

**REPORTABLE IRREGULARITIES:
A GUIDE FOR REGISTERED AUDITORS**

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INDEPENDENT REGULATORY BOARD FOR AUDITORS

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Authority of the guide

Registered auditors should be aware of and consider this guide applicable to an audit as defined in the Auditing Profession Act. A registered auditor who does not apply the guidance in this guide should be prepared to explain how the objective of the Auditing Profession Act has been otherwise achieved.

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Reportable irregularities: A guide for Registered Auditors

The purpose of this guide is to provide guidance to registered auditors on their responsibility to report reportable irregularities in terms of section 45 of the Auditing Profession Act, 2005 (Act 26 of 2005)(APA) In cases of uncertainty, registered auditors are advised to obtain legal advice. In this guide reference to an "auditor" or a "registered auditor", unless the context requires otherwise, means an auditor registered as such under the APA.

The guide is divided into five parts:

Part 1 provides the definition of a reportable irregularity and general principles.

Part 2 deals with when the duty to report irregularities arises and therefore highlights when this guide becomes applicable. It also highlights the process followed by the Independent Regulatory Board for Auditors (IRBA) on receipt of a reportable irregularity report made in terms of section 45.

Part 3 deals with the impact of a section 45 reportable irregularity on the audit opinion.

Part 4 provides guidance on specific situations which may require action from the auditor in terms of Section 45.

Part 5 deals with professional responsibilities, disciplinary measures and other sanctions.

The guide, *Material Irregularities: A Guide for Registered Accountants and Auditors*, of the Public Accountants' and Auditors' Board (PAAB) is withdrawn as of 1 April 2006, the date on which the Public Accountants' and Auditors' Act was repealed.

Part 1 - Definition and General principles

1 Section 1 of the APA

1.1 Section 1 of the APA defines a reportable irregularity as follows:

"reportable irregularity" means any unlawful act or omission committed by any person responsible for the management of an entity, which —

(a) has caused or is likely to cause material financial loss to the entity or to any partner, member, shareholder, creditor or investor of the entity in respect of his, her or its dealings with that entity; or

(b) is fraudulent or amounts to theft; or

(c) represents a material breach of any fiduciary duty owed by such person to the entity or any partner, member, shareholder, creditor or investor of the entity under any law applying to the entity or the conduct or management thereof.

2 An unlawful act or omission

2.1 For a reportable irregularity to exist there must be an unlawful act or omission, committed by any person responsible for the management of an entity.

2.2 An unlawful act would be an act which is contrary to any law passed by a government which applies to the activities of the entity, an act which is contrary to regulation and an act which is contrary to accepted common law principles.

2.3 Such an unlawful act might arise as a result of negligence or due to the intentional act of any person responsible for management of the entity (discussed in section 3) which, based on prima facie (meaning *'on the face of it'*) evidence, indicates that such negligence or intentional act is

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an apparent contravention of such law. Unlawful acts include the intentional breach of laws in the various jurisdictions in which the entity operates. Negligence arises when a person (and in the context of a reportable irregularity, this would be a person responsible for the management of the entity) reasonably ought to have known that an act or omission committed is unlawful.

- 2.4 The auditor considers reporting a reportable irregularity only if the auditor is satisfied or has reason to believe that the unlawful act or omission (including negligence where applicable) by a person responsible for the management of the entity is in contravention of any applicable law, or represents a material breach of fiduciary duty owed to the entity or to any partner, member, shareholder, creditor or investor of the entity.
- 2.5 An auditor is not a legal expert and performs an audit in accordance with principles and guidance contained in the International Standards on Auditing (ISA). The APA does not introduce additional audit procedures required to be performed for the purposes of detecting reportable irregularities and in the absence of these, the auditor reverts to principles and guidance contained in the ISA.
- 2.6 ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, states that, when designing and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognise that non-compliance by the entity with laws and regulations may materially affect the financial statements. However, an audit cannot be expected to detect non-compliance with all laws and regulations.
- 2.7 The final determination of whether an act or omission constitutes non-compliance is a legal determination that is ordinarily beyond the auditor's professional competence. However, the auditor's training,

experience and understanding of the entity and its industry may provide a basis for recognition that some acts coming to the auditor's attention may constitute non-compliance with laws and regulations.

- 2.8 The determination as to whether a particular act or omission constitutes or is likely to constitute non-compliance is generally based on the advice of an informed expert qualified to practise law and can ultimately only be determined by a court of law. The auditor therefore only has the duty to report the unlawful act or omission as a reportable irregularity where, based on the professional judgement of the auditor, he/she has prima facie evidence that causes the auditor to be satisfied or have reason to believe that the unlawful act or omission meets the definition of a reportable irregularity. The auditor then reports the reportable irregularity in good faith, based on the prima facie information that has come to the auditor's attention. 'Satisfied' in the context of this section does not mean that the auditor has to be satisfied that the person involved will be found to have contravened any law. It is also important to note that the auditor needs to have *reason to believe* and not necessarily *believe* that an unlawful act or omission had occurred. (Discussed in Section 26).

Consideration of unlawful acts or omissions where more than one individual registered auditor is responsible and accountable for an audit

- 2.9 It might occur that more than one individual registered auditor is responsible and accountable for an audit, such as in a joint audit where an individual registered auditor is appointed by each audit firm to be responsible and accountable for the audit. The duty to consider whether an unlawful act or omission is a reportable irregularity lies with each individual auditor. Depending on whether both auditors are satisfied or have reason to believe that a reportable irregularity exists, or whether one auditor is satisfied or has reason to believe, and one is

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not satisfied or does not have reason to believe that a reportable irregularity exists, the auditor's responsibilities are as follows:

2.9.1 Both individual registered auditors are satisfied or have reason to believe that the unlawful act or omission meets the definition of a reportable irregularity:

- The individual registered auditors responsible and accountable for the audit may send a combined report in terms of section 45; or
- Each individual registered auditor responsible and accountable for the audit may send a separate report, and still comply with the requirements of section 45.

2.9.2 One individual registered auditor may be satisfied or have reason to believe that the unlawful act or omission meets the definition of a reportable irregularity while the other is not so satisfied or does not have such reason to believe that the unlawful act or omission meets the definition of a reportable irregularity. As the onus to report a reportable irregularity rests with each individual auditor, the individual registered auditor that is satisfied or has reason to believe that the unlawful act or omission meets the definition of a reportable irregularity must send a report in terms of section 45 to comply with the requirements of the section. A copy of the report should also be sent to the other individual registered auditor.

Cross border audits

2.10 The APA does not apply to jurisdictions outside of South Africa. In a situation where the holding company is a South African entity and the auditor identifies a reportable irregularity in a foreign subsidiary of that holding company due to a contravention of South African law or a law in the foreign country, where local management was involved, the

auditor has a responsibility to report such a reportable irregularity in relation to the South African holding company.

- 2.11 The auditor considers whether such acts of the subsidiary are the result of an unlawful act or omission on the part of any person responsible for the management of the subsidiary which may be reportable in relation to the South African entity.

3 Committed by any person responsible for management of an entity

- 3.1 For a reportable irregularity to exist there must be an unlawful act or omission on the part of a person responsible for management of an entity. The discussion below outlines the reasoning which the auditor considers and provides guidance on determining whether a person is responsible for the management of an entity.¹

- 3.2 While the APA does not define the person responsible for management of an entity, the definition of a **"management board"**, a defined term which is only used in relation to reportable irregularities in the APA, suggests that a person responsible for the management of an entity would be someone who has the responsibilities and duties normally associated with the board of directors of a company or, in relation to any other entity, the body or individual responsible for the management of the business of the entity. The APA includes the following definition:

"management board" in relation to an entity which is a company, means the board of directors of the company and, in relation to any

¹ Decisions in the following court cases have been used as references for the interpretation in the guide:

- R v Boal (1992)
- Gibson v Barton (1875)
- Registrar of Restrictive Trading Agreements v W. H. Smith & Son Ltd (1969)

other entity, means the body or individual responsible for the management of the business of the entity.

- 3.3 The Glossary of Terms² to the International Auditing, Assurance, and Ethics Pronouncements issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) furthermore contains the definitions of management and governance. ISA 240, *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements*, and ISA 260, *Communications with Those Charged with Governance*, reinforces the notion of the distinction between governance and management³.
- 3.4 A person responsible for management of an entity would usually, individually or as a member of a group of others, be responsible for:
- The setting of the strategic objectives and operational policies of the entity;
 - The allocation of resources within the entity to achieve the strategic objectives and support the operational policies of the entity; and
 - The selection of accounting policies, review and authorisation of the financial statements, and the authorisation of personnel to act within predefined guidelines and frameworks.
- 3.5 In applying this section, it may be useful for the auditor to determine if the unlawful act or omission has been perpetrated by any person in the organisation responsible for overall planning, organising, leading, coordinating or controlling of the business affairs of the entity.
- 3.6 In the light of the above the auditor, in considering the class of persons covered by the description "*any person responsible for the*

² Refer to the IAASB Glossary of Terms for definitions

³ For additional guidance on reporting fraud suspected or identified refer to ISA 240, *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements*, and ISA 260, *Communications with Those Charged with Governance*.

management of the entity” has regard to the unlawful acts or omissions committed by:

3.6.1 In relation to companies:

- The board of directors of the company (including ‘shadow’ directors) and holding companies in group situations; and
- A manager as defined in Section 1 of the Companies Act – i.e. “any person who is a principal executive officer of the company for the time being, by whatever name he may be designated and whether or not he is a director.”; and
- Any person who in the affairs of the company exercises executive control which reflects the general policy of the company for the time being or which is related to the general administration of the company.

In considering whether a person is responsible for managing the company an auditor will have due regard both to the published details of the management structure thereof and to the *de facto* exercise of the requisite characteristics of control and management.

3.6.2 In relation to any other entity:

- The board of the entity; and
- The individual or individuals responsible for the management of the business of the entity; and
- Any person who in the affairs of the entity exercises executive control which reflects the general policy of the entity for the time being or which is related to the general administration of the entity.

In considering whether a person is responsible for managing the entity an auditor will have due regard both to the published details of the

management structure thereof and to the *de facto* exercise of the requisite characteristics of control and management.

