes of this thesis.

5.4 Section 76(3) – duty to act in good faith, in the best interests of the entity with a degree of care and skill

5.4.1 Overview

> (3) Subject to subsections (4) and (5), a director of a company, when acting in that capacity, must exercise the powers and perform the functions of director—
>
> (a) in good faith and for a proper purpose;
> (b) in the best interests of the company; and
> (c) with the degree of care, skill and diligence that may reasonably be expected of
>
> a person—
>
> (i) carrying out the same functions in relation to the company as those carried out by that director; and
> (ii) having the general knowledge, skill and experience of that director.

[42] Op cit note 43.

5.4.2 Explaining what the statutory duties in section 76(3) entail using case law and common law

The director duties to act in good faith and in the best interest of the company are considered to be the two fiduciary duties of utmost importance in terms of the common law and is the underlying basis underpinning all other fiduciary duties.[43]

5.4.2.1 Duty to act in good faith (subsection a)

The duty of good faith requires directors to act honestly. In order to be found in breach of this duty, the director must be aware that his or her actions were wrong. Directors are therefore required to act honestly in terms of what they believe to be in the best interests of the company. This subjective test was established based on the legal principle established in Re Smith & Fawcett Ltd[44] whereby the court stated that it is not what the courts consider to be in the best interest of the court but rather what the directors believe to be in the best interests of the company. Likewise, in Hogg v Cramphorn Ltd[45] it was established that it is not for the courts to question the actions of directors that have been performed honestly and in accordance with the powers conferred upon them. In Darvall v North Sydney Brick & Tile Co Ltd[46] it was established that the directors have more knowledge, time and skill to better assess what is in the best interest of the company than the courts. When applying the subjective test for good faith, in Greenhalgh v Ardene Cinemas Ltd[47] and Regentcrest plc v Cohen[48], the state of the director's mind must be considered.[49]

The duty of good faith encompasses the duties of directors to exercise their minds independently and the duty to not exceed the limits of the powers conferred upon them. In exercising their minds independently, this requires directors to act objectively and be free from bias and undue influence as established in Kregor v Collins.[50] If a director is not free

[43] Op cit note 43.
[44] [1942] Ch 304 at 306
[45] [1967] Ch 254 at 268
[46] (1989) 15 ACLR 230 SC (NSW)
[47] [1950] 2 All ER 1120 (CA)
[48] [2001] 1 BCLC 80 at 104
[49] Op cit note 43.
[50] (1913) 109 LT 225 (KB and CA)

from bias and undue influence, this will inhibit the ability of the director to act honestly in what they believe to be the best interest of the company.[51]

5.4.2.2 Duty to act in the best interest of the entity (subsection b)

However, in Shuttleworth v Cox[52] if there are no reasonable grounds for the director believing that their actions were in the best interests of the company, this may result in the director failing to demonstrate good faith in carrying out their duties. Furthermore, while the courts will not assess whether the actions of the directors were in the best interests of the company, the test is whether a reasonable man would believe that the actions of the director are in the best interest of the company. Teck Corp Ltd v Millar[53] and Extrasure Travel Insurances Ltd v Scattergood[54] also emphasised the need for reasonable grounds as a basis for the belief that the actions of a director were in the best interest of the company.[55]

5.4.2.3 Duty to act for a proper purpose (subsection a)

While a director may exercise their duties honestly in what they believe to be the best interests of the company, the director will be in breach of their fiduciary duty if they do not exercise their power for the purpose it was intended for but rather for another unintended purpose.[56] This will result in the director not exercising their fiduciary duties for a 'proper purpose'.

[51] Andrew Keay 'The Duty of Directors to Exercise an Independent Judgement' (2008) 29 *The Company Lawyer (*No 10) 290.
[52] [1927] 2 KB 9 at 23
[53] (1972) 33 DLR (3d) 288 (BCSC)
[54] [2003] 1 bclc 598 (ChD) at 619
[55] Op cit note 43
[56] Ibid

In Hogg v Cramphorn Ltd[57] the court established that the test for 'proper purpose' is objective, unlike the test for 'good faith', which is subjective. In Extrasure Travel Insurances Ltd v Scattergood,[58] the court applied a four-step test to determine whether the action of a director is for a proper purpose:

1. Identify the power which is subject to dispute,
2. Identify the proper purpose for which the director was intended to exercise the power in dispute,
3. Identify the purpose which was actually achieved by the director exercising their power, and
4. Assess whether the power was carried out for a 'proper purpose'

Based on the test applied above, it is clear that it is not necessary to prove that the actions of the director was dishonest. Nor is it necessary to prove that the director was aware that he or she was carrying out their powers for a purpose other than what it was initially intended for.[59]

5.4.2.4 Duty to act with a degree of care, skill and diligence (subsection c)

Lastly, subsection 3(c) imposes a duty on directors to act with a degree of care, skill and diligence. Under the common law, directors are required to act with good faith, honesty and loyalty. The duty to act with a degree of care, skill and diligence is therefore no longer a fiduciary duty but is now imposed on directors in terms of the Act. However, despite not being a fiduciary duty, the common law does impose liability on directors for delictual damages[60] suffered by the company as a result of negligence caused from the incompetent or careless actions of directors. In determining whether the actions of directors are considered incompetent or careless, reference has to be made to the experience, skill and ability of the person in question – a subjective test.[61] Therefore, less experienced directors are held to a lower standard of care and skill. Unless a specific qualification is required in terms of the Memorandum of Incorporation per s 69[62] of the Act, directors are not required to have any

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[57] Supra note 53
[58] Supra note 62
[59] Op cit note 43.
[60] Ex parte Lebowa Development Corporation Ltd 1989 (3) SA 71 (T); Du Plessis NO v Phelps 1995 (4) SA 165 (C)
[61] Op cit note 43.
[62] In terms of s 69(6) of the Act:

specific qualification in order to be appointed.

However, in terms of s 94(5), the Minister may prescribe minimum qualifications which the audit committee, as a whole, must possess. The Regulations to the Act,[63] states that at least one third of the members of the audit committee must possess relevant commercial academic qualifications or experience. Per reg 42 of the Act, the academic qualifications or experience must relate to 'economics, law, corporate governance, finance, accounting, commerce, industry, public affairs or human resource management.' It must, however, be emphasised that the reg 42 is aimed at ensuring that the audit committee, as a whole, rather than on an individual basis, is suitably competent to perform their functions.

Given the use of the word 'or' this implies that the audit committee, as a whole, does not need qualifications or experience in all of the fields identified in regulation 42. Given the higher degree of competence expected from the audit committee, as a whole, it does raise interesting questions in terms of how the test for experience, skill and ability, as described above, will be applied to members of the audit committee. Section 76(3)(c) clarifies this by stating:

> with the degree of care, skill and diligence that may reasonably be expected of a person—
> (i) carrying out the same functions in relation to the company as those carried out by that director; and
> (ii) having the general knowledge, skill and experience of that director.

The wording of s 76(3)(c) therefore introduces a two-step test, which is partly objective and partly subjective. Through the wording of s 76(3)(c)(i) above, the Act requires the director to act with a degree of care, skill and diligence that would be expected of a reasonable person, emphasis on a reasonable person rather than that of a reasonable director, carrying out the same duties as the director. This is an objective test. Even if the director is less experienced, the minimum standard of care and skill is what would be expected of a person acting as a director.[64]

In addition to the provisions of this section, the Memorandum of Incorporation of a company may impose-
(a) additional grounds of ineligibility or disqualification of directors; or
(b) minimum qualifications to be met by directors of that company.

[63] See reg 42 of the Act.
[64] Op cit note 43.

However, if the director has any additional qualifications or experience, s 76(3)(c)(ii) introduces a subjective test which then requires the director to act with a higher degree of care, skill and experience as their increased skill and competence is considered. This therefore means that although the audit committee, as a whole, must possess relevant commercial qualifications and experience, the individual members of the audit committee who possess additional qualifications and experience will be expected to exercise a higher degree of care and skill than those members of the audit committee who do not possess those qualifications or experience stipulated in reg 42.

It is interesting to note that through the wording of 'carrying out the same functions… as those carried out by that director' it implies that there is a different standard of skill which is expected of non-executive directors than executive directors. In terms of s 94(4)(a) and (b)(i) and (ii), each member of the audit committee must be a non-executive director.[65] Non-executive directors are not involved in the day to day running of the company and are therefore not expected to possess the same level of knowledge of the company as directors who are involved in the day to day running of the company. Therefore, it makes sense that non-executive directors, ceterus paribus, are held to a lower standard of skill than the executive directors.

Despite not being required to possess academic qualifications or experience in all the fields identified in reg 42 of the Act, s 76 (4) does allow the members of the audit committee to make use of experts in fields where the audit committee does not have the necessary skills, knowledge and experience to ensure that the audit committee effectively discharges its duties in terms of section 94(7).[66]

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[65] In terms of s94(4) of the Companies Act:

> Each member of an audit committee of a company must-
> (a) be a director of the company, who satisfies any applicable requirements prescribed in terms of subsection (5);
> (b) not be-
> (i) involved in the day-to-day management of the company's business or have been so involved at any time during the previous financial year;
> (ii) a prescribed officer, or full-time employee, of the company or another related or inter-related company, or have been such an officer or employee at any time during the previous three financial years; or
> (iii) a material supplier or customer of the company, such that a reasonable and informed third party would conclude in the circumstances that the integrity, impartiality or objectivity of that director is compromised by that relationship; and
> (c) not be related to any person who falls within any of the criteria set out in paragraph (b).

[66] Per s94(7) of the Act:

5.5 Section 76(4) – discharge of statutory duties and reliance on information provided by others (including external experts)

5.5.1 Overview

(4) In respect of any particular matter arising in the exercise of the powers or the performance of the functions of director, a particular director of a company—

(a) will have satisfied the obligations of subsection (3)(b) and (c) if—

(i) the director has taken reasonably diligent steps to become informed about the matter;

(ii) either—

(aa) the director had no material personal financial interest in the subject matter of the decision, and had no reasonable basis to know that any related person had a personal financial interest in the matter; or

(bb) the director complied with the requirements of section 75 with respect to any interest contemplated in subparagraph (aa); and

(iii) the director made a decision, or supported the decision of a committee or the board, with regard to that matter, and the director had a rational basis for believing, and did believe, that the decision was in the best interests of the company; and

(b) is entitled to rely on—

An audit committee of a company has the following duties:
(a) To nominate, for appointment as auditor of the company under section 90, a registered auditor who, in the opinion of the audit committee, is independent of the company;
(b) to determine the fees to be paid to the auditor and the auditor's terms of engagement;
(c) to ensure that the appointment of the auditor complies with the provisions of this Act and any other legislation relating to the appointment of auditors;
(d) to determine, subject to the provisions of this Chapter, the nature and extent of any non-audit services that the auditor may provide to the company, or that the auditor must not provide to the company, or a related company;
(e) to pre-approve any proposed agreement with the auditor for the provision of non-audit services to the company;
(f) to prepare a report, to be included in the annual financial statements for that financial year-
(i) describing how the audit committee carried out its functions;
(ii) stating whether the audit committee is satisfied that the auditor was independent of the company; and
(iii) commenting in any way the committee considers appropriate on the financial statements, the accounting practices and the internal financial control of the company;
(g) to receive and deal appropriately with any concerns or complaints, whether from within or outside the company, or on its own initiative, relating to-
(i) the accounting practices and internal audit of the company;
(ii) the content or auditing of the company's financial statements;
(iii) the internal financial controls of the company; or
(iv) any related matter;
(h) to make submissions to the board on any matter concerning the company's accounting policies, financial control, records and reporting; and
(i) to perform such other oversight functions as may be determined by the board.

(i) the performance by any of the persons—
(aa) referred to in subsection (5); or
(bb) to whom the board may reasonably have delegated, formally or informally by course of conduct, the authority or duty to perform one or more of the board's functions that are delegable under applicable law; and
(ii) any information, opinions, recommendations, reports or statements, including financial statements and other financial data, prepared or presented by any of the persons specified in subsection (5).

(5) To the extent contemplated in subsection (4)(b), a director is entitled to rely on—
(a) one or more employees of the company whom the director reasonably believes to be reliable and competent in the functions performed or the information, opinions, reports or statements provided;
(b) legal counsel, accountants, or other professional persons retained by the company, the board or a committee as to matters involving skills or expertise that the director reasonably believes are matters—
(i) within the particular person's professional or expert competence; or
(ii) as to which the particular person merits confidence; or
(c) a committee of the board of which the director is not a member, unless the director has reason to believe that the actions of the committee do not merit confidence.

5.5.2 Conditions to rely on information provided by others (including external experts)

The provisions of s 76(4) and (5) of the Act have made it possible for directors to rely on tasks executed and information provided in reports by an employee, a person offering professional services such as an accountant or lawyer, an expert or another director in order to discharge their statutory duties.

Before relying on the information, the director must believe that the person who provided the information was competent and reliable. In terms of any reports provided, the director must be familiar with the contents of the report. In order to rely on the work or reports provided by another person, the director must believe that the person has performed a task or provided information within their area of expertise. It is important to note that the Act requires a 'reasonable belief' by the director that they could rely on the work of another. If a director has correctly applied the provisions of ss 76(4)(b) and (5), he/she will not be held liable for a

breach of their fiduciary duties if their actions were based on the work performed by another person.[67]

However, the director's belief must be justified. If the director has reason to believe that the other person has not acted ethically or does not have the necessary competence, the director cannot place reliance on the work performed by another person. The director will therefore not be able to escape liability for any loss or damaged suffered by the company because of the actions of the director.[68]

5.5.3 Reliance on external experts by audit committee members

There may be instances where members of the audit committee must rely on external experts to assist them to discharge their duties under s94 of the Companies Act.

One of the duties which the audit committee must perform in terms of s 94(7)(a) is to assess the independence of the auditor before nominating the auditor for appointment. In order to make this assessment, s 94(8)[69] requires the audit committee to consider a number of factors. One of those factors is the independence criteria established by IRBA through the Code of Conduct.[70] As reg 42 of the Act does not require members of the audit committee to have academic qualifications or experience in all the fields identified in the regulation, the audit committee, as a whole, may not have the necessary knowledge of IRBA's independence requirements. However, through the provision of s 76(4) and (5), the audit committee may

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[67] Op cit note 43.
[68] Op cit note 43.
[69] In terms of s94(8) of the Act

> (8) In considering whether, for the purposes of this Part, a registered auditor is independent of a company, the audit committee of that company must-
> (a) ascertain that the auditor does not receive any direct or indirect remuneration or other benefit from the company, except-
> (i) as auditor; or
> (ii) for rendering other services to the company, to the extent permitted in terms of subsection (7)(d);
> (b) consider whether the auditor's independence may have been prejudiced-
> (i) as a result of any previous appointment as auditor; or
> (ii) having regard to the extent of any consultancy, advisory or other work undertaken by the auditor for the company; and
> (c) consider compliance with other criteria relating to independence or conflict of interest as prescribed by the Independent Regulatory Board for Auditors established by the Auditing Profession Act, in relation to the company, and if the company is a member of a group of companies, any other company within that group.

[70] Op cit note 8 at s 290.

rely on reliable and competent people who are able to provide them with the necessary knowledge of the independence criteria to consider through which they can then execute their duties as outlined in s 94(7).

6. How MAFR may impact the statutory duties of directors as outlined in section 76 of the Companies Act

6.1 Acting in the best interest of the entity – section 76(3)

6.1.1 Costs associated with changing auditors

Section 7.3.5 of this thesis provides further detail regarding the costs associated with MAFR. While many of the studies below only consider the financial costs, further research is required to explore the other non-financial costs involved such as the cost related to the time spent by the audit committee members tendering for new auditors and the time the accounting staff will have to spend sharing information with the new auditors so that the new auditors can develop an understanding of the entity and its operations for the purposes of conducting their audit.

It may therefore be argued that the increased costs associated with the implementation could result in the directors not acting in the best interest of the entity. However, as the audit regulator, IRBA, has proposed the implementation of MAFR through the Auditing Profession Act, the MAFR rule will be binding on all registered auditors in South Africa. Therefore, although the Auditing Profession Act is not legally binding on the directors, the directors cannot discharge their duty of acting in the best interest of the entity if they engage in actions which would clearly result in a contravention of laws and regulations, even if the laws and regulations relates to the appointment of the auditor.[71]

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[71] In terms of s94(2)(c), in order to be appointed as auditor, the person:

> must be acceptable to the company's audit committee as being independent of the company, having regard to the matters enumerated in section 94(8), in the case of a company that has appointed an audit committee, whether as required by section 94, or voluntarily as contemplated in section 34(2).

Section 94(8) states that in assessing the independence of the auditor, the audit committee must:
'consider compliance with other criteria relating to independence or conflict of interest as prescribed by the Independent Regulatory Board for Auditors established by the Auditing Profession Act.'

6.1.2 Enforced rotation of auditors when it is not advisable from a business perspective to do so

Even though MAFR is imposed through an Act, changing auditors may have a negative impact on the entity. Imagine a situation where the entity is undergoing financial difficulty and can therefore not afford increased costs associated with changing auditors or a situation where the entity has entered into a new complex transaction which give rise to many risks which may cause the financial statements to not be fairly presented,[72] it would not be advisable to change auditors. The unfamiliarity of the incoming auditor may result in risks which affect the fair presentation of the financial statements not being identified and appropriately responded to. This does create a tension for the directors as not changing their auditors due to an enforced rotation as a result of MAFR through the Auditing Profession Act will result in the directors not discharging their duty to act in the best interest of the entity but it would not be considered sound business practice to change auditors. This does create a predicament for directors as the directors have to choose the action which must be done (nominating a new auditor for appointment due to MAFR) rather than engaging in the action which should be done (supporting the retention of their existing auditor by the shareholders until such time that the entity is in a better position to change auditors).

The tension between what must be done (per the legislation) versus what should be done (in terms of what makes more sense from a practical business perspective) is not explored in this thesis but could be an area for future research.

[72] 'Fairly presented' is used interchangeable with 'free from material misstatement' in this thesis. The auditor expresses an opinion that the financial statements are fairly presented, in all material respects.

6.2 Reliance on reports by experts – section 76(4)

6.2.1 Requirement to produce financial statements in accordance with applicable financial reporting standards

Before conducting the audit, management[73] and the auditor enter into a contractual relationship through a document called an engagement letter. The purpose of the engagement letter is to define the various responsibilities of each party, the scope of the audit and the compensation which is due to the audit firm. Upon agreeing to the terms of the engagement letter, management agree to be responsible[74] for the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation, as identified in the International Standards on Auditing[75] (ISA) 210, *Agreeing the terms of Audit Engagements*. If the directors do not fairly present the financial statements, this may result in a contravention of s 29 of the Companies Act. Section 29(1)(a) states that if the company provides financial statements to any person, that those financial statements must satisfy the financial reporting standards.

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[73] The International Standards on Auditing (ISA) are internationally recognised professional standards that are used in the audits of financial statements in South Africa.

In terms of the International Standards on Auditing 210 para 5, where reference is made to 'management' this includes those charged with governance, such as the directors where appropriate.

[74]In terms of ISA 210 para 6:

> Obtain the agreement of management that it acknowledges and understands its responsibility: (Ref: Para. A11–A14, A20)
> (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation*;*

[75] The International Standards on Auditing (ISA) are internationally recognised professional standards that are used in the audits of financial statements in South Africa.

SAICA, 'Members Handbooks' available at https://www.saica.co.za/Technical/Assurance/SAICAHandbookIFRSHandbook/tabid/535/language/en-US/Default.aspx, accessed on 11 September 2018.

6.2.2 Objectives of an audit

Per ISA 200, *Overall Objectives of the Independent Auditor and the conduct of an Audit in accordance with International Standards on Auditing*, the objective of the auditor is to express an opinion on the financial statements that fair presentation is achieved.[76] The opinion is expressed in a written document called the audit report. In terms of s 29(3) of the Companies Act, the financial statements of a company which has been audited, must contain an auditor's report. Although it is not the responsibility of the auditors to ensure that the financial statements satisfy the applicable financial reporting standards, the opinion expressed in the audit report provides the users of the financial statements with a high degree of confidence that the financial statements do satisfy the applicable financial reporting standards.

6.2.3 How the auditors may assist management to produce financial statements in accordance with the applicable financial reporting standards

In terms of ISA 450, *Evaluation of misstatements identified during the audit*, when performing an audit, if the auditor identifies that the financial statements do not satisfy the applicable financial reporting standards, the auditor will propose a correction to management based on work performed during the audit in order for the financial statements to satisfy the applicable financial reporting standards.[77] Should management refuse to process the

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[76] Ibid

Per ISA 200 para 11:

> In conducting an audit of financial statements, the overall objectives of the auditor are:
>
> (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
>
> (b) To report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings.

[77] Op cit note 84.
Per ISA 450 A10 & A12:

applicable adjustments or should management not adequately correct the financial statements so that the financial statements satisfy the applicable financial reporting standards, ISA 700, *Forming an opinion and reporting on financial statements*, requires the auditor to modify their opinion in the audit report to disclose this information to the users of the financial statements.[78] Therefore, having independent auditors who perform a high quality audit, will help the directors produce financial statements that satisfy the applicable financial reporting standards and thereby help the directors to not contravene s 29 of the Act.