- 3.7 Other individuals, or groups of individuals, as the case may be, may also be responsible for the management of the entity, for instance the management committee of a company. However, any person responsible for the management of the entity should carry sufficient responsibility for the entity and not only for parts of the entity's activities. So for instance, a branch manager within an entity carrying on business in various cities may or may not be responsible for management of the entity. The Executive Committee, on the other hand, will be responsible for the day to day implementation of the directives of the Board of Directors and therefore for the management of the entity.
- 3.8 Third parties may be contracted to discharge the responsibility of management of an entity – for instance a business manager, fund manager, pension fund administrator, medical scheme administrator or investment manager. The people within such third parties contracted to manage the entity would also be people responsible for management of the entity.
- 3.9 It is important to consider the concept of control in group situations. The auditor should consider whether those persons responsible for the management of a subsidiary within the group include individuals from the holding company.
- 3.10 It also follows that an unlawful act or omission of an employee of an entity with the knowledge or direction of any person responsible for management would, in the context of the above, be viewed by the auditor as an unlawful act or omission by a person responsible for the management of the entity.

4 Conditions for an unlawful act or omission being reportable
(Refer to Appendix 1 for a diagrammatic presentation to determine whether an irregularity is reportable)

4.1 The conditions for an unlawful act or omission being reportable are contained in sections (a) to (c) of the definition of a **“reportable irregularity”**. Each condition would give rise to a reportable irregularity and accordingly guidance is provided in respect of each condition. The conditions are:

- (a) has caused or is likely to cause material financial loss to the entity or to any partner, member, shareholder, creditor or investor of the entity in respect of his, her or its dealings with that entity; or*
- (b) is fraudulent or amounts to theft; or*
- (c) represents a material breach of any fiduciary duty owed by such person to the entity or any partner, member, shareholder, creditor or investor of the entity under any law applying to the entity or the conduct or management thereof.*

4.2	<i>“has caused or is likely to cause material financial loss to the entity or to any partner, member, shareholder, creditor or investor of the entity in respect of his, her or its dealings with that entity”</i>
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4.2.1 If the unlawful act or omission by any person responsible for the management of the entity has the consequence of causing or being likely to cause material financial loss to any of the parties named then the act or omission is reportable.

4.2.2 If the unlawful act or omission has not or is not likely to cause such financial loss then under this sub-section it is not reportable. The auditor then considers whether or not the act or omission meets the

requirements of the other two conditions stipulated in the definition of reportable irregularities. The auditor also considers whether or not he or she should report the act or omission in accordance with any other legislation, for example the Financial Intelligence Centre Act (FICA) or The Prevention and Combating of Corrupt Activities Act (PRECCA). (Discussed in Section 22).

- 4.2.3 The measure of materiality should be applied within the context of the absolute financial loss caused by the unlawful act or omission and not the level of materiality as applied for purposes of the audit of the financial statements. The auditor need not determine what the level of materiality is in relation to the financial affairs of any partner, member, shareholder, creditor or investor of the entity, either in their individual capacity or as a group, but considers the material financial loss to the entity or to any partner, member, shareholder, creditor or investor of the entity in respect of his, her or its dealings with that entity.
- 4.2.4 While it is difficult to set such a materiality level, the auditor considers the relative size of the loss or potential loss with regard to such parties on the basis of the auditor's professional judgment having regard to the nature and value of their collective dealings with the entity.
- 4.2.5 The auditor may not take into account any benefit that may arise from a reportable irregularity committed by management, for example, where a reportable irregularity arises as a result of the entity's dealings with a creditor but where that creditor is also a debtor of the entity. As a result, it may be inappropriate for an auditor to justify a net position that may result from the entity's collective dealings with that creditor/debtor.

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4.3 *"is fraudulent or amounts to theft"*

- 4.3.1 An unlawful act or omission may itself not give rise to financial loss or potential financial loss, but nonetheless constitutes fraud or amounts to theft. The auditor exercises professional judgment to determine whether an unlawful act or omission constitutes fraud or theft. In cases of uncertainty the auditor may or may not seek professional or legal advice.
- 4.3.2 Fraud in this context must be considered in the context of the legal definition of fraud. Fraud has been defined as follows: 'Fraud is the unlawful and intentional making of a misrepresentation which causes actual prejudice or which is potentially prejudicial to another'⁴. Fraud involves a deliberate deceit, or action, or omission in order to mislead another party to the other party's prejudice. Likewise, theft must also be considered in the context of the legal definition of theft. Theft has been defined as follows: 'Theft is the unlawful taking of a thing which has value with the intention to deprive the lawful owner or the lawful possessor of that thing.'
- 4.3.3 While fraud can be difficult to determine from a legal perspective, the auditor takes account of the evidence available and draws a conclusion on the possibility that the act or omission of any person responsible for management of the entity may amount to deceit or misrepresentation intended to cause prejudice to another.

⁴ The Law of South Africa 2nd Edition Volume 6

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4.4 *"represents a material breach of any fiduciary duty owed by such person to the entity or any partner, member, shareholder, creditor or investor of the entity under any law applying to the entity or the conduct or management thereof"*

4.4.1 A fiduciary duty can generally be defined as the legal duty of a fiduciary to act in the best interests of the beneficiary. In other words, a fiduciary duty is the obligation to act solely for the benefit of another party and to avoid a conflict of interest between his or her own interests and those of the other party.

4.4.2 A person generally comes into a fiduciary relationship when he or she controls the assets of another or holds the power to act. Fiduciaries are expected to be extremely loyal to the person they owe the fiduciary duty to: they must act in good faith on behalf of and for the sole benefit of the person to whom they owe the fiduciary duty and not put their personal interests before the duty, and must not profit from their position as a fiduciary.

4.4.3 Examples of fiduciary relationships include, without being exhaustive:

- A director in respect of his or her relationship to a company;
- A member in respect of his or her relationship to a close corporation;
- An employee in respect of his or her relationship to the employer;
- A partner in respect of his or her relationship to his or her co-partners; and
- A trustee in his or her relationship to the beneficiaries of the trust.

4.4.4 The measure of materiality for a breach of fiduciary duty should be applied within the context of the unlawful act or omission and not the level of materiality as applied for purposes of the audit of the financial

statements. Materiality is reviewed in the context of the nature of the breach and not purely in financial terms. The auditor determines the nature of the fiduciary duty and assesses the materiality of the breach having regard to its impact and consequences. The purpose for which the fiduciary duty was established, the impact upon governance within the entity and the consequences for the entity and third parties ought to be considered as well as the high requirement of loyalty and good faith expected of those responsible for management. Only inconsequential and trivial breaches of this form of duty ought to be regarded as non-material. The auditor may or may not seek legal advice in cases of uncertainty.

4.4.5 The key obligations in terms of the directors' fiduciary duties owed toward their company include:

- preventing a conflict of interest;
- not exceeding the limitations of their power;
- maintaining an unfettered discretion; and
- exercising their powers for the purpose for which they were conferred.

4.4.6 *Directors should prevent a conflict of interest*

A person in a fiduciary position, such as a director, has a legal duty to prevent a conflict arising between his or her own interests and those of the party whom he or she serves. It follows, therefore, that a director may obtain no other advantage from his or her office than that to which he or she is entitled by way of director's remuneration.

4.4.7 *Directors may not exceed the limitations of their power (Acts ultra vires)*

A director has a fiduciary duty to observe limitations of the powers of the company as well as the limits of his or her own authority to act on behalf of the company.

4.4.8 *Directors must maintain an unfettered discretion*

The directors must consider the affairs of the company in an objective manner and then, in their discretion, act in the best interest of the company.

5 Dealing with the entity

5.1 An unlawful act or omission by a person responsible for the management of the entity which has caused or is likely to cause material financial loss to the entity is a reportable irregularity. Similarly, an unlawful act or omission by a person responsible for the management of the entity which has caused or is likely to cause material financial loss to any partner, member, shareholder, creditor or investor of the entity in respect of his, her or its dealings with that entity, and irrespective of whether it has caused or is likely to cause material financial loss to the entity, is a reportable irregularity.

5.2 The unlawful act or omission by a person responsible for the management of an entity must cause direct financial loss to a partner, member, shareholder, creditor or investor in respect of their direct dealings with that entity in the sense that the unlawful act or omission directly causes the individual to suffer financial loss in respect of the particular dealing with the entity (see also 4.2.3).

5.3 The section does not require the auditor to engage in an exercise to consider materiality of losses to a partner, member, shareholder, creditor or investor who has no dealings affected by the unlawful act or

omission of the management of the entity. This may, of course, be an incidental conclusion flowing from the assessment of what constitutes a material financial loss of the entity in the first place.

- 5.4 Where an unlawful act or omission causes material financial loss only to certain partners, members, shareholders, creditors or investors of the entity and not to the general body of such persons then the auditor would not be obliged to enquire into the position of the general body. The matter would be reportable (see 5.2). It is, of course, a necessary corollary of a finding that a particular act would only cause loss to certain parties that, by the same token, the reasonable conclusion is reached that it will not cause loss to the others.

Part 2 – When the duty to report reportable irregularities arises and the process of dealing with reportable irregularities in terms of section 45

6 Requirements of section 45

(Refer to Appendix 2 for a diagrammatic presentation of the process to deal with a Reportable Irregularity)

6.1 The requirements are set out in section 45 of the APA:

(1)(a) An individual registered auditor referred to in section 44(1)(a) of an entity that is satisfied or has reason to believe that a reportable irregularity has taken place or is taking place in respect of that entity must, without delay, send a written report to the Regulatory Board.

(b) The report must give particulars of the reportable irregularity referred to in subsection (1)(a) and must include such other information and particulars as the registered auditor considers appropriate.

(2)(a) The registered auditor must within three days of sending the report to the Regulatory Board notify the members of the management board of the entity in writing of the sending of the report referred to in subsection (1) and the provisions of this section.

(b) A copy of the report to the Regulatory Board must accompany the notice.