6.2.4 How MAFR may cause directors to not rely on the work performed by the auditor

Section 7.3 of this thesis provides evidence that the implementation of MAFR will have an impact on the quality of the audit performed. While MAFR does improve audit quality in certain circumstances, it also creates situations which may be detrimental to audit quality. Similarly, while the implementation of MAFR may help to strengthen auditor independence in certain instances, it also creates situations which may pose threats to the independence of auditors. If the auditor is not independent, this may influence the audit opinion which is expressed.

> Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the items are misstatements, inform the auditor if it disagrees, and take action as necessary.
>
> The correction by management of all misstatements, including those communicated by the auditor, enables management to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.

[78] Op cit note 84.
Per ISA 700 para 10 & 11:

> The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.
>
> In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.
>
> That conclusion shall take into account:
>
> (a) The auditor’s conclusion, in accordance with ISA 330, whether sufficient appropriate audit evidence has been obtained;
> (b) **The auditor’s conclusion, in accordance with ISA 450, whether uncorrected misstatements are material. [Emphasis added]**

If the directors have reason to believe that they cannot rely on the audit report due to concerns related to audit quality or auditor independence, then the directors cannot rely on the opinion expressed by the auditors. If the financial statements are subsequently not fairly presented, the directors will not be able to escape liability for a breach of their fiduciary duties.

7. Review of academic literature and statements from relevant stakeholders

As proposed above, MAFR may create situations which impact the independence of the auditor and the overall quality of an audit. This section of the thesis reviews academic literature and statements made from relevant stakeholders such as local and international professional accounting bodies to determine what impact, if any, MAFR will have on the independence of the auditor and the overall quality of the audit.

In this chapter, we will consider several studies which have defined 'audit quality' (section 7.1). The relationship between auditor independence and audit quality is then considered (section 7.2).

Section 7.3 focuses on exploring the impact MAFR will have on the independence of the auditor and the overall audit quality by reviewing academic literature and statements related to the following areas:

- Effects of changing auditors, considering improvements and challenges associated with new approaches (section 7.3.1), technology (section 7.3.4), and audit performance through enhanced professional scepticism (section 7.3.5), and
- The impact of long audit tenure on auditor independence, audit quality (section 7.3.2), including how specialised knowledge developed over time may impact audit quality (section 7.3.3).

Section 7.3.5 considers how the costs associated with changing auditors may impact auditor independence and overall audit quality by considering international and local research related to this area.

Lastly, although MAFR is proposed to regulate public interest entities in South Africa, many of our local companies have global exposure through their foreign operations. Section 7.3.6 analyses how the implementation of MAFR may potentially impact the quality of multinational audits.

7.1 Studies defining audit quality

Various studies have attempted to define audit quality.

Studies by Krishnan and Schauer[79]; Tie[80]; McConnell and Banks[81] and Cook[82] have defined audit quality by the extent to which the audit has been conducted in accordance with applicable auditing standards, while Titman and Trueman,[83] Beatty[84] and Krinsky and Rotenberg[85] have defined audit quality as the ability of the auditor to report accurate information. A 1981 study by DeAngelo,[86] however, describes audit quality as the likelihood that the financial statements will not fairly represent that the state of affairs of the entity, in all material aspects, and that the auditor will identify and then report the material misstatements to the users of the financial statements. Lastly, Wallace[87] (1980) measures audit quality as the ability of the audit to improve the reliability of accounting data.

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[79] Krishnan, G. & Schauer, P. 'Differences in quality among audit firms' (2001) 192(1) *Journal of Accountancy* at 85.
[80] Tie, R. 'Concerns over auditing quality complicate the future of accounting' (1999) 188(6) *Journal of Accountancy* at 14-15.
[81] McConnell, D.K. Jr & Banks, G. 'A common peer review problem' (1998) 185(6) *Journal of Accountancy* at 39-44.
[82] Cook, M.J. (1987) 'Two years of progress in financial accounting and reporting – February 1985 to January 1987' (1987) 163(6) *Journal of Accountancy* at 96-108.
[83] Titman, S. & Trueman, B. 'Information quality and the valuation of new shares' (1986) 8(2) *Journal of Accounting and Economics* at 159-72.
[84] Beatty, R.P. 'Auditor reputation and the pricing of initial public offerings' (1989) 64(5) *The Accounting Review* at 693-709.
[85] Krinsky, I. & Rotenberg, W. 'The valuation of initial public offerings' (1989) 5(2) *Contemporary Accounting Research* at 501-15.
[86] DeAngelo, L. 'Auditor size and audit quality' (1981) 3(3) *Journal of Accounting and Economics* at 183-99.
[87] Wallace, W.A. 'The economic role of the audit in free and regulated markets', (1982) 57(2) *The Accounting Review* at 462.

7.2 The impact of auditor independence on audit quality

In their 2015 study,[88] Tepalagul and Lin stated that audit quality is impacted by auditor independence.[89] Audit quality is compromised if the auditors are not independent because the auditors will be less likely to identify and reports irregularities which they identify.

In their 2015 study, Tepalagul and Lin developed a four-dimension framework for assessing the impact of auditor independence on audit quality.

As noted from figure 1 (see section 9.3 of this thesis), the four dimensions represent potential threats to the independence of auditors, namely (1) client importance, (2) the provision of non-audit services, (3) audit tenure and the audit firm's affiliation with audit clients. These threats then impact audit quality by threatening the capabilities and independence of the auditor.

Three of the four threats to independence are discussed briefly below:

1) Client importance

Auditors are paid directly by their audit clients. This then creates the incentive for audit firms to retain clients that contribute to a larger proportion of their overall firm income. As a result, the auditors may be too accommodating to the needs and wants of their client at the expense of maintaining independence.[90]

In South Africa, there are safeguards in place to reduce this threat to the independence of the auditor to an acceptable level.

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[88] Tepalagul, N. & Lin, L. 'Auditor Independence and Audit Quality: A Literature Review.' (2015) 30(1) *Journal of Accounting, Auditing & Finance*, at 101–21.
[89] Ibid at 102.
[90] Op cit note 97 at 103-05.

In terms of s 290 of the SAICA Code of Professional Conduct,[91] where the fees of the audit client exceeds 15 per cent of the audit firm's revenue, the audit firm is required to disclose this fact to the board of directors and is required to undergo quality control reviews (discussed in further detail in section 7.3.5 of this thesis).

Furthermore, s 94(7)[92] of the Act requires the audit committee to perform various duties such as determining the remuneration to the auditors.

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[91] South African Institute of Chartered Accountants (SAICA) 'Code of Professional Conduct 2017/2018' available at https://www.saica.co.za/TechnicalInformation/Discipline/CodeofProfessionalConduct/tabid/701/language/en-ZA/Default.aspx, accessed on 13 December 2017.

The SAICA Code of Professional Conduct applies to all registered members of SAICA while the IRBA Code of Professional Conduct applies to all registered auditors. One of the requirements to be a registered auditor in South Africa is that the person must also be a registered member of SAICA. Both Codes are based on code released by the International Ethics Standards Board for Accountants (IESBA).

In terms of section 290 paragraph 217 of the SAICA Code of Professional Conduct:

> Where an audit client is a public interest entity and, for two consecutive years, the total fees from the client and its related entities (subject to the considerations in paragraph 290.27) represent more than 15 per cent of the total fees received by the firm expressing the opinion on the financial statements of the client, the firm shall disclose to those charged with governance of the audit client the fact that the total of such fees represents more than 15 per cent of the total fees received by the firm, and discuss which of the safeguards below it will apply to reduce the threat to an acceptable level, and apply the selected safeguard:
>
> - Prior to the issuance of the audit opinion on the second year's financial statements, a chartered accountant, who is not a member of the firm expressing the opinion on the financial statements, performs an engagement quality control review of that engagement or the Regulatory Board performs a review of that engagement that is equivalent to an engagement quality control review ("a pre-issuance review"); or
>
> - After the audit opinion on the second year's financial statements has been issued, and before the issuance of the audit opinion on the third year's financial statements, a chartered accountant, who is not a member of the firm expressing the opinion on the financial statements, or the Regulatory Board performs a review of the second year's audit that is equivalent to an engagement quality control review ("a post-issuance review").
>
> When the total fees significantly exceed 15 per cent, the firm shall determine whether the significance of the threat is such that a post-issuance review would not reduce the threat to an acceptable level and, therefore, a pre-issuance review is required. In such circumstances a pre-issuance review shall be performed.
>
> Thereafter, when the fees continue to exceed 15 per cent, each year, the disclosure to and discussion with those charged with governance shall occur and one of the above safeguards shall be applied. If the fees significantly exceed 15 per cent, the firm shall determine whether the significance of the threat is such that a post-issuance review would not reduce the threat to an acceptable level and, therefore, a pre-issuance review is required. In such circumstances a pre-issuance review shall be performed.

[92] In terms of s 94(7) of the Act:
'An audit committee of a company has the following duties:
(b) to determine the fees to be paid to the auditor and the auditor's terms of engagement.'

2) Non-audit services

Auditor independence may be compromised through the provision of non-audit services as auditor independence is compromised as financial incentives are created. Furthermore, a self-review threat is created as the auditor may ultimately audit matters relating to the financial statements which they were directly involved in preparing. The auditor will therefore be less likely to identify errors in work they performed or admit to making errors in fear of looking incompetent.[93]

Similarly, s 290[94] of the SAICA Code of Professional Conduct[95] and the s 94(7) of the Act provide safeguards in South Africa to mitigate this threat to independence.

3) Audit tenure

The effects of long audit tenure on audit quality has been the subject of contention for many academic studies. One view states that long audit tenure is detrimental to promoting audit independence as the auditor may develop a close relationship with the client, thereby reducing the ability of the auditor to act objectively and free from bias. This view has been adopted by the regulator and this been used to promote the implementation of MAFR. However, proponents to MAFR argue that long audit tenure strengthens the quality of audits as the auditor develops a better understanding of the client's business over time. Generally, the research conducted on long audit tenure supports the latter view.[96] The research related to audit tenure is discussed in further detail under section 7.3.2 of this thesis.

The last dimension, audit firms affiliation with audit clients, relates specifically to the auditor subsequently seeking employment with the audit client.[97] Safeguards for this matter are provided in s 290 of the SAICA Code of Professional Conduct[98] which provide for a cooling-

[93] Op cit note 97 at 105-08.
[94] Per para 154 to 214.
[95] Op cit note 100.
[96] Op cit note 97 at 108-10.
[97] Ibid at 110.
[98] Op cit note 100.

off period before the auditor may join an audit client but this situation create threats similar to that of long audit tenure.

Using the framework developed by Tepalagul and Lin provides a useful basis for further discussion regarding how the implementation of MAFR may create or reduce threats to independence which may threaten audit independence and thus cause audit quality to be compromised.