(3) The registered auditor must as soon as reasonably possible but no later than 30 days from the date on which the report referred to in subsection (1) was sent to the Regulatory Board —

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- (a) take all reasonable measures to discuss the report referred to in subsection (1) with the members of the management board of the entity;*
 - (b) afford the members of the management board of the entity an opportunity to make representations in respect of the report; and*
 - (c) send another report to the Regulatory Board, which report must include —*
 - (i) a statement that the registered auditor is of the opinion that —*
 - (aa) no reportable irregularity has taken place or is taking place; or*
 - (bb) the suspected reportable irregularity is no longer taking place and that adequate steps have been taken for the prevention or recovery of any loss as a result thereof, if relevant; or*
 - (cc) the reportable irregularity is continuing; and*
 - (ii) detailed particulars and information supporting the statement referred to in subparagraph (i).*
- (4) The Regulatory Board must as soon as possible after receipt of a report containing a statement referred to in paragraph (c)(i)(cc) of subsection (3), notify any appropriate regulator in writing of the details of the reportable irregularity to which the report relates and provide it with a copy of the report.*
- (5) For the purpose of the reports referred to in subsections (1) and (3), a registered auditor may carry out such investigations as the*

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registered auditor may consider necessary and, in performing any duty referred to in the preceding provisions of this section the registered auditor must have regard to all the information which comes to the knowledge of the registered auditor from any source.

(6) Where any entity is sequestrated or liquidated, whether provisionally or finally, and a registered auditor referred to in section 44(1)(a) at the time of the sequestration or liquidation -

(a) has sent or is about to send a report referred to in subsection (1) or (3), the report must also be submitted to a provisional trustee or trustee, or a provisional liquidator or liquidator, as the case may be, at the same time as the report is sent to the Regulatory Board or as soon as reasonably possible after his or her appointment; or

(b) has not sent a report referred to in subsection (1) or (3), and is requested by a provisional trustee or trustee, or a provisional liquidator or liquidator, as the case may be, to send a report, the registered auditor must as soon as reasonably possible –

(i) send the report together with a motivation as to why a report was not sent; or

(ii) submit a notice that in the registered auditor's opinion no report needed to be submitted, together with a justification of the opinion.

Section 44(1)(a) provides:

Where a registered auditor that is a firm is appointed by an entity to perform an audit, that firm must immediately after the appointment is

made, take a decision as to the individual registered auditor or registered auditors within the firm that is responsible and accountable for that audit.

7 When the obligation to report a reportable irregularity arises

7.1 The obligation to report a reportable irregularity to the IRBA arises when:

7.1.1 The individual registered auditor (or individual registered auditors in the case of joint audits) responsible and accountable for an audit of an entity;

7.1.2 is satisfied or has reason to believe that an unlawful act or omission committed by any person responsible for the management of that entity, and which meets the requirements of the definition of a reportable irregularity, has taken place or is taking place in respect of that entity, based on the evidence (information) which comes to the knowledge of the registered auditor from any source.

7.2 Once the auditor is satisfied or has such reason to believe that a reportable irregularity has taken place or is taking place, the auditor, **"without delay"**, issues a letter to the IRBA indicating that the auditor has reason to believe that such a reportable irregularity has or is taking place.

8 Identification of a possible reportable irregularity

8.1 Section 45(5) of the APA states:

For the purpose of the reports referred to in subsections (1) and (3), a registered auditor may carry out such investigations as the registered auditor may consider necessary and, in performing any duty referred to in the preceding provisions of this section the registered auditor must

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have regard to all the information which comes to the knowledge of the registered auditor from any source.

- 8.1.1 In considering a matter relating to a potential reportable irregularity the individual registered auditor, or the firm, as the case may be, considers all information which comes to the knowledge of the individual registered auditor or the knowledge of the firm from any source.
- 8.1.2 This legal provision will require the auditor to consider information which comes to the auditor's attention which would otherwise be ignored due to the confidentiality requirements contained in the Code of Professional Conduct, regarding knowledge the auditor gains when providing services of another nature to the audit client or providing services to a client other than the audit client.
- 8.1.3 The auditor also considers matters which come to the auditor's knowledge from third party sources. For instance, criminal charges, allegations of non-compliance raised, press coverage of suspicions, or inquiries directed to the auditor would be information which the auditor should consider in determining whether a reportable irregularity exists.
- 8.1.4 The auditor can reasonably be expected to consider the reliability of the source, the nature of the information and the relationship of such information to other knowledge regarding the entity. Based on such considerations the auditor decides whether to investigate the information further at that stage.
- 8.1.5 In terms of section 45(5), the auditor only has to consider information which comes to the auditor's attention. There is no requirement or onus on the auditor in terms of the APA to design procedures and inquiries to discover reportable irregularities. The requirement is solely for the auditor to respond to any information that comes to the attention of the auditor.

- 8.1.6 A registered auditor may carry out such investigations as the registered auditor may consider necessary to enable the auditor to report in terms of the APA.
- 8.1.7 The investigations are designed only to provide the auditor with sufficient grounds to conclude whether or not a reportable irregularity has taken place or is taking place or whether or not the auditor has reason to believe that such reportable irregularity has taken place or is taking place. Although investigations may or may not include discussions with management, such investigations are not designed to provide management with time to rectify the situation so as to avoid the auditor issuing the initial report on the potential reportable irregularity.
- 8.1.8 An auditor should bear in mind that no legal protection exists for the auditor issuing a reportable irregularity report, where the auditor did not have sufficient grounds to do so.

9 Reporting 'without delay'

- 9.1 The reference to 'without delay' in section 45(1) should be interpreted as applying from the point at which the auditor is satisfied or has reason to believe that a reportable irregularity exists, based on the evidence which has come to the auditor's attention. A delay in breach of the section would occur, for example, whenever an auditor who is so satisfied or has such reason to believe defers reporting solely because the auditor is waiting on management to rectify the circumstances. The 'reasonable auditor' test is appropriate in these circumstances, i.e., the time a reasonable auditor would take to report the irregularity once he or she is satisfied or has reason to believe that the reportable irregularity has taken or is taking place. Other circumstances may also arise where delay may occur, but this may not necessarily result in the

auditor not complying with the provisions of this section, for example, obtaining legal advice in determining whether an act or omission is a reportable irregularity as defined.

10 Responsibility to report

10.1 *Section 45(1) provides as follows:*

(a) An individual registered auditor referred to in section 44(1)(a) of an entity that is satisfied or has reason to believe that a reportable irregularity has taken place or is taking place in respect of that entity must, without delay, send a written report to the Regulatory Board.

10.1.1 The individual registered auditor is the sole proprietor or, in the case of companies or partnerships, the individual registered auditor/s nominated by the firm to take responsibility and accountability for the audit of the financial statements⁵ and who has/have the obligation to report a reportable irregularity to the IRBA.

10.1.2 Section 45(5) requires the individual registered auditor, or the firm, as the case may be, to respond to information that has come to the attention of the individual registered auditor or the firm. The APA includes the following provisions for registration of firms as auditors:

Registration of firms as registered auditors

38(1) The only firms that may become registered auditors are —

⁵ In terms of section 44(1) and section 45 (1) an auditor who is appointed to perform an audit as defined in section 1 has a responsibility to consider and report, if appropriate, a reportable irregularity. Section 1 defines an audit as including the audit of financial statements, financial information and other information in order to express an opinion on such financial statements, financial information or other information. In terms of section 44(2) a 'fairly presents' opinion on any financial statement or any supplementary information attached thereto in respect of a period may not be issued without an appropriate qualification where a reportable irregularity exists or existed.

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- (a) *partnerships of which all the partners are individuals who are themselves registered auditors;*
- (b) *sole proprietors where the proprietor is a registered auditor; and*
- (c) *companies which comply with subsection (3).*

Furthermore, section 44(1) requires that, where the registered auditor is a firm, the firm must immediately take a decision as to the individual registered auditor or registered auditors within the firm that is responsible and accountable for that audit.

- 10.1.3 Audit firms are encouraged to consider the establishment of policies encouraging employees and registered auditors within the firm to render assistance to the individual registered auditor by bringing information relating to potential reportable irregularities to his or her attention.
- 10.1.4 Audit programmes and manuals could be a means to provide guidance to all members of the audit team with regard to the concept of a reportable irregularity and the necessity to bring any evidence of actual or potential reportable irregularities to the attention of the individual registered auditor.
- 10.1.5 A registered auditor only has an obligation to report reportable irregularities in respect of an audit client. A client of a registered auditor is classified as an audit client if the auditor provides professional services to that client that meet the definition of an "audit" in terms of section 1 of the APA:

***"audit"** means the examination of, in accordance with prescribed or applicable auditing standards –*

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- (a) *financial statements with the objective of expressing an opinion as to their fairness or compliance with an identified financial reporting framework and any applicable statutory requirements;*
or
- (b) *financial and other information, prepared in accordance with suitable criteria, with the objective of expressing an opinion on the financial and other information*

10.1.6 Paragraph (a) of the definition relates to an audit of financial statements, and as such any engagement to express an opinion as to fairness or compliance of the financial statements with an identified financial reporting framework and any applicable statutory requirements will result in the client of the audit firm being an audit client.

Paragraph (a) also relates to a review engagement of interim financial and other information, performed in accordance with the International Standards on Review Engagements (ISRE) 2410, *Review of Interim Financial Information Performed by the Independent Auditor*, where the auditor expresses a limited assurance opinion. ISRE 2410 falls in the scope of the definition as the auditor performing such a review of interim financial information is also the auditor who performs the audit of the financial statements.

10.1.7 Paragraph (b) of the definition addresses any other audit of financial and other information, prepared in accordance with suitable criteria, with the intention of expressing an opinion on such financial and other information.

10.1.8 ISRE 2400, *Engagements to Review Financial Statements*, is one in which the individual registered auditor provides a moderate level of assurance (limited assurance). An engagement to review financial

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statements falls outside the scope of the definition where such an engagement is performed at a client that is not also an audit client, that is, the auditor does not also perform the audit of the financial statements.

10.1.10 An agreed-upon procedures engagement or an engagement to compile financial information, performed in accordance with the International Standards on Related Services (ISRS), does not require the auditor to either express an opinion or assurance and falls outside the scope of an 'audit' as defined in the APA.