7.3 Effects of changing auditors on audit quality

An enforced rotation due to MAFR will bring with it a new audit team. As noted by SAICA,[99] a new audit team bring with it several advantages to the quality of the audit.

7.3.1. Improvements created by new approaches

One of these advantages includes having a fresh set of eyes providing a fresh look at the various business processes and the fair presentation of the financial statements. As the new auditors do not have a previous relationship with management, the new auditors may highlight a previous error of judgement or may be able to spot errors that were previously overlooked by the predecessor auditor. If the faulty judgement or previously overlooked error was made by the previous auditor, the previous auditor may also be less willing to acknowledge and correct their errors (a threat to independence similar to that identified by Tepalagul and Lin when the auditors perform non-audit services), thereby perpetuating the problem in the future. If past practices have worked for an audit firm, the audit firm may tend to repeat the same practices even if the situation facing the company has changed. A new audit firm is not constrained by the same past practices and may ultimately push for doing things differently.[100]

[99] South African Institute of Chartered Accountants (SAICA) 'The Initial Test of Competence June 2018 Paper 3 Question 1 Part II section (f) Suggested Solution' available at *https://www.saica.co.za/Portals/0/LearnersStudents/Examinations/Past%20Exam%20Papers/ITC_June2018/ITC%20June%202018%20Paper%203%20Question%201%20Part%20II%20Final%20Solution.pdf,* accessed on 17 August 2018.

[100] Oliver Hearsum '6 reasons why your business needs a fresh pair of eyes' available at *https://www.kgmoore.co.uk/6-reasons-business-needs-fresh-pair-eyes/*, accessed on 17 August 2018.

An additional advantage of changing auditors which will have a positive effect on the quality of the audit will be that the new auditors could be better at servicing the needs of the client and identifying and addressing risks that are unique to the audit client. In a statement[101] by one of the board members of the Public Company Accounting Oversight Board (PCAOB), a non-profit company organisation (which performs a function similar to the IRBA) established in the United States through the Sarbanes Oxley Act of 2002, it was stated that the advances in technology will equip the auditors with additional tools to provide the directors with insight about their operations and processes. Furthermore, as a by-product of the audit, the auditor can provide management with value added comments on operational business risks, which if not addressed, could result in the fair presentation of the financial statements being affected.

7.3.2 The impact of audit tenure on audit quality

As noted by Tepalagul and Lin, audit tenure may be a factor which threatens the independence of the auditor and therefore impact audit quality. Proponents of MAFR argue that as audit tenure increases, the auditor becomes too familiar with their client, thereby impairing audit independence. This in turn threatens audit quality as the auditor may become too sympathetic and accepting of their client's desires, even if those desires could result in the financial statements not achieving fair presentation. The opposing view is that long audit tenure allows the auditor to increase their understanding of the entity and develop expertise over time, resulting in the auditor being able to perform a higher quality audit.

7.3.2.1 Threats to independence created by long audit tenure

Table 1 (see section 9.1 of this thesis) provides examples of the audit tenure of companies by audit firms.[102] Given the long association that some audit firms may have with their audit clients, some may question whether the long association, especially ones exceeding 20 years, may have resulted in the independence of the auditor being compromised as the auditor may

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[101] Steven B. Harris, 'Technology and the Audit of Today and Tomorrow' available *https://pcaobus.org/News/Speech/Pages/Harris-statement-PCAOB-AAA-4-20-17.aspx,* accessed on 17 August 2018.

[102] Op cit note 1 at 18.

become too sympathetic to the client's interest or accepting of their work.

Long audit tenure has been noted by the audit regulator, IRBA, as one of their concerns to the threat to independence of auditors.[103] In order to highlight the threat of long audit tenure to users of financial statements and to strengthen auditor independence and transparency, in terms of ss 9 and 10 read with ss 1, 2 and 3 of the Auditing Profession Act, IRBA requires all auditor's reports of all public companies (one of the category of companies which will be subject to MAFR) to disclose the number of years that the audit firm has been the auditor of the public company.[104]

The Public Investment Corporation (PIC), a state owned South African Company and the largest institutional investor on behalf of public sector entities with an estimated holding of 12,5 per cent of the Top 40 listed companies on the Johannesburg Stock Exchange, has voted against the reappointment of any audit firm that has an audit tenure of more than nine years.[105] The PIC believes that after a period of nine years, the auditors may become too familiar with their audit client, which poses a threat to their independence.[106] IRBA has therefore noted that the concerns of a major investor such as the PIC must be taken into consideration in order to protect the interests of the investing public.[107]

In support of the IRBA's view that long audit tenure threatens auditor independence, research[108] conducted by two North American academics, Singer and Zhang, found that auditors discover misstatements far more quickly in the first three years of their appointment but audit tenures exceeding ten years results in the far less misstatements being identified. The research suggests that audit quality benefits from short audit tenures and having a fresh look at the business processes and financial statements.

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[103] Op cit note 1 at para 3.4.1.
[104] Op cit note 1 at para 3.4.2.
[105] Op cit note 1 at para 3.5.3.
[106] Op cit note 1 at para 3.5.4.
[107] Op cit note 1 at para 3.5.2.
[108] Zvi Singer & Jing Zhang 'Audit quality benefits from short audit tenure' available at *https://economia.icaew.com/news/april-2018/audit-quality-benefits-from-short-audit-tenure,* accessed on 18 August 2018.

In their formal written response to the IRBA's consultation paper, one of the Big 4 respondents acknowledged the concerns shared by the IRBA and the Public Investment Corporation but also identified the existing measures which have been put in place and how long audit tenure may provide some improvements to audit quality:

> Clearly, MAFR will directly impact the perceived lack of independence in the case of long firm tenure. However, since the introduction of the IRBA requirement for firms to disclose the length of audit firm tenure at a particular client, audit committees and shareholders (especially the Public Investment Corporation) are well aware of this matter. We have seen this issue receive attention at both audit committee level and at companies' annual general meetings with a number of listed companies either already changing audit firms or initiating a process to consider a change in audit firm. We believe that this is a sensible approach as those charged with governance, and shareholders, are best placed to balance the risk of long tenure (e.g. perceived or actual lack of independence) with the benefits thereof (e.g. knowledge of the business, understanding of the key risks, etc.).[109]

7.3.2.2 Improvements to audit quality as a result of long audit tenure

As mentioned above, there are benefits associated with a long audit tenure. While long audit tenure may compromise audit quality by threatening the independence of the auditor, the loss of industry specific knowledge may also threaten audit quality as the incoming auditors may not be as capable. While MAFR may address concerns to audit quality created by long audit tenure, it does not address other measures (such as a lack of competence) which may threaten audit quality.

The studies below support the view that long audit tenure improves audit quality.

In their 2008 study[110], Jackson et al examined, using statistical methods, a sample of 772 auditor switches occurring between 1995 and 2003 for Australian entities listed on the Australian Stock Exchange (ASX) to determine the effect of MAFR on audit quality.

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[109] Op cit note 6 at 5.
[110] Andrew B. Jackson, Michael Moldrich & Peter Roebuck 'Mandatory audit firm rotation and audit quality' (2008) 23(5) *Managerial Auditing Journal* at 420 – 37.

The authors used two indicators to measure audit quality, namely the tendency of auditors to issue a going-concern[111] report and the level of discretionary accruals.[112]

The first measure, while controlling for other factors that may influence the auditor's decision, considers that as audit tenure increases, this decreases the likelihood that the auditor will issue a going-concern opinion. If found to be true, this would then provide strong evidence in favour of the implementation of MAFR because this would indicate that the increased audit tenure has impaired the independence of the auditor.[113]

The second measure, discretionary accruals incorporates accruals that are considered to not be in the ordinary course of business. A higher level of discretionary accruals indicates that the management is able to exert influence over the auditor and that the auditor's independence has been impaired by reporting favourably in line with the views of management.[114]A limitation of the study above is that while the results of the study showed that there is a positive relationship between audit quality and actual tenure, the study does not address how perceived quality may be affected by long audit tenure. The introduction of MAFR, while based on the aforementioned study, does not improve actual audit quality, but it may still improve the perceptions of audit quality.[115] Actual quality is defined as the extent to which the risk of the auditor failing to report a material misstatement in the financial statements is decreased, while how the users of the financial statements believe that the auditor will be effective in reducing material misstatements is defined as perceived quality.[116] As perceived quality increases, this increases investor confidence in the use of the financial statements of audited entities as a basis for making investment decisions.[117]

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[111] An entity is considered to be able to continue to operate as a going concern if it is able to realise its assets and discharge its liabilities in the ordinary course of business. A 'going concern opinion' is therefore issued by the auditor to alert users of the financial statements that the entity may not be able to operate as a going concern in the 12 months following the current financial year end.
[112] Op cit note 117 at 420.
[113] Op cit note 117 at 425.
[114] Ibid.
122 Op cit note 117 at 426.
[115] Op cit note 117 at 434.
[116] Op cit note 117 at 422.
[117] Ibid.

The results of study above do not provide evidence in support of MAFR, and while there may be concerns related to auditor independence from long audit tenure and as a result, audit quality, other measures may be needed to address the concerns.

Lastly, as noted by the authors, the resignation of the auditor provides a very valuable signal to the market that the auditor is experiencing conflict with their client regarding the correct accounting treatment of a matter. If the auditor is forced to rotate due to MAFR, the market misses out on potential valuable information that a resignation would have provided under a system of voluntary auditor rotations.[118]

7.3.3 The impact of specialist knowledge gathered over time and its effects on audit quality

A long audit tenure also helps the auditor develop specialised knowledge about the entity, thereby improving audit quality.

Figure 2 (see section 9.4 of this thesis) demonstrates a model[119] developed to Daugherty et al to examine the effects (direct and indirect) of partner rotation on audit quality. The model shows that the retention of client specific knowledge has a positive effect (as denoted by a '+') on audit quality. However, partner rotation results in a loss of client specific information (as denoted by a '-'). Therefore, the rotation of the auditor, results in a loss of client specific knowledge which has a detrimental impact on audit quality. While partner rotation does improve audit quality by improving auditor independence (as discussed in section 7.3.2.2 of this thesis) and provides a 'fresh look' at the audit (as discussed in section 7.3.1 of this thesis), there are also indirect negative effects on the audit partner's quality of life such as having to retrain to adapt to a new industry/entity which may also negatively impact audit quality.[120]

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[118] Ibid.

[119] Daugherty, B. E., Dickins, D., Hatfield, R. C., & Higgs, J. L. 'An Examination of Partner Perceptions of Partner Rotation: Direct and Indirect Consequences to Audit Quality.' (2012) 31(1) *Auditing: A Journal of Practice & Theory* at 97–114.

[120] Op cit note 129.

Consistent with Daugherty et al, in their 2018 study[121], Gaver & Utke argue that industry specialisation and audit quality are influenced by how long a period the auditor has gathered specialist knowledge. The authors measured audit quality through analysing various financial measures using a sample of 'Big 4' audit clients from 2003 to 2015 and concluded the following:

1) Auditors that have only recently gained specialist knowledge in an industry (a period estimated by the authors to be two to three years) are not able to increase the level of their audit quality beyond that of audit firms that are not industry specialists.
2) Auditors that have gained industry specific knowledge over a lengthy period of time exhibit increased levels of audit quality.

Using the result of Gaver et al's study and the data from table 1 (see section 9.1 of this thesis), many of the listed entities in South Africa have been audited by the same audit firm for a number of years. During that time, those audit firms have built up specialist knowledge related to the industry. With an enforced rotation, there is no transfer of institutional knowledge from one audit firm to another. As such, it is likely that the incoming auditors will not be industry specialists and therefore be perceived to not improve audit quality.

7.3.4 Access to improved technology and skills

Audit quality will also be improved through the use of advanced technologies. By enforcing a change of auditor, the entity may appoint new auditors who have access to technology and skills which the previous auditors did not possess. When the audit committee needs to nominate an auditor for appointment by the shareholders, the audit committee invites audit firms to tender for the audit. The tendering process gives the members of the audit committee an opportunity to assess whether the audit firm which is selected have the appropriate level of skills, technology and expertise in order to perform the audit.

The Institute of Chartered Accountants in England and Wales (ICAEW), a professional accounting body established by royal charter in 1880 with 150 000 members worldwide, has

[121] Jennifer J. Gaver and Steven Utke (2018) 'Audit Quality and Specialist Tenure' 2018 *The Accounting Review In-Press*.

stated[122] that the increasing introduction of more advanced technology will enable audits in the future to be of a higher quality than is previously experienced due to the many advantages that technology brings such as the ability to analyse large data sets in a more efficient, effective and economical manner.[123]

One of the current inherent limitations of performing an audit is that the auditor tests a large volume of transactions on a sample basis.[124] As a result of this inherent limitation, the auditor is able to provide a high, but not absolute, level of assurance that the financial statements are fairly presented in all material respects. As improvements in technology may enable the auditor to test 100 per cent (rather than a sample) of the transactions in the business, this may result in the auditor providing a much higher level of assurance than is currently expressed.

Furthermore, the introduction of more advanced technology will result in many of the routine time-consuming tasks currently being performed by the auditors being automated. This will then provide the auditor with more time to examine the areas of the company that are more complex and prone to risks, which could result in fair presentation of the financial statements not being achieved. Highly skilled individuals will always be required to analyse the results in a meaningful manner and where necessary, take further action through interacting with other individuals on areas that require significant judgement in order to provide assurance on the data that is produced by the technology.[125]

As further noted by the ICAEW, all audit firms, regardless of their size, will have to adapt to the introduction of technological advancement. However, given that these technologies will require significant investment in resources, both financial and non-financial, the large audit firms will be in a better position to take advantage of new and emerging technologies as the large audit firms are part of large international networks of audit firms and can therefore leverage off other firms within the same network. Many of the small and medium audit firms do not belong to an international network of audit firms. Furthermore, the large audit firms

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[122] The Institute of Chartered Accountants in England and Wales (ICAEW) 'The Future of Audit: Technology' available at *https://www.icaew.com/technical/audit-and-assurance/faculty/the-future-of-audit/the-future-of-audit-technology*, accessed on 25 August 2018.

[123] Ibid

[124] Op cit note 84.

Per ISA 530 A4:

> Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn.

[125] Op cit note 132.

will have more resources, financial and human capital, to invest in developing new technologies. [126]

Given that one of IRBA's objectives is to decrease market concentration, it does raise the question whether the enforced rotation from one of the 'Big 4' audit firms will probably result in entities moving to another one of the 'Big 4' audit firms in order to take advantage of the benefits associated with technological advances.

7.3.5 Improvements to audit performance and professional scepticism

Further improvements to audit quality are created by improving the performance of the previous auditor's work and use of professional scepticism.

When new auditors are appointed, as part of their actions before accepting the audit client, the new auditors obtain the client's permission to contact the previous auditor to discuss whether there would be any ethical or professional reasons for the new auditor to not undertake the audit. The new auditor also reviews the audit work of the previous auditor. As such, the previous auditors will be more likely to ensure that their audit testing is performed more thoroughly and that the results thereof are meticulously documented. This will undoubtedly increase the quality of the audit performed by the previous auditor.

Furthermore, as the new auditors are not as familiar with the client's operations and personnel, the auditors are inherently more sceptical and will place less reliance on the representations made by management. The exercise of professional judgement by the auditor is important as it ensures that the auditor remains alert to instances which may cause the financial statements to not achieve fair presentation. Ultimately, the application of professional judgement should help the auditor avoid situations where they neglect unusual circumstances, identify situations where the results of the work performed is contradicted by the results of work performed in a different area of the audit or deter the auditor from arriving at inappropriate assumptions. Professional scepticism is also closely linked to the fundamental principle of independence, which calls for the auditor to remain objective. This in turn will result in the quality of the audit.

[126] Ibid.

As noted previously,[127] under ISA 200, one of the objectives of an audit is to express an opinion on the financial statements. In order to do so, the auditor performs audit procedures in order to gather sufficient (refers to quantity) and appropriate (refers to quality) audit evidence on which to express an opinion. In deciding what audit procedures to perform to gather audit evidence, the auditor applies professional judgement. The auditor relies on their previous experience and exercises integrity, objectivity and professional scepticism in order to arrive at appropriate judgements. Professional scepticism is therefore one of the important qualities used in applying appropriate professional judgement.[128]

Per ISA 200 A18,[129] professional scepticism includes being alert to:

> • Audit evidence that contradicts other audit evidence obtained.
> • Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
> • Conditions that may indicate possible fraud.
> • Circumstances that suggest the need for audit procedures in addition to those required by the ISAs.

At its core, professional scepticism[130] refers to the audit team members' attitudes or state of mind when performing the audit. Professional scepticism thus entails having a questioning mind and being alert to circumstances that may arise during the audit which may indicate that the financial statements may be materially misstated due to error or fraud and to assess audit evidence obtained from audit procedures for sufficiency and appropriateness. This involves being alert to any audit evidence which may contradict audit evidence which has already been obtained or identifying circumstances which may cause the auditor to question the underlying

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[127] See section 6.2.2 of this thesis
[128] Jana Lamprecht CA(SA) 'Defining professional judgement and professional scepticism' available at *https://accountingweekly.com/defining-professional-judgement-and-professional-scepticism/,* accessed on 11 September 2018.
[129] Op cit note 84.
[130] Ibid.
Per ISA 200 A20:

> Professional skepticism [spelling as per the ISA] is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example, in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

reliability of the audit evidence obtained.[131] The independence of the auditor therefore enhances the ability of the auditor to apply professional scepticism.[132]

Auditors therefore rely on professional scepticism when applying professional judgement throughout the audit. The ethical requirements such as the SAICA and IRBA Code of Conduct[133] (hereafter referred to as the 'CPC') provide specific guidance on specific matters which the auditor may encounter in practice which could threaten their independence. Where such matters arise, the CPC provides guidance on how the auditor can reduce those threats to an acceptable level by applying applicable safeguards. There are some threats that are so significant that no safeguards can be applied and the auditor has no other option but to not take part in the audit engagement. The CPC does not provide guidance on every threat that the auditor may encounter in practice. Where no specific guidance is provided, the CPC provides general principles which the auditor can apply to identify threats to their independence, assess whether the threat may impair their independence and consider safeguards which may be applied to reduce the threat to an acceptable level so that independence is not impaired.[134] Likewise, the ISAs provide objectives and minimum requirements which the auditor must satisfy when conducting an audit but it is not always prescriptive in how those objectives and minimum requirements must be achieved. Both the CPC and the ISAs therefore rely on the auditor exercising professional judgement to interpret and apply the relevant ethical and professional requirements.[135]

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[131] Op cit note 84.
Per ISA 200 A21:

> The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence. In cases of doubt about the reliability of information or indications of possible fraud (for example, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), the ISAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.

[132] Op cit note 135.
[133] Op cit note 100.
[134] Harber, M & McGregor, D 'Regulation vs. professional judgement? The role of professional judgement in the mandatory audit firm rotation debate.' (2017) *South African Accounting Association (SAAA) Biennial Conference Proceedings* at 453-474.
[135] Ibid.

There are two professional auditing standards,[136] namely ISA 220 and International Standard of Quality Control (ISQC) 1 that are aimed at promoting quality control on audits. A system of quality control is important because it ensures that the auditor satisfies all professional and ethical requirements and that the audit opinion expressed by the auditor is appropriate. Currently, in terms of ISQC 1, all listed companies (these entities also fall into the scope of MAFR and will be subject to the requirements of MAFR) which are audited are required to undergo an engagement quality control review (EQCR). The quality control reviewer is an audit partner who is not part of the engagement team and is thus not involved in performing the audit. The purpose of the EQCR is for the quality control reviewer to review, and where necessary challenge the audit team members on, the areas of the audit where the audit team has applied significant professional judgement and therefore provides additional assurance that the auditor has appropriately applied professional judgement.[137]

The following was noted by the 'Big 4' respondents to IRBA's consultation paper in this regard as an existing measure in South Africa to ensure audit quality:

> Effective (Independent) Engagement Quality Control Review - The engagement quality control review (EQCR) process plays a significant role in ensuring audit quality by providing an independent evaluation of the key judgments made. It serves as a safeguard in ensuring that the audit risks have been appropriately addressed and the audit opinions issued are correct and sufficiently supported. This task is carried out by the engagement quality control reviewer who is experienced and whose role is to challenge the opinion of the key audit partners.[138]

[136] Op cit note 100.
[137] Op cit note 144.
[138] Op cit note note 4 at 2.

7.3.6 Costs associated with changing auditors

7.3.6.1 International findings

7.3.6.1.1 Effect on audit fees associated with the introduction of new auditors

As at the time of writing, there has been very little research exploring the costs and benefits associated with the rotation of auditors as a result of MAFR. This is an emerging area of research and could be a future area of research which will be useful in helping inform appropriate decision-making policies.