10.1.11 However, if the audit firm provides services other than the audit of financial and other information, for example while performing an agreed-upon procedures engagement, or any other assurance engagement, which does not fall within the scope of the definition of "**audit**" but the client is nevertheless an audit client of the audit firm, the auditor considers any information which comes to the knowledge of the auditor which may cause the auditor to be satisfied or have reason to believe that a reportable irregularity has taken place or is taking place, while performing those professional services. Another example would be where the audit firm, in conducting a forensic investigation at a client that is also an audit client of the firm is satisfied or has reason believe that a situation exists, which meets the conditions of being reportable. Where such a situation exists, such information should be brought to the attention of the individual registered auditor. Firms are encouraged to have policies in place for employees and registered auditors within the firm to bring information relating to a potential reportable irregularity to the attention of the individual registered auditor.

10.1.12 Audits performed on behalf of the Auditor-General (AG) do not result in a responsibility for the individual registered auditor to report the

reportable irregularity to the IRBA. The registered auditor in this instance should report the matter to the AG because the entity has not appointed the auditor. However, in circumstances where the AG has opted not to audit the entity, and such public sector entity appoints the auditor, the registered auditor reports the reportable irregularity to the IRBA.

10.2 *Reportable irregularities identified at subsidiary level within a group of companies*

10.2.1 Where a reportable irregularity has occurred at a subsidiary within a group of companies the question arises as to whether the reportable irregularity will affect the group. It is suggested that the group individual registered auditor will act in terms of section 45 where the audit report on the subsidiary's annual financial statements has been modified as appropriate by the auditor of the subsidiary on the basis of section 45. The group individual registered auditor will apply the criteria of the definition of a reportable irregularity to the group as a whole with regard to the reportable irregularity identified in the subsidiary - for example, group management's unlawful acts or omissions to the extent of their involvement in the management of the subsidiary. Where the group auditor is satisfied that the reportable irregularity applies to the group, the group individual registered auditor acts in accordance with section 45. The group individual registered auditor modifies his or her audit report as appropriate on the group where he or she has complied with section 45 (Discussed in Part 3 of the guide).

10.2.2 The group individual registered auditor and subsidiary individual registered auditor may be the same person. In such circumstances it may benefit the auditor, particularly in terms of timing, to apply the

considerations of section 45 to the subsidiary and the group simultaneously.

11 Advising clients on the auditor's responsibility in terms of section 45

11.1 In order to protect the auditor against any potentially unjustifiable action by a client, and to ensure that the client understands the auditor's responsibility in terms of section 45, engagement letters, whether it be for 'audit' engagements as defined or for other professional services provided, should include suitable wording which indicates this responsibility as well as the legal requirements imposed on the auditor by the APA.

11.2 Auditors are encouraged to review the current engagement letters they have with their clients, to amend the wording appropriately and to re-issue their client with new engagement letter(s) so as to reflect the auditor's responsibility in terms of section 45.

12 Reasonable measures to discuss the report with members of the management board of the entity

12.1 The paragraphs below are included to provide more clarity on what the auditor should consider in complying with the provisions in the APA which require that reasonable measures should be taken to discuss the report in section 45(1) with the members of the management board of the entity, as contemplated in terms of section 45(2).

12.2 The requirement of reasonableness involves the application of an objective test based upon the measures which ought to be taken by a 'reasonable auditor'.

12.3 The concept of a discussion involves an interactive process between the auditor and the management board. The auditor has no means of

compelling the management board to enter into that interactive process with him or her. The section requires the auditor to send a copy of the irregularity report to the members of the management board within three days. It then requires the auditor to take reasonable measures to discuss the report with *"the members of the management board of the entity"*. The auditor is required to afford *"the members of the management board of the entity an opportunity to make representations in respect of the report"*. It is relevant to note that the requirement of reasonableness is only specified in relation to the attempts to discuss the report with the management board. Clearly this is because the legislature recognises that the auditor has no mechanism to compel the board to interact with him or her. The other consideration is that the section contemplates that the discussions and representations will be with or by *"the members of the management board"* collectively. Finally, it must be recognised that each individual case must be judged according to the prevailing facts. An auditor dealing with a properly constituted and active management board would not act in the same way as an auditor dealing with a management board which has abandoned its responsibilities.

12.4 Against that background, the above can be summarised as follows:

12.4.1 *"reasonable measures"* would include at least the following conduct depending upon the circumstances of the case:

- Extending an invitation to discuss the matter with the board by clear and appropriate communication at the earliest reasonable opportunity.
- Prudence would suggest that the invitation ought to be recorded in writing and it might be most conveniently done by incorporating the invitation to discuss in the notice addressed to the management board under Section 45(2)(a).

- If the auditor has reasonable grounds for believing that the systems and administration of the entity are such that one collective notice to the management board will be properly disseminated by the entity then one such notice would be appropriate. If, however, there is any reasonable basis for believing that the invitation will not be extended to all members of the management board then the auditor ought reasonably to address an individual invitation to each board member at such addresses as have been provided to him or her, or which he or she may, upon reasonable enquiry, obtain.
- Where no physical or postal address is available the auditor should attempt to establish contact to extend the invitation telephonically or by other electronic communication systems if contact details are available to him.
- The auditor is not required to assume the role of tracing agent or to publish notices in the mass media.
- The invitation extended should indicate the auditor's reasonable availability both from the perspective of time and venue. The absence of any response from the management board may lead the auditor to take reasonable steps to establish that the notice/invitation has reached its destination.
- The wording of the notice/invitation should clearly reflect that if the management board fails or declines to engage in discussion with the auditor then the matter will proceed in conformity with the requirements of Section 45.

12.4.2 If the individual registered auditor has taken all reasonable measures to communicate with the management board of the entity but is unable to do so through no fault of the auditor then such auditor has complied with the requirements of the section and cannot be criticised or

prosecuted for failing to do so. Under these situations, the auditor should submit a statement, together with the second report sent to the IRBA in terms of section 45(3), that the auditor has taken all reasonable measures to discuss the report referred to in section 45(1) with the members of the management board of the entity.

13 The IRBA's duty to report to any appropriate regulator

13.1 An "appropriate regulator" is defined in terms of section 1 of the APA:

"appropriate regulator", in relation to any entity, means any national government department, registrar, regulator, agency, authority, centre, board or similar institution established, appointed, required or tasked in terms of any law to regulate, oversee or ensure compliance with any legislation, regulation or licence, rule, directive, notice or similar instrument issued in terms of or in compliance with any legislation or regulation, as appears to the Regulatory Board to be appropriate in relation to the entity;

13.2 *The process the auditor can expect where a matter has been referred to the Director of Public Prosecutions*

13.2.1 Where a matter is referred by the IRBA to the Director of Public Prosecutions, the Commercial Branch of the SAPS may be requested by the Director of Public Prosecutions to investigate the matter, in which case it will open a docket and the first step that it will take will be to obtain a statement from the auditor concerned indicating what criminal offence might have been committed by the entity or its management board.

13.2.2 Auditors will generally receive a call from the member of the Commercial Branch who is responsible for the particular investigation. Many auditors are uncertain as to their professional obligations when this happens as section 45 is silent on the subject. Auditors should

afford the police official full co-operation as far as answering questions is concerned. Where, however, the police official wishes to remove documents from the auditor's office, regard should be had to the following:

- No legal privilege exists between a practitioner and the practitioner's client as exists in certain other professional relationships. The Code of Professional Conduct, read with Disciplinary rule 2.1.8 does not create a legal privilege in favour of an auditor. Therefore, an auditor may not lawfully refuse to hand over documents of relevance when called upon by the South African Police Service, provided the latter have shown that they are acting within the ambit of their powers.
- The relevant sections of the Criminal Procedure Act, 1977 (Act 51 of 1977) are the following:

"Section 21 – Article to be seized under search warrant:

- (1) *Subject to the provisions of sections 22, 24 and 25, an article referred to in section 20 shall be seized only by virtue of a search warrant issued –*
 - (a) *by a magistrate or justice, if it appears to such magistrate or justice from information on oath that there are reasonable grounds for believing that any such article is in the possession or under the control of or upon any person or upon or at any premises within his area of jurisdiction; or*
 - (b) *by a judge or judicial officer presiding at criminal proceedings, if it appears to such judge or judicial officer that any such article in the possession or under the*

control of any person or at any premises is required in evidence at such proceedings.

(2) A search warrant issued under subsection (1) shall require a police official to seize the article in question and shall to that end authorise such police official to search any person identified in the warrant, or to enter and search any premises identified in the warrant and to search any person found on or at such premises.

(3)(a) A search warrant shall be executed by day, unless the person issuing the warrant in writing authorises the execution thereof by night.

(b) A search warrant may be issued on any day and shall be of force until it is executed or is cancelled by the person who issued it or, if such person is not available, by a person with like authority.

(4) A police official executing a warrant under this section or section 25 shall, after such execution, upon demand of any person whose rights in respect of any search or article seized under the warrant have been affected, hand to him a copy of the warrant."

13.2.3 Articles may be seized without a search warrant if the person concerned consents thereto, or if the police official believes a search warrant would be issued if he or she applied for one and the delay in obtaining one would defeat the object of the search (*section 22*).

13.2.4 In view of the Code of Professional Conduct, read with Disciplinary Rule 2.1.8, it is suggested that any police official requesting documentary evidence be asked to produce a search warrant as envisaged by section 21 of the Criminal Procedure Act. It is suggested that auditors do not

consent to search or seizure without the police official producing the written search warrant. If the police official maintains that he or she would be issued with a search warrant if it were applied for and that the delay in obtaining such a warrant would defeat the object of the search, auditors may not lawfully refuse to allow the police official to search and seize any documents. It would be advisable to request the police official to confirm this assertion in writing.

- 13.2.5 Auditors should also take note of paragraphs 9.6 and 9.7 of the Code of Professional Conduct which provide that, where an auditor is required to disclose information, or provide documentation relating to a client's affairs, the auditor should inform his client that this is the case, and take care not to disclose more information, or provide more documentation, than is strictly necessary.
- 13.2.6 Search and seizure authority also vests in state officials under other legislation. Any request for access to documentation should be acceded to only after the official has provided proper identification and an official warrant authorizing the seizure. If in doubt auditors should seek legal advice on their obligations.

Part 3 - The impact of reportable irregularities on the audit opinion

14 Requirements of section 44

14.1 Section 44 provides as follows:

(2) *The registered auditor may not, without such qualifications as may be appropriate in the circumstances, express an opinion to the effect that any financial statement or any supplementary information attached thereto which relates to the entity —*

(a) *fairly presents in all material respects the financial position of the entity and the results of its operations and cash flow; and*

(b) *are properly prepared in all material aspects in accordance with the basis of the accounting and financial reporting framework as disclosed in the relevant financial statements.*

unless a registered auditor who is conducting the audit of an entity is satisfied about the criteria specified in subsection (3).

(3) *The criteria referred to in subsection (2) are —*

.....

(e) *that the registered auditor has not had occasion, in the course of the audit or otherwise during the period to which the auditing services relate, to send a report to the Regulatory Board under section 45 relating to a reportable irregularity or that, if such a report was so sent, the registered auditor has been able, prior to expressing the opinion referred to in subsection (1), to send to the*

Regulatory Board a notification under section 45 that the registered auditor has become satisfied that no reportable irregularity has taken place or is taking place;.....

15 Application of section 44

15.1 In the context of the APA, the reference to “*without such qualifications as may be appropriate in the circumstances*” has the same meaning as a modified audit report as contemplated by the auditing standards. A reportable irregularity may not affect the fair presentation of the financial statements. However, where the existence of a reportable irregularity does affect the fair presentation of the financial statements, the auditor follows the guidance contained in ISA 700, *The Auditor’s Report on Financial Statements*.

15.2 The auditor is unable to issue an audit report on financial statements or supplementary information thereto without including an appropriate modification, in the event that:

- The reporting process to IRBA is incomplete;
- A reportable irregularity did exist, even if it is no longer taking place and in respect of which adequate steps have been taken for the prevention or recovery of any loss as a result thereof, if applicable; or
- A reportable irregularity existed which could not be/was not corrected (i.e. the reportable irregularity is continuing).

15.3 Therefore, the fact that a reportable irregularity which existed is no longer taking place and adequate steps have been taken for the prevention or recovery of any loss as a result thereof, would nonetheless require the inclusion of an appropriate modification of the audit report on financial statements or supplementary information thereto.

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15.4 A modification that results from a reportable irregularity is included in the auditor's report as a separate paragraph that follows the opinion paragraph.

15.5 An example of such modification may be:

- Where management has made adequate and appropriate disclosure and the financial statements are fairly presented, in all material respects:

“Report on Other Legal and Regulatory Requirements

In accordance with our responsibilities in terms of sections 44(2) and 44(3) of the Auditing Profession Act, we report that we have identified certain unlawful acts or omissions committed by persons responsible for the management of XYZ which constitute reportable irregularities in terms of the Auditing Profession Act, and have reported such matters to the Independent Regulatory Board for Auditors. The matters pertaining to the reportable irregularities have been described in note xx to the directors' report.”

- Where management has not made adequate and appropriate disclosure and the financial statements are fairly presented, in all material respects, the auditor discloses the information relating to the reportable irregularity in the audit report.

15.6 Depending on the circumstances the auditor may or may not consider it appropriate to add explanatory text following the modification paragraph required in terms of section 44, for example:

- “Management have been unable within the period of 30-days allowed by the Auditing Profession Act to satisfy us that such conduct did not amount to a reportable irregularity”; or

- “Management have responded to the circumstances and conduct in question to the extent that we believe no further loss is being experienced and such loss as was experienced has been recovered [or steps to recover such loss have been initiated by management].”; or
- The conduct which may have been [fraudulent] [amounted to theft] [a breach of a material fiduciary duty owed] and amounted to a reportable irregularity is to the best of our knowledge [no longer occurring] [continues at the date of this report to be evident].

15.7 As the APA is not applicable to review (other than a review of interim financial statements) and other assurance engagements, it does not specifically require the inclusion of an appropriate modification to:

- An assurance report on matters other than financial statements or supplementary information thereto (in terms of ISAE 3000); or
- A review report on financial statements (in terms of ISRE 2400).

However, where the client is an audit client, the auditor considers in the circumstances whether such a modification is appropriate in the context of such other assurance report or review report on financial statements (other than a review report on interim financial statements). The auditor documents this consideration and the conclusion reached.

15.8 Where the auditor issues a review report on an engagement to review interim financial statements (in terms of ISRE 2410) and a reportable irregularity has been reported to the IRBA and the circumstances described in 15.2 above exist, the auditor should modify his or her report in accordance with the requirements of section 44(2) and 44(3).

16 Unresolved/recurring reportable irregularities in subsequent years

- 16.1 The auditor will reassess the reportable irregularity for which the last audit report was modified before issuing any subsequent audit report. Where the prior year reportable irregularity is relevant to the current audit of the annual financial statements, the auditor treats the reportable irregularity as a new reportable irregularity and complies with the provisions of section 45.
- 16.2 The auditor considers the continued professional relationship with the client in circumstances where reportable irregularities remain unresolved or reoccur in subsequent years.

17 Withdrawal from the audit engagement

- 17.1 The International Standards on Auditing (ISA) and in particular ISA 240, *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements*, and ISA 250, *Consideration of Laws and Regulations in the Audit of Financial Statements*, provides that the auditor may conclude that withdrawal from the engagement is necessary when the entity does not take the remedial action that the auditor considers necessary in the circumstances, even where the non-compliance or irregularity is not material to the financial statements.
- 17.2 The auditor should complete the reporting of a reportable irregularity before resigning from an audit. In the case of companies, this is required by the provisions of sections 300 and 301 of the Companies Act, 1973. In the case of other audit appointments, the IRBA expects auditors to complete such reporting prior to resigning. The report process is completed once the auditor has submitted the second report to the IRBA as required by Section 45(3).

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- 17.3 If an auditor has reason to believe or suspects the existence of a reportable irregularity and the auditor is replaced (following resignation or a termination of services) such auditor should communicate the circumstances and details to the superseding auditor.

Part 4 - Specific situations which may require action in terms of Section 45

It is not possible to envisage every situation which will give rise to a reportable irregularity and the extent of the auditor's action will depend on the specific circumstances of each case. The existence of the following situations might prompt the auditor to consider reporting in terms of Section 45:

18 Fraud in relation to the financial statements

- 18.1 ISA 240 (revised), *The Auditor's Responsibility to consider Fraud in an Audit of Financial Statements*, defines fraud as an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Fraud is a broad legal concept and the auditor is concerned with fraud that causes a material misstatement in the financial statements. Auditors do not make legal determinations of whether fraud has actually occurred and should obtain legal advice where appropriate. ISA 240 refers to two types of misstatements which would result in fraud: misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. It also emphasises fraudulent financial reporting resulting from pressures on management to manage earnings and requires the auditor to be particularly alert for these situations. Reference should be made to ISA 240 for further guidance.
- 18.2 The auditor should also consider other unlawful acts or omissions committed by any person responsible for management of the entity that are fraudulent.

19 Clients trading while their liabilities exceed their assets

19.1 The mere fact that an undertaking's liabilities exceed its assets, fairly valued, (factual insolvency), is not regarded by the IRBA as a "reportable irregularity" as contemplated in section 45. However, there is no doubt that this fact creates a situation which is susceptible to reportable irregularities taking place, which would, in turn, give rise to a duty to report.

19.2 Fraud can be committed by any undertaking or its officers or employees, whether or not the undertaking is a company. However, Section 424 of the Companies Act, 1973, and its provisions relating to "intent to defraud" and "carrying on of the business recklessly" are obviously relevant only where the Companies Act is applicable to the client.

19.3 *Fraud*

19.3.1 The crime of fraud includes unlawfully making, with intent to defraud, a misrepresentation which causes actual prejudice or which is potentially prejudicial to another.

19.3.2 Directors who, for example, order goods for their company, make an implied representation to the seller that they believe the company will be able to pay its debts when they fall due. Hence, if they know that there is no likelihood of payment and no means of payment, they commit fraud. The same is true if they do not really believe that the company will be able to pay, or if they are recklessly careless about whether there is any chance of the debt being able to be paid for or not.⁶

⁶ *Orkin Brothers Ltd. V Bell* 1921 TPD 92; *Ruto Flour Mills (Pty) Ltd V Adelson* 1959(4) SA 120 (T); *R v Myers* 1984(1) SA 375 (A).

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- 19.3.3 There is a clear danger of criminal fraud where a company is trading in insolvent circumstances. There can be no doubt at all that fraud is an “irregularity”. If the auditor is satisfied or has reason to believe that an irregularity has taken or is taking place, as contemplated in section 45, the auditor’s duty to report arises.
- 19.3.4 Fraud is a delict as well as a crime. For this reason the directors, or where the entity is not a company, the management, as defined, responsible for the misrepresentation may also incur a personal liability to the defrauded third party.⁷
- 19.4 *“Intent to defraud” under section 424 of the Companies Act, 1973*
- 19.4.1 Directors and others who knowingly carry on a company’s business “with intent to defraud” creditors of the company or creditors of any other person or “for any fraudulent purpose” are guilty of an offence in terms of section 424(3). It should be noted that the auditor has no responsibility to establish conclusively whether intent existed or not.
- 19.4.2 If a company continues to carry on business and to incur debts when there is, to the knowledge of the directors, no reasonable prospect of the creditors ever receiving payment of those debts it is, in general, a proper inference that the company is carrying on business with “intent to defraud”.⁸
- 19.4.3 Again, there can be no doubt that this statutory offence based on fraud constitutes an “irregularity” that requires a written report if the other considerations mentioned in section 45 are present.

⁷ *Orkin Brothers Ltd. v Bell* 1921 TPD 92; *Ruto Flour Mills (Pty) Ltd. v Adelson* 1959(4) SA 120 (T); *Alex Murray (Pty) Ltd v Perry* 1961(2) SA 154 (N); *Milne NO v Marilal* 1961(1) SA 799 (D).

⁸ *S v Harper* 1981(2) SA 638 (D) at 681 C; *R v Wax* 1957(4) SA 399 (C); *Dorklerk Investments (Pty) Ltd v Bhyat* 1980(1) SA 411 (W); *Re William C Leitch Brothers Ltd* [1932]2 Ch 71.