A 2015 study[139] by Cameran et al focused on the adverse consequences of MAFR by examining the experience in Italy, where mandatory rotation of auditors has been a requirement since 1975. The study found the following:

1) Auditors maintain the quality of their audit in the final year before their mandatory rotation (hereafter referred to as 'final year'). There is no decrease in audit quality which has been proposed by many proponents of MAFR.
2) Audit fees in the final year are 7 percent higher than previous years. This suggests that final year audit fees are based on the escalating perceptions of what the market will bear rather than on actual costs, a term called opportunistic pricing.
3) 'Low-balling' usually involves the practice of offering a low audit fee in the first year of a new audit, usually with the objective of securing the audit, and then recovering the cost through efficiencies that are developed in subsequent years. The new incoming auditors engage in low-balling by offering a 16 per cent discount even though the hours for the new engagement will be 17 per cent higher than that of subsequent years. The higher engagement hours are expected because the auditors are not familiar with the company and its operations and therefore must spend significantly more time trying to understand the company and its operations.

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139 Mara Cameran, Jere R. Francis, Antonio Marra, and Angela Pettinicchio 'Are There Adverse Consequences of Mandatory Auditor Rotation? Evidence from the Italian Experience.' (2015) 34(1) *AUDITING: A Journal of Practice & Theory: February 2015* at 1-24.

4) The audit fees of the new auditor are subsequently higher and more than offset the initial discount offered in the first year. This suggests that the financial costs associated with changing auditors are not trivial.
5) The higher financial costs of changing auditors are not associated with an improvement in audit quality. The authors found that the quality of earnings in the first three years of the audit by the new auditor were lower than that of subsequent financial years. This suggests that audit quality improves with longer tenure in Italy.

Similarly, in a 1988 study,[140] Simon and Francis also identified evidence of low-balling by examining a sample of 214 firms who had changed auditors over the five-year period from 1979 to 1984. It is interesting to note that although this study took place 21 years before the 2015 study conducted by Cameran et al above, the practice of low-balling has been a practice that has continued for several years.

The results of the study performed by Simon and Francis found evidence of low-balling in the first year of a new audit and discounted over fees for the following two financial years. Audit fees are 24 per cent lower in the first year and discounted by 15 per cent each over the next two years.[141] These results, although conducted in 1988 are in line with the results of Cameran et al which also found evidence of discounted audit fees in the initial years of an audit, symbolic of low-balling.

7.3.6.1.2 The impact of low audit fees on audit quality

In the United States, the ethical rulings related to auditors, state that when an audit client is unable to pay their audit fee, that this may threaten the independence of the auditor.[142]

[140] Daniel T. Simon and Jere R. Francis 'The Effects of Auditor Change on Audit Fees: Tests of Price Cutting and Price Recovery' (1998) LXIII (2) *The Accounting Review* at 255 – 257.
[141] Ibid
[142] Op cit note 149 at 255.

Similar guidance related to unpaid audit fees is provided for auditors in South Africa. The SAICA CPC[143] states that that a self-interest[144] threat is created when the audit fees of a client remain unpaid for a significant amount of time, particularly if the audit fee remains unpaid before the audit report for the following financial year is issued. The auditor is thus required to evaluate the existence of the self-interest threat and to determine is safeguards can be put in place to reduce the threat to an acceptable level where independence will not be compromised. The unpaid audit fee may cause the auditor to develop a vested interest in the continued survival and ability of the entity to generate strong financial performance in order to pay the auditor.[145]

Simon and Francis thus believe that a similar vested interest is developed when the auditors are willing to accept a low audit fee in the first year of the audit with the hopes of recovering the initial losses in subsequent years through efficiencies that are developed over time. The authors thus conclude that the practice of low-balling threatens the independence of the auditor.[146]

Simon and Francis further acknowledge that the initial discounted audit fee could be regarded as a sunk cost,[147] as identified by DeAngelo in his 1981 study.[148] As such, a sunk cost should not affect the economic decision making of the auditor. However, as noted by Simon and Francis, psychological studies performed by Arkes and Blummer in 1985 have provided evidence that sunk costs do in fact affect decision making. Arkes and Blummer note that the effects of incurring a sunk cost creates a greater endeavour to continue with an initiative once money, time and effort has been invested.[149] If the auditor was to offer an initial discounted audit fee, symbolic of low-balling, the auditor has made a considerable investment to obtain the new client. This would then create a strong incentive for the auditor to not lose the audit client to recover their initial investment in subsequent years. This could then compromise the independence of the auditor as even in the presence of serious disagreements between the auditor and the client regarding matters which affect the fair presentation of the financial

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[143] Op cit note 100.

144 Paragraph 12 of Section 100 of the SAICA Code of Professional Conduct defines a self-interest threat as the threat that a financial or other interest will inappropriately influence the registered auditor's judgment or behaviour;

[145] Ibid IRBA Code of Professional Conduct at s290 para 218.

[146] Op cit note 149 at 255.

[147] A sunk cost is defined as a cost that has been incurred and can therefore not be recovered.

[148] Op cit note 149 at 256.

[149] Ibid.

statements, the desire to not lose the audit client could cause the auditor to compromise their objectivity and make decisions in line with the arguments made by the client.

Evidence of low-balling and change of auditors may also send a signal to the market of inferior audit quality.

Regarding the above concern, a study[150] by Kamath, Huang and Moroney investigated the costs and benefits associated with mandatory rotation in the United States to determine the effect on the perceptions of the competence and independence of the incoming auditor as a result of mandatory rotation. The authors focused on analysing two production costs associated with audits, namely, audit fees and audit timeliness. The results of the study are summarised below:

1) Following a period of mandatory rotation, audit fees were significantly higher (possibly as the auditor attempts to recover the initial discount offered over time)
2) Likewise, there were longer time lags between the issuing of the audit report (This would generally be expected as the new auditors have to spend more time trying to understand the entity).
3) The results described in the first two points above were more prominent amongst auditors not making up the 'Big 4' and audit firms who did not possess specialised industry knowledge.
4) Higher audit fees and time lags between audit reports remain even after successive rotations.
5) Participants are indifferent to whether rotation is enforced at an individual (partner) level or at the audit firm level.
6) Higher audit fees following mandatory rotation are associated with higher degrees of auditor competence and independence by the participants.
7) Participants assess auditor competence to be higher when the incoming auditor is an industry specialist rather than a non-industry specialist.
8) Findings 6 and 7 above are consistent regardless of whether the rotation is enforced at an individual (partner) level or at the audit firm level.

[150] Roger Kamath, Ting-Chiao Huang, and Robyn Moroney 'Auditor Rotation and Perceived Competence and Independence: The Effect of Fees and Industry Specialization' (2018) 17(3) *Journal of International Accounting Research In-Press* at 153-175.

The results from the aforementioned study is significant given the following:

1) South Africa already has s 92 of the Companies Act which enforces rotation of the individual audit partner every five years. If users of financial statements are indifferent to whether the rotation happens at an individual (partner) level or at the audit firm level, the implementation of MAFR seems redundant.
2) Given the results of the previous studies which suggest that low-balling of audit fees is experienced with new audit engagements, this does raise concerns whether the incoming auditors would be perceived to not be as competent and independent.
3) Based on table 1 (see section 9.1 of this thesis), given their long audit tenure, many of those audit firms have built up specialist knowledge. As such, it is likely that the incoming auditors will not be industry specialists and therefore be perceived to not be as competent.

The implications of the aforementioned study does raise concerns whether this will result in the members of the audit committee not effectively discharging their statutory duties.

7.3.6.2 Local findings

7.3.5.6.1 Evidence of low-balling in South Africa

To date, very little formal studies have been conducted in South Africa which prove the existence of low-balling of audit fees, however, in their Consultation Paper,[151] IRBA noted low-balling as a concern related to the current practice of mandatory audit tendering and mandatory audit firm rotation. It is concerning to note that no evidence was provided in the Consultation Paper on which the audit regulator can justify identifying low-balling as a concern.

[151] Op cit note 1 at Table 4: Concerns raised for each measure.

In addition, in their response[152] to IRBA's consultation, the South African Institute of Chartered Accountants (SAICA), the concerns raised by chartered accountants in public practice (such as registered auditors) as a result of the implementation of MAFR is the possible detrimental effect on the quality of audits as fees have become a determining factors which clients consider in choosing audit firms and that the presence of low-balling exists as fees are set with the purpose of obtain certain engagements. While no evidence has been provided to establish that low-balling exists in South Africa, the fact that it was mentioned by the audit regulator and chartered accountants operating in public practice in South Africa does warrant further research into whether the practice of low-balling exists in South Africa.

In a recent South African study[153] of the effect on audit fees for voluntary changes of auditors for listed companies between the years of 2000 and 2010, Grant et al (2018) analysed the financial statements of over 400 companies and identified that there were 29 voluntary change of auditors during the period studied.

The results of the analysis showed that 66.67 per cent of the companies that changed auditors were given initial discounts to audit fees in the first year of the audit under the new auditors. The discounts were on average 24.67 per cent but varied greatly between 1.5 per cent and 71 per cent. Grant et al further identified that 33.33 per cent of the audit firms implemented an increase in audit fees in the second year of the audit with the new audit firm. The audit firms implemented a further fee discount on average. This is contrary to the results of many of the international studies above which found that audit fees increase in subsequent years following an initial fee discount.

However, the study did not consider any increases in audit fees which may have happened after year two of the audit and thus there may have been a delay in audit fee increases. If the company did experience an increase in audit fees, the increase was on average equal to 51.11 per cent. This is a substantial increase and as pointed out by the authors indicates that firms

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[152] South African Institute of Chartered Accountants (SAICA) 'Discussion Paper: Considering Mandatory Audit Firm Rotation (MAFR) (and other Related Measures) as Possible Means of Enhancing Auditor Independence' available at https://www.saica.co.za/portals/0/technical/assurance/AttachA_MAFRDiscussionPaper27Sep2016.pdf, accessed on 21 July 2018.

[153] Grant, R., Harber, M. and Minter, T. 'An analysis of the impact of audit firm rotation on audit fees: a South African perspective' (2018) 6(2) African J. Accounting, Auditing and Finance, at 91–108.

who do wish to recover the loss from the initial fee discount do not do so gradually but rather try to immediately recover their losses.

7.3.6.2.2 Cost concerns associated with MAFR raised by audit practitioners

In a 2016 study,[154] Harber conducted semi-structured open-ended interviews with fourteen experienced audit partners from Big 4, mid-tier and black-owned mid-tier audit firms in Gauteng and Cape Town to explore and understand the perceptions that audit practitioners had regarding the possible consequences that the implementation of MAFR will have on the audit profession. Many of the audit partners interviewed expressed their concerns regarding the extent of audit tendering that will increased and the associated costs that the implementation of MAFR will bring to the audit profession. The auditor partners raised many concerns related to the changing of auditors that MAFR will bring such as disruptions to the audit firm related to planning and activities of staff, increased costs, both financial and non-financial, associated with tendering for new clients, loss of institutional knowledge developed over time auditing a specific audit client and the potential effect on audit fees as a low audit fee is offered in order to obtain the business of an audit client in a competitive market (Many of the audit partners noted that low-balling would probably become a common practice as a result of MAFR). Many of the participants interviewed stated that in order for audit industry to remain profitable and continue to provide a quality audit, it would be unavoidable but necessary for audit firms to increase their audit fees. The audit partners stated that the implementation of MAFR will exacerbate the pressure experienced by the audit profession caused by changing auditors. As concluded by Harber, audit firms may compromise on audit quality as a result of having to offer substantial discounts on audit fees to remain competitive and attract new clients.

[154] Harber, M. 'An analysis of audit partner perceptions regarding the state of auditor independence in South African audit firms', (2016) *in Proceedings of the September 2016 Southern African Accounting Association Conference* at 6–24.

7.3.6.3 Evidence of counter measures to threats created by low-balling

Research shows that there are other measures which may counteract the threats created to auditor independence created by low-balling.

A study[155] by Ruiz-Barbadillo, Go-mez-Aguilar and Carrera conducted in 2009 explored whether MAFR enhanced auditor independence. The study used Spanish archival data as rotation of audit firms was mandatory in Spain every nine years from 1988 to 1995. The authors studied a sample of audit reports of financially distressed companies for a nine-year period from 1991 to 2000. The nine-year period consisted of a period in which mandatory rotation was in effect (1991 to 1994) and one without (1995 to 2000). Based on the results of their analysis, the authors concluded the following:

1) The decision to issue opinions that the financial statements are not materially misstated (called an unqualified opinion) was not influenced by the decision to retain their existing clients.
2) The decision to issue a qualified opinion was influenced by the auditor's incentive to protect their reputation as issuing the wrong opinion would severely damage the credibility of the audit firm.
3) The results above are consistent in both periods with and without MAFR, which does not provide empirical support that the introduction of MAFR will enhance auditor independence.

The above study may provide information contrary to the studies performed by Cameran et. al and Simon and Francis. Although the presence of low-balling exists as proposed by the aforementioned studies, research shows that there are other mitigating factors which may cause auditor independence to not be impaired by the vested interest in the audit client caused by offering an initial discount in the first year of a new audit.

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[155] Emiliano Ruiz- Barbadillo, Nieves Go´mez- Aguilar, and Nieves Carrera 'Does Mandatory Audit Firm Rotation Enhance Auditor Independence? Evidence from Spain.' (2009) 28(1) *AUDITING: A Journal of Practice & Theory: May 2009* 28 at 113-135.

It would be interesting for a similar analysis to be conducted in South Africa to determine whether the findings of Ruiz-Barbadillo et al are applicable to our local context. This could be an area for future research.

7.3.7 Impact on multinational audits

7.3.7.1 South African companies with global exposure

Many South African companies have expanded their operations internationally as a means to generate revenue from other markets, expand their operations and gain access to new talent and capital from foreign investors.

Appendix 1 (see section 9.2 of this thesis) provides a brief overview of the largest South African companies and the extent of their involvement in foreign countries.

7.3.7.2 Complexities created for group audits

Given that many of the South African companies now have a global footprint, this does increase the complexity related to the audit of these South African Groups.[156] In terms of the International Financial Reporting Standard 10,[157] *Consolidated Financial Statements*, the holding company must present financial statements separately from the companies making up the group. The financial statements of the group (called the consolidated financial statements) therefore show the consolidated results of all the economic activities of the companies making up the group.

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[156] A Group of Companies is the term given to the holding company and all entities controlled or under significant influence, either directly or indirectly, of the holding company which function together as one economic unit.

Elements of the 'control' and 'significant influence' definition under the International Financial Reporting Standards have been incorporated into the 'related party' definition under section 2 of the Companies Act.

[157] SAICA, 'Members Handbooks' available at https://www.saica.co.za/Technical/Assurance/SAICAHandbookIFRSHandbook/tabid/535/language/en-US/Default.aspx, accessed on 11 September 2018.

Given the costs involved such as the transport of resources and the unfamiliarity with the laws and regulations of foreign countries, it is likely that the South African auditors will not audit the foreign companies of the group. Instead, the foreign companies will be audited by a different team of auditors, generally by auditors located in the foreign jurisdiction. In terms of ISA 600, *Special considerations – Audits of Group Financial Statements (including work of component auditors),* When conducting the audit for the Group, the group auditor must satisfy themselves that the audit work performed by the auditors of the foreign companies and the conclusions reached as a result thereof are appropriate.[158] If the results of one of the foreign companies making up the group are not fairly presented, when those results are consolidated, if the foreign company is a significant component of the group, it could also cause the results of the group to not achieve fair presentation.

In many of the 'Big 4' audit firms, there is a network of audit firms across the world. Therefore, you may find the situation that where there is a group audit, the South African company and the foreign companies within the group, appoint the same audit firm eg. KPMG. The network of audit firms makes use of the same audit methodology (a common interpretation and application of the International Auditing Standards), quality control procedures and policies, HR and training practices. This helps to ensure that there is consistency in the application of the International Auditing Standards across the various network firms and that the employees are hired and upskilled in terms of shared technical and ethical values. These shared measures help to contribute towards a consistent standard of audit quality across the network of audit firms.

The implementation of MAFR will however cause complications for group audits as South African entities will not be able to consistently use the same auditors due to the enforced rotation implemented under MAFR. A situation may arise where all the entities within the group are audited by one network of audit firms eg. KPMG but after a period of ten years, any South African entities within the group will be unable to use the audit firm from the same network of audit firms eg. If KPMG are the auditors of the group, the South African company

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[158] Op cit note 84.
Per ISA 600 para 44:

> The group engagement team shall evaluate whether sufficient appropriate audit evidence has been obtained from the audit procedures performed on the consolidation process and the work performed by the group engagement team and the component auditors on the financial information of the components, on which to base the group audit opinion.

will have to replace KPMG South Africa as their auditors. The new incoming auditor will be different be a different audit firm from the group auditor which increases the complexity with the group audit as the new auditors will use different audit methodologies, quality control procedures, technology and resources to the rest of the audits conducted in the group. The increased complexity of group audits caused by this situation may result in the financial statements of the group not being fairly presented.

7.3.7.3 The implications for joint audits

When a new entity is acquired and becomes part of a group, if the newly acquired entity existing auditors are different to the auditors of the group this will result in the newly acquired entity replacing its existing auditor with that of the group. With group audits, a common situation has arisen where many group audits are now subject to joint audits.[159] A joint audit is where an entity is audited by two different auditors, one being the appointed group auditor ('group auditor') along with another audit firm ('existing auditor'). Both audit firms then provide an audit opinion on the same entity. The existing auditors may be small to medium-sized audit firms and it is most likely that these audit firms are replaced by large audit firms, typically audit firms from the 'Big 4'. Joint audits are therefore important for small or medium-sized audit firms as this allows those audit firms to still be involved with the audit client and therefore not lose a source of income, thereby increasing competition in the audit industry which ultimately promotes audit quality.[160]

Conducting a joint audit is therefore beneficial because it will allow the newly acquired entity's existing auditors to continue with the audit and therefore result in institutional knowledge acquired over time to be retained on the audit. This will allow the new auditors of the group to build up their knowledge of the new entity over time and also develop an understanding of the audit methodology applied by the existing auditors.[161]

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[159] Association of Certified Chartered Accountants (ACCA), 'ISA 600 (revised and redrafted), special considerations – audits of group financial statements (including the work of component auditors)' available at https://www.accaglobal.com/africa/en/student/exam-support-resources/professional-exams-study-resources/p7/technical-articles/group-audit-issues.html, accessed on 11 September 2018.

[160] Ibid
[161] Ibid

An additional benefit of a joint audit is that the two audit firms are able to pool their resources and expertise across the two audit firms in planning the audit, performing their audit procedures to gather audit evidence to support the audit opinion, review the work performed on the audit and to finally evaluate the audit evidence gathered and express an opinion. This should therefore also improve the quality of the audit.[162]

However, it may be time consuming and difficult for the audit firms to develop a joint approach to performing the audit, particularly if there are substantial differences in the audit methodologies used by each audit firm. Joint audit will also be costly as the entity will have to pay the audit fees of two audit firms instead of just one.[163]

While typically used in the context of group audits, it will be interesting to see if many entities engage in joint audits once MAFR becomes effective. As one audit firm approaches the maximum period of 10 years, a new audit firm is appointed to jointly audit the entity as this will allow for a transfer of institutional knowledge before the existing auditors are mandatorily rotated from the audit client.

According to Hay in his 2015 study,[164] joint audits are required in France and Denmark. However, there is little evidence exploring the effectiveness of joint audit. Joint audits remain a prevalent issue in Europe. Hay did however find that joint audits do lead to improved levels of audit quality but this comes at a trade-off as there is more evidence that joint audits are more expensive. In Hay's study, he notes that the higher costs associated with joint audits was confirmed by Ratzinger-Saker et al in their 2012 study.

Further research is required in this area to determine the costs and effectiveness of joint audits performed in South Africa.

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[162] Ibid

[163] Op cit note 169.

[164] David Hay, 'The frontiers of auditing research' (2015) 23(2) *Meditari Accountancy Research* at 158 – 174.

8. Conclusion & recommendation

8.1 Conclusion

The IRBA proposed the implementation of MAFR through the Auditing Profession Act.

The proposed amendment has sparked much debate amongst relevant stakeholders such as audit practitioners who have highlighted concerns that the implementation of MAFR may impact the statutory duties of directors.

The statutory duties of duties, include but are not limited, to directors acting in the best interest of the entity. Even though the implementation of MAFR was made through the Auditing Profession Act, legislation which is binding on auditors in South Africa and not directors, the directors are required to consider the Auditing Profession Act prior to their appointment of the auditor. Therefore, while it may not be advisable from a business perspective to change auditors, the directors will not be in breach of their statutory duty to act in the best interest of the entity, if their actions were performed in order to comply with legislation. This however, does create a natural tension between what makes sense from a business perspective versus what must be done to comply with legislation.

In order to discharge their statutory duties, the directors may rely on the information prepared by experts, provided the directors have reasonable grounds to believe that the information is reliable. The auditors are experts in the field of auditing and provide the directors with a report containing an opinion as to whether the financial statements are prepared in all material respects.

The preparation and fair presentation of the financial statements is the responsibility of the directors and not the auditors. While the auditors do not prepare the financial statements, through performing their audit, they identify misstatements which could result in the financial statements being materially misstated. These misstatements are communicated to management who then have the opportunity to correct the misstatements in order for the financial statements to be fairly presented.

A study by Tepalagul and Lin stated that audit quality is impacted by auditor independence. Audit quality is compromised if the auditors are not independent because the auditors will be less likely to identify and reports irregularities which they identify. Therefore, having independent auditors who perform a high quality audit will assist the directors in discharging their duty of fairly presenting the financial statements, as required by s 29 of the Companies Act.