19.4.4 When considering whether the entity is trading under insolvent conditions, the auditor also considers the existence of subordination agreements and guarantees.

19.5 *Recklessness under section 424*

19.5.1 A director or any other person who is knowingly a party to the reckless carrying on of a company's business is guilty of an offence in terms of section 424(3). This does not automatically imply that there has been a reportable irregularity. Where such recklessness will, however, result in material financial loss, a reportable irregularity will exist.⁹ There can be no doubt that:

- where a company's liabilities exceed its assets, there is a danger of it being found that its business has been carried on recklessly (which includes gross negligence);
- recklessly carrying on a company's business as contemplated in section 424(3) constitutes an "irregularity" in terms of section 45; and
- this form of irregularity, which in essence consists of an appreciation of the risk and a willful disregard for likelihood of its occurrence, is, from the auditor's point of view, the most important one to consider where his client company is trading under circumstances where its liabilities exceed its assets.

20 Non-compliance with laws and regulations

20.1 In terms of ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, the auditor is required, when planning and performing audit procedures and in evaluating and reporting the results

⁹ *Fisheries Development Corporation of SA Ltd v Jorgensen* 1980(4) SA 156 (W) 170B-C; *S v Harper* 1981(2) SA 638 (D) 681 A-B.

thereof, to recognise that non-compliance by the entity with laws and regulations may materially affect the financial statements.

20.2 Instances of non-compliance with laws and regulations may require reporting in terms of section 45. The auditor applies the criteria of section 45 to the circumstances of each case and acts accordingly.

20.3 For further audit guidance with regard to compliance with laws and regulations, refer to ISA 250.

21 Complying with the requirements of the Financial Advisory and Intermediary Services Act

21.1 The Financial Advisory and Intermediary Services Act, Act 37 of 2002, (FAIS) aims to regulate the rendering of certain financial advisory and intermediary services.

21.2 In terms of section 19(4) of FAIS, the auditor is to report to and inform the registrar¹⁰ of financial services providers in writing of any irregularity or suspected irregularity in the conduct of the affairs of the authorised financial services provider concerned, of which the auditor became aware in performing functions as auditor and which, in the opinion of the auditor is material. FAIS creates a duty on the auditor to report irregularities directly to the registrar of authorised financial services providers. A report in terms of section 19(4) is made regardless of steps taken by management to correct the irregularity and, unlike section 45 of the APA, section 19(4) does not allow a 30 day period within which members of the management board are allowed to make representations in respect of the report.

21.3 An irregularity for purposes of section 19(4) is broader than an irregularity in terms of section 45. Hence an irregularity in terms of

¹⁰ Financial Services Board (FSB).

section 19(4) is not necessarily a reportable irregularity in terms of section 45. Where the auditor comes across a section 19(4) irregularity he or she must, however, also consider section 45.

21.4 Guidance on the responsibilities of auditors in terms of FAIS can be sought directly from the Financial Services Board.

22 Complying with the requirements of the Financial Intelligence Centre Act

22.1 The Financial Intelligence Centre Act, Act 38 of 2001, (FICA) establishes the Financial Intelligence Centre (FIC) to which every business and every employee of every business is required to report specified unusual and suspicious transactions in relation to that business. It also creates other administrative money laundering control duties on those entities which classify as “accountable institutions” in terms of schedule 1 of FICA. Money laundering activities constitute non-compliance with laws and regulations and may be connected with fraudulent activity. The conduct of an audit is not aimed at discovery of possible money laundering activities.

22.2 The IRBA has issued a guide, *Money Laundering Control: A Guide for Registered Accountants and Auditors*, which provides guidance on the responsibilities of auditors with regard to the money laundering legislation.

22.3 Where the auditor has identified suspicious or unusual transactions during the performance of the audit, no report is made directly to the FIC. The provisions of FICA do not apply to the auditor in that situation; however section 45 may be applicable.

22.4 It must be emphasised that the auditor considers the circumstances particular to each case and seeks legal advice in cases of uncertainty.

22.5 The auditor must also consider the requirements of ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, regarding reporting of non-compliance to management. Management should be made aware of any non-compliance with FICA by the entity as soon as practicable. In situations where management is involved in such non-compliance, the auditor considers his reporting responsibility under section 45.

23 Failure to present books for audit

23.1 Failure to present books and records for audit is not in itself a reportable irregularity. However, failure to present books or records may be a means by which a reportable irregularity is being hidden. The auditor should consider carefully whether or not the client is deliberately withholding the books and records so as to prevent the auditor from detecting a reportable irregularity. Where the auditor is satisfied, or has reason to believe, that this is the case the auditor should proceed with the steps set out in section 45.

Part 5 – Professional responsibility, disciplinary measures and other sanctions

24 Consequences for the individual registered auditor failing to report a reportable irregularity

24.1 The auditor faces three possible consequences for failing to report a reportable irregularity as required by the APA:

- In terms of sections 48, 49 and 50, the auditor may face investigation and disciplinary sanction by the IRBA – which sanction may include the following:
 - a caution or reprimand to the registered auditor;
 - a fine not exceeding the amount calculated according to the ratio for five year's imprisonment prescribed in terms of the Adjustment of Fines Act, 1991 (Act No. 101 of 1991);
 - suspension of the right to practise as a registered auditor for a specific period; and/or
 - cancellation of the registration of the registered auditor concerned and removal of his or her name from the register of auditors.
- In terms of section 46(7) of the APA, the individual registered auditor may face a civil claim for damages by parties aggrieved by the reportable irregularity, if this was not reported, and a duty to report was owed. Section 46(7), however, does not extend an unconditional right to any party to make such claim for damages. Only those parties able to prove the necessary elements of the delictual action for breach of statutory duty including the requirements of loss and causation may have such rights.

- In terms of section 52 of the APA, the individual registered auditor or the registered auditor may face criminal prosecution with a jail term not exceeding 10 years, and/or the equivalent fine being imposed if found criminally liable, or both.

25 Consequences for a registered audit firm failing to report a reportable irregularity

25.1 The registered audit firm may face the following if the individual registered auditor fails to report the reportable irregularity:

- In terms of section 46(7) of the APA, the registered audit firm may face a civil claim for damages by parties aggrieved by the reportable irregularity, if this was not reported, and a duty to report was owed. Section 46(7), however, does not extend an unconditional right to any party to make such claim for damages. Only those parties able to prove the necessary elements of the delictual action for breach of statutory duty including the requirements of loss and causation may have such rights.

26 Failing to report a Reportable Irregularity

26.1 The paragraphs below are extracts from a legal opinion sought on the auditor's liability for failure to report a reportable irregularity, even though the audit was performed in terms of auditing standards.

26.1.1 The discussion on this topic relates only to the category of reportable irregularity in which the registered auditor "has reason to believe" that such conduct has taken place. If the registered auditor is "satisfied" that a reportable irregularity has taken place, there is a mandatory reporting obligation and failure to report constitutes an offence in terms of Section 52(1)(a). This follows from the unambiguous wording of Section 45(1)(a) which applies the subjective criteria that it is the

individual registered auditor “that is satisfied”. (See the discussion below).

- 26.1.2 The phrase “has reason to believe” has been the subject of interpretation by South African courts in many cases dealing with criminal and administrative process, insolvency legislation and in cases dealing with the grounds justifying an order that security be given. In Vumba Intertrade CC v Geometric Intertrade CC 2001 (2) SA 106(A) Cloete J summarised the position as follows:

“Although the phrase ‘there is reason to believe’ places a much lighter burden of proof on an applicant than, for instance, ‘the court is satisfied’, the ‘reason to believe’ must be constituted by facts giving rise to such belief and a blind belief, or a belief based on such information or hearsay evidence as a reasonable man ought or could not give credence to, does not suffice.

In short, there must be facts before the court on which the court can conclude that there is reason to believe that a plaintiff close corporation will be unable to satisfy an adverse costs order; and the onus of adducing such facts rests upon the applicant.” (We have omitted the intervening case reference citations in this passage).

- 26.1.3 The subjective nature of the wording of Section 45(1)(a) – i.e. “*an individual registered auditor ... of an entity that ... has reason to believe that a reportable irregularity has taken place*” is clear insofar as it imposes a reporting obligation on an auditor who has such belief. The issue which is more complicated is whether it is necessary or appropriate to contemplate the imposition of criminal sanctions on an auditor who was aware of a set of facts which ought reasonably to have led him/her to the belief that a reportable irregularity had occurred but who subjectively did not reach that conclusion by virtue of his/her negligence. The imposition of criminal sanctions based upon the

subjective actual belief by an auditor and the deliberate failure to report represents a clear and unambiguous interpretation of the statute and would accord with the obvious intention of the legislature in introducing this new substantial penalty stipulation. The issue is whether the phrase is properly capable of interpretation to include the situation in which the auditor ought but did not subjectively so believe. The extension of a penalty in respect of negligent conduct would generally not be inferred in the absence of a clear indication to the contrary or in order to give proper effect to the obvious intention of the legislature. As Kellaway states in his book "*Principles of Legal Interpretation*" at page 236:

"A South African Court has clearly stated the principle that where a section of a penal enactment is capable of a reasonable interpretation which will avoid the penalty in any particular case, a court should adopt that construction."

26.1.4 In White v White and another (2001) 2 AER 43 the House of Lords was required to interpret the provisions of an industry based insurance agreement which was in turn intended to apply the stipulations of an EEC directive. In considering the interpretation of the phrase "*knew or ought to have known*" Lord Nicholls stated:

"Against this background I turn to the interpretation of the phrase 'knew or ought to have known' in cl 6(1)(e) of the 1988 MIB agreement. This question of interpretation is governed by English law. 'Ought' imports a standard by reference to which conduct is measured. Such is the prevalence of negligence in English law that the phrase immediately prompts the thought that the standard imported by 'ought' is the standard of the reasonable person. In cases of professional negligence the standard is that of the reasonably competent and careful professional in the relevant discipline. But this is not necessarily the

standard. The meaning of the phrase depends upon its context. Here the context is the directive. The MIB agreement was entered into with the specific intention of giving effect to the directive."