Several studies in this thesis have indicated that the implementation of MAFR creates instances which may promote and strengthen auditor independence and overall audit quality. The implementation of MAFR results in a new audit team being appointed which results in new approaches, access to new resources in the form of technology and skills, the reduction of familiarity bias created by long audit tenures and the strengthening of professional scepticism.

However, many studies have provided evidence which does not support the view that MAFR will strengthen and promote auditor independence and overall audit quality. Long audit tenure results in the audit firm developing specialist knowledge of the entity and the industry, which ultimately improves audit quality. Where the audit firm is forced to rotate, there is a loss of institutional knowledge. In addition, studies have shown that low-balling of audit fees is prevalent following the introduction of new auditors. Offering a low audit fee creates financial incentives for the auditor to retain the client so that the initial audit fee discount can be recovered over time, thereby impairing auditor independence. Under MAFR, there will likely be more enforced rotations which will only exacerbate the pressures on audit firms to reduce their audit fees. Lastly, many South African entities operate in a global market and have foreign operations. It is commonplace for the local and foreign operations to be audited by audit firms in the same network as the audit firms have a common audit methodology, training, quality control standards and shared ethical values. An enforced rotation, as a result of MAFR, may create a situation where the auditors of the South African entity may be different from the auditors of the rest of the entities in the Group. This therefore increases the potential complexity associated with group audits and may negatively impact audit quality.

So while the implementation of MAFR may provide some benefits to auditor independence and overall audit quality, it does also pose some concerns which cannot be ignored by the

directors. If the directors have reason to believe that the auditors are not independent or have not performed a high quality audit, the directors will not be able to rely on the report issued by the auditors in order to discharge their statutory duty. Therefore, the implementation of MAFR may negatively impact the ability of the directors to discharge their statutory duties.

8.2 Recommendation

South Africa already has several existing measures to promote auditor independence and overall audit quality, some of which are contained, and discussed in this thesis, in the Companies Act and the ethical (Code of Conduct) and professional (International Standards on Auditing) standards prescribed and followed by auditors in South Africa. It is recommended that the audit regulator, IRBA, consider alternative means other than MAFR, possibly assessing whether existing measures which are already in place can be strengthened. In addition, further research is required in terms of whether the implementation of MAFR may infringe upon the ability of the shareholders to appoint the auditor. If a change of this nature may negatively impact the statutory duties of directors, it may warrant that a change of this nature being made through an amendment of the Companies Act and not the Auditing Profession Act.

9. Appendices

9.1 Table 1: Audit tenure exceeding 20 years (as at October 2016)[165]

NAME OF COMPANY	AUDITOR	AUDIT TENURE
AUDIT TENURE EXCEEDING 20 YEARS		
AECI Limited	KPMG	91 years
AngloGold Ashanti Limited	EY	72 years
Alexander Forbes Group Limited	PwC	20 years
Astrapak Limited	Deloitte	21 years
Aveng Limited	EY	30 years
Basil Read Limited	PwC	29 years
Bell Equipment Limited	Deloitte	22 years
Brimstone Investment Corporation Limited	Deloitte	20 years
Combined Motor Holdings Limited	PwC	40 years
Group Five Limited	PwC	46 years
Hulamin Limited	PwC	66 years
Illovo Sugar Limited	Deloitte	39 years
JSE Limited	KPMG	35 years
Lewis Group Limited	PwC	25 years
Mr Price Group Limited	EY	34 years
MTN Group Limited	PwC	22 years
	SizweNtsalubaGobodo	13 years
Mondi Limited	Deloitte	48 years
Murray & Roberts Holdings Limited	Deloitte	114 years
Naspers Limited	PwC	101 years
Nedbank Limited	Deloitte & KPMG	42 years
PSG Group Limited	PwC	20 years
Santam Limited	PwC	87 years
Standard Bank Group Limited	KPMG & PWC	53 years
Sun International Limited	PwC	32 years
Shoprite Holdings Limited	PwC	34 years
The Foschini Group Limited	KPMG	45 years
Tongaat Hulett Limited	Deloitte	78 years
Tsogo Sun Holdings Limited	PwC	47 years
Wilson Bayly Holmes-Ovcon Limited	BDO	30 years
Woolworths Holdings Limited	EY	84 years

[165] Op cit note 1.

9.2 Appendix 1: Eight largest South African companies and the extent of their foreign operations[166]

British American Tobacco

British American Tobacco South Africa forms part of the British American Tobacco Group. The Group operates in more than 180 countries across the world. The South African company was established following the successful global merger of Rothmans International, which is partly owned by the Rembrandt Group, and British American Tobacco p.l.c which is situated in London.

SABMiller

Following its incorporation in 1895, SABMiller was listed two years on the Johannesburg Stock Exchange (JSE), thereby becoming the first company in the industrial sector to be listed locally. SABMiller operates in more than 75 countries across six continents with an estimated 70 000 employees.

Naspers

Naspers is a multinational media and internet group, providing internet communication, entertainment, gaming and e-commerce services in more than 130 countries. Through MultiChoice, the group provides satellite television services to more than 6 million households across 48 countries in Africa.

[166] Gerhard Jacobs 'And the winners are: The top eight companies on the Johannesburg Stock Exchange', available at https://www.thesouthafrican.com/and-the-winners-are-the-top-eight-companies-on-the-johannesburg-stock-exchange/, accessed on 12 September 2018.

Glencore

The Glencore produce and market more than 90 commodities through approximately 150 assets situated across 50 different countries. The Group is dual-listed on the JSE and the London Stock Exchange (LSE) with its headquarters situated in Switzerland.

Richemont

Compagnie Financière Richemont SA is a luxury goods holding company based in Switzerland. For its 2018 financial year end, the Richemont Group generated 10 979 euros worth of sales across Europe, the Americas, Japan, Asia Pacific, the Middle East and Africa. Richemont has a primary listing on SIX Swiss Exchange and a secondary listing on the JSE.

MTN Group

MTN is one of the largest telecommunications Groups in South Africa. The company has expanded its operations to the Middle East and Africa and now operates in 24 different countries.

FirstRand Limited

FirstRand Limited is one of the largest financial institutions operating within South Africa with listings on the JSE and the Namibian Stock Exchange. The Group offers full banking services in eight African countries through its subsidiaries in Namibia, Botswana, Swaziland, Lesotho, Mozambique, Tanzania, Ghana and Nigeria.

9.3 Figure 1: Tepalagul and Lin[167]

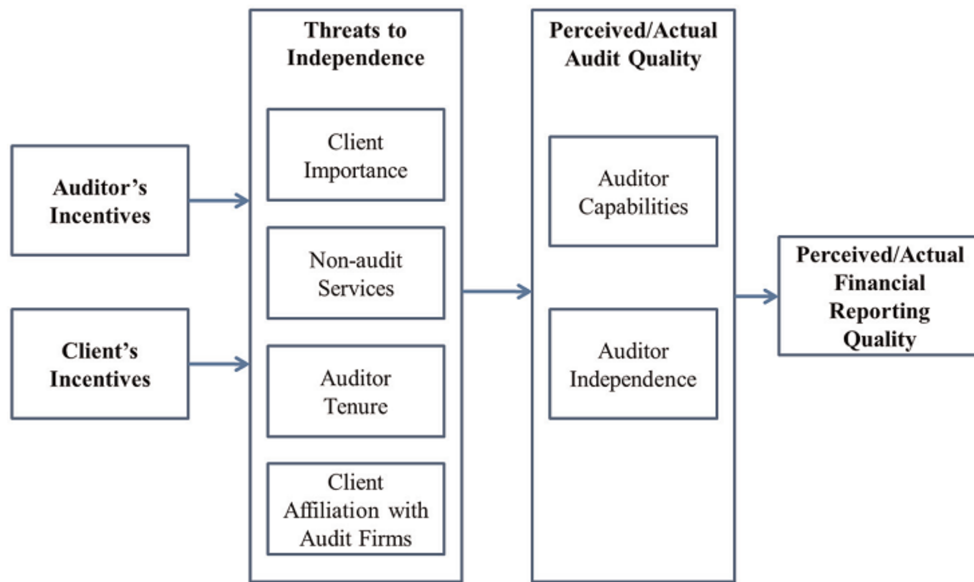

Figure 1. A framework for assessing the impact of auditor independence on audit quality.

9.4 Figure 2: Model of effects (direct and indirect) of partner rotation on audit quality[168]

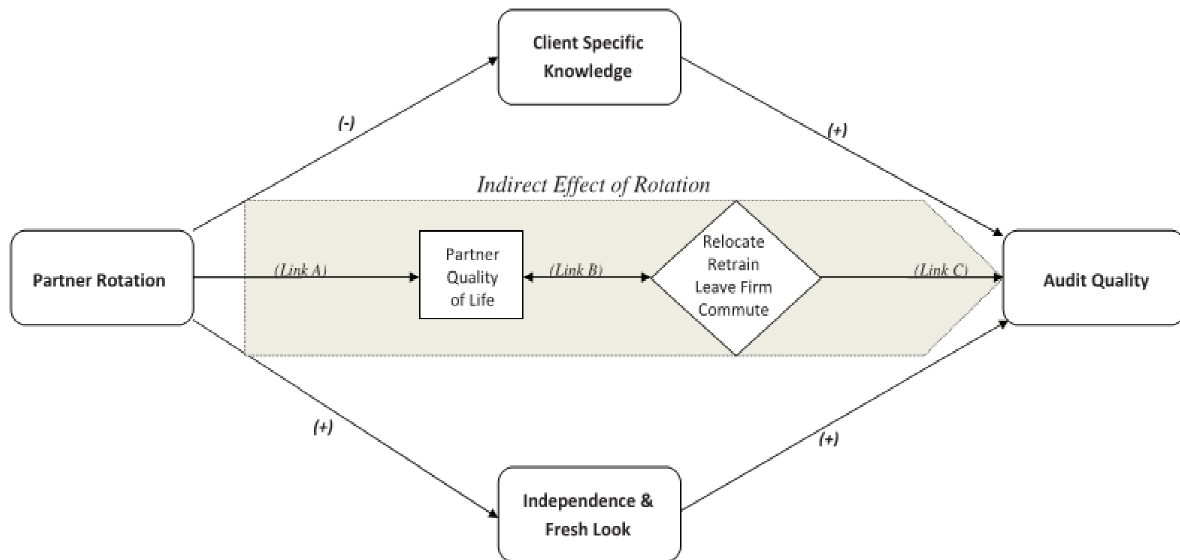

Figure 2. Model of effects (direct and indirect) of partner rotation on audit quality

[167] Op cit note 97 at 103.
[168] Op cit note 129.

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