- 26.1.5 Having concluded that the provision in the industry agreement ought to be restrictively interpreted, Lord Nicholls continued:

"The phrase 'knew or ought to have known' in the MIB agreement was intended to be co-extensive with the exception permitted by art 1 of the directive. It was intended to bear the same meaning as 'knew' in the directive. It should be construed accordingly. It is to be interpreted restrictively. 'Ought to have known' is apt to include knowledge which an honest person who enters the vehicle voluntarily would have. It includes the case of a passenger who deliberately refrains from asking questions. It is not apt to include mere carelessness or negligence. A mere failure to act with reasonable prudence is not enough. Hence it does not embrace the present case."

- 26.1.6 In a dissenting judgment in the same case Lord Scott referred to this notion of a party deliberately refraining from acquiring a knowledge or belief when he quoted a previous judgment of his in which he sought to express the essentials of what he termed "*blind-eye*" knowledge as follows:

"Blind-eye knowledge requires, in my opinion, a suspicion that the relevant facts do exist and a deliberate decision to avoid confirming that they exist. The deliberate decision must be a decision to avoid obtaining information of facts in whose existence the individual has good reason to believe."

- 26.1.7 It was this type of knowledge that was the basis of the earlier conclusion by Lord Nicholls that:

"The law generally treats this state of mind as having the like consequences as would follow if the person, in my example the passenger, had acted honestly rather than disingenuously. He is treated as though he had received the information which he deliberately sought to avoid. In the context of the directive that makes good sense. Such a passenger as much colludes in the use of an uninsured vehicle as a passenger who actually knows that the vehicle is uninsured. The principle of equal treatment requires that these two persons shall be treated alike."

26.1.8 A court would restrictively interpret the provisions of Section 45(1)(a) as read with Section 52(1)(a) to hold that there has been a criminal offence in the case of an auditor who is subjectively satisfied or who subjectively has reason to believe or who, in the above sense, has "blind-eye" knowledge – i.e. who deliberately elects not to pursue an enquiry in order to avoid obtaining confirmation of the facts which he suspects would give him reason to believe that a reportable irregularity has taken place. It is not believed that a court would interpret the statute as imposing criminal sanctions on a registered auditor who *bona fide* but negligently does not draw the conclusion that a reportable irregularity has occurred from facts discovered (even if a reasonably prudent auditor in his position would have done so) or who does not discover the facts in the first place (even if he ought to have done so by the exercise of reasonable care).

26.2 In summary:

Section 45 only imposes an additional regulatory reporting requirement on the auditor. The auditor is required to conduct his/her audit in accordance with the standards set out in the definition of "auditing pronouncements" and if he acts in accordance with those standards and fails to identify a reportable irregularity, then, absent particular

factual circumstances, it ought not to be concluded that he acted negligently and certainly not that he acted in a manner subject to criminal or civil sanction. If the auditor acted bona fide but negligently in the sense discussed in 26.1.8 above, there may be civil consequences for the auditor and the firm under section 46(7) in appropriate cases, but criminal sanctions ought not to follow.

27 Statutory protection for auditors

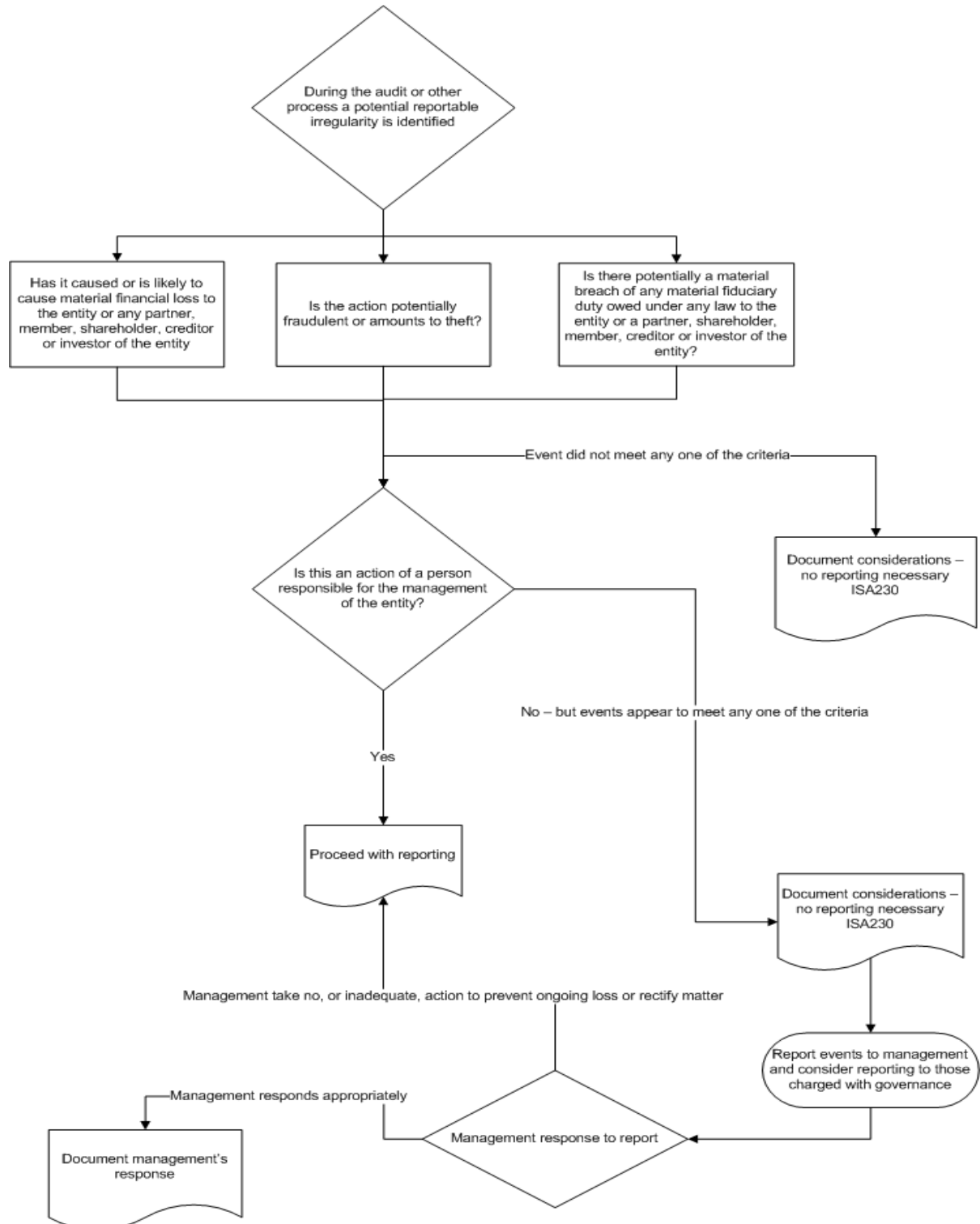
27.1 There is no statutory protection for an auditor who inappropriately concludes that an event is reportable, reports such reportable irregularity and modifies the audit report in this regard.

28 Transitional provisions

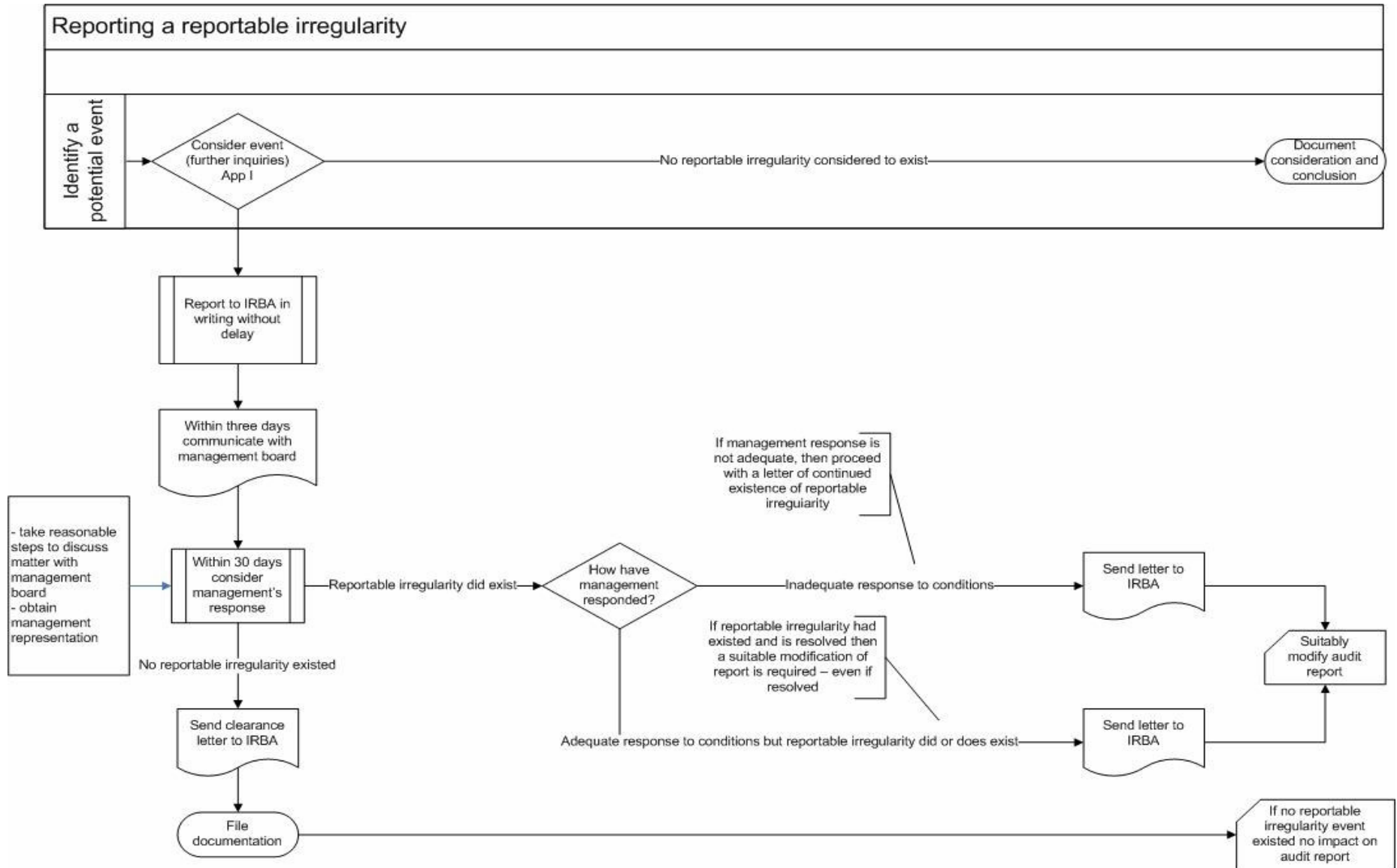
28.1 The APA does not include any transitional provisions in respect of reportable irregularities. This means that the effective date of the sections on reportable irregularities is 1 April 2006.

APPENDICES

APPENDIX 1: A DIAGRAMATIC PRESENTATION TO DETERMINE WHETHER AN IRREGULARITY IS REPORTABLE



APPENDIX 2: A DIAGRAMMATIC PRESENTATION OF THE PROCESS FOR DEALING WITH POTENTIAL REPORTABLE IRREGULARITIES



**APPENDIX 3: PRACTICAL EXAMPLES OF CIRCUMSTANCES WHICH
MAY INDICATE THE EXISTENCE OF A REPORTABLE IRREGULARITY**

The following summarised examples are drawn from the more typical situations where material irregularity reports were issued under the Public Accountants' and Auditors' Act, along with circumstances auditors have identified which may meet the conditions of being a reportable irregularity.

This list is not intended to be exhaustive but rather to illustrate the kinds of acts or omissions which amount to reportable irregularities. Auditors should apply their professional judgement to specific facts presented in each case as circumstances may differ from the scenarios illustrated in the examples. The facts should be evaluated by the auditor for each individual case. Further, auditors may wish to seek legal counsel in specific circumstances.

Reportable irregularities: A guide for Registered Auditors

	Is this an act of a person responsible for the management of the entity?	Is this an unlawful act or is it an omission?	Which conditions does this meet (Material financial loss; fraudulent or amounting to theft; material breach of any fiduciary duty)	Is this a reportable irregularity? If not, what action should the auditor take?	What is the impact on the audit report?
<i>1. Non payment of withholding amounts:</i>					
<i>1.1 During the audit it is identified that a branch of the entity has failed to make a payment to a third party of amounts withheld on that party's behalf – often PAYE, VAT, Pension Fund Contributions or Medical Aid Contributions. The person responsible for these payments is the Branch Financial Manager. Management is not aware of these non-payments.</i>					
	No – the branch financial manager is not responsible for management of entity but has day to day responsibility to perform duties under an employment contract.	Yes In the case of some payments (e.g. PAYE, VAT, Pension Fund contributions) this would be unlawful. The omission in this case is clearly incorrect.	This action may give rise to a material financial loss to employees, fiscal authorities or others.	This is not a reportable irregularity. The auditor should report the incident to those responsible for management of the entity.	None.
<i>1.2 The auditor reports the incident in 1.1 to those responsible for the management of the entity. These persons acknowledge receipt of the report but do not take steps to pay over the amounts in question to the ultimate intended recipient.</i>					
	Yes – those responsible for management of the entity have not acted (an omission).	In the case of some payments (e.g. PAYE, VAT, Pension Fund contributions) this would be unlawful. The omission in this case	This unlawful act may meet the conditions of a material financial loss to creditors, it may be fraudulent and may also amount to a breach of a material fiduciary duty	Yes. While management may rectify the loss, the existence of the irregularity will	The audit report is modified appropriately.

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	Is this an act of a person responsible for the management of the entity?	Is this an unlawful act or is it an omission?	Which conditions does this meet (Material financial loss; fraudulent or amounting to theft; material breach of any fiduciary duty)	Is this a reportable irregularity? If not, what action should the auditor take?	What is the impact on the audit report?
		is clearly incorrect.	owed.	remain.	
<i>2. Tender payments</i>					
<p><i>2.1 While conducting a forensic investigation (not an audit of financial statements, financial information or other information) at a construction company (not an audit client) a receipt of cash from another client of the audit firm – who is an audit client of the firm – is identified. The payment was made by cheque and was made without any apparent services or goods provided. The audit client of the firm was subsequently awarded a material supply contract by the construction company. The cheque was signed by the Chief Executive of the audit client. The forensic staff advise the individual registered auditor of the audit client.</i></p>					
	<p>With regard to the construction client the auditor has no obligation to consider any potential reportable irregularity (the receipt of a potential bribe).</p> <p>With regard to the audit client, the Chief Executive of the audit client is a person responsible for management of that entity.</p>	Payments to secure business not otherwise due may be unlawful.	<p>Unlawful act is at a non-audit client.</p> <p>This unlawful act, if authorised by the Board of Directors, would amount to a material breach of a fiduciary duty owed to the entity in ensuring that its affairs</p>	<p>Yes, in respect of the audit client (not in respect of the non-audit client).</p> <p>The auditor should also consider his or her reporting obligation in terms of FICA or PRECCA.</p>	As the action cannot be undone the audit report would be modified appropriately, even if the money is repaid by the building company to the audit client.

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	Is this an act of a person responsible for the management of the entity?	Is this an unlawful act or is it an omission?	Which conditions does this meet (Material financial loss; fraudulent or amounting to theft; material breach of any fiduciary duty)	Is this a reportable irregularity? If not, what action should the auditor take?	What is the impact on the audit report?
			are conducted within the law.		
<p>2.2 <i>The office of the audit firm in Country Y identified that the operations manager of an audit client (a subsidiary of a South African parent company) in that country was paying bribes to government officials in order to obtain contractual awards. On investigation it was discovered that the manager was instructed to commit these acts by the local operations manager (in country Y), as this is the common business practice in Country Y. This is a breach of a law in Country Y.</i></p>					
	<p>No – the branch manager in Country Y is not responsible for management of the South African parent company.</p> <p>If the subsidiary was in South Africa then it would be assessed on its own – and in that circumstance the branch manager would be considered responsible for the management of <i>the subsidiary</i>, and not the parent company.</p>	<p>This is a breach of the laws in Country Y.</p> <p>If this was a South African subsidiary then this would be a breach of South African law with regard to <i>the subsidiary</i>.</p>	<p>If there are financial consequences of the payments (a fine for example) this would amount to a potential material financial loss to the entity.</p> <p>The actions described amount to a breach of fiduciary duties owed to others.</p>	<p>In circumstance described – no reportable irregularity has occurred.</p> <p>If this was an unlawful act within a South African subsidiary then, with regard to <i>that subsidiary</i>, a reportable irregularity has occurred.</p>	<p>None.</p> <p>The audit report of <i>the subsidiary (if in South Africa)</i> is modified appropriately.</p>

Reportable irregularities: A guide for Registered Auditors

	Is this an act of a person responsible for the management of the entity?	Is this an unlawful act or is it an omission?	Which conditions does this meet (Material financial loss; fraudulent or amounting to theft; material breach of any fiduciary duty)	Is this a reportable irregularity? If not, what action should the auditor take?	What is the impact on the audit report?
<i>3. Trading in contravention of section 424 of the Companies Act</i>					
<i>3.1 At the end of the audit of Company A, the auditor discovers that Company A is factually insolvent and trading recklessly (a contravention of section 424 of the Companies Act). The audit report is modified in this regard.</i>					
	Yes.	This is in contravention of the Companies Act.	It will result in material financial loss to creditors and shareholders and possibly other third parties.	Yes.	The audit report is modified appropriately.
<i>4. Non-compliance with laws and regulations</i>					
<i>4.1 Income tax returns or other tax returns incomplete in a material respect.</i>					
	If management was aware (and management is normally aware) or directly responsible for the non-compliance, it will be an act or omission by management.	Yes.	Material financial loss in respect of potential fines; breach of fiduciary duty.	Yes	The audit report is modified appropriately.
<i>4.2 Late submission of VAT returns, where the amount owing (with or without resultant penalties or interest) is not material</i>					
	If management was aware (and management is	Yes	Not a material financial loss in respect of	No	None.

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	Is this an act of a person responsible for the management of the entity?	Is this an unlawful act or is it an omission?	Which conditions does this meet (Material financial loss; fraudulent or amounting to theft; material breach of any fiduciary duty)	Is this a reportable irregularity? If not, what action should the auditor take?	What is the impact on the audit report?
	normally aware) or directly responsible for the non-compliance, it will be an act or omission by management. The act or omission does not result in material financial loss or material breach of fiduciary duty.		potential fines; not a material breach of fiduciary duty.		
<i>4.3 Non submission of VAT returns</i>					
	If management was aware (and management is normally aware) or directly responsible for the non-compliance, it will be an act or omission by management.	Yes	Fraudulent (This is fraudulent whether it is material or immaterial)	Yes	The audit report is modified appropriately.
<i>4.4 Books and records not maintained to a material degree.</i>					
	If management was aware (and management is normally aware) or directly responsible for the non-compliance, it will be an	Yes	Material financial loss in respect of potential fines; breach of fiduciary duty.	Yes	The audit report is modified appropriately.

Reportable irregularities: A guide for Registered Auditors

	Is this an act of a person responsible for the management of the entity?	Is this an unlawful act or is it an omission?	Which conditions does this meet (Material financial loss; fraudulent or amounting to theft; material breach of any fiduciary duty)	Is this a reportable irregularity? If not, what action should the auditor take?	What is the impact on the audit report?
	act or omission by management.				
<i>4.5 Unauthorised directors expenses and loan accounts.</i>					
	If management was aware (and management is normally aware) or directly responsible for the non-compliance, it will be an act or omission by management.	Yes	Material financial loss in respect of potential fines; theft or fraud; breach of fiduciary duty.	Yes	The audit report is modified appropriately
<i>4.6 Annual financial statements not issued on time, absence of required directors' meeting or shareholders' meeting.</i>					
	If management was aware (and management is normally aware) or directly responsible for the non-compliance, it will be an act or omission by management.	Yes	A material breach of fiduciary duty.	Yes	The audit report is modified appropriately.
<i>5. Non compliance with financial reporting standards</i>					
At the moment this will not necessarily constitute a reportable irregularity. However, as soon as Financial Reporting Standards are legislated in the new Companies Act, it will.					