Article

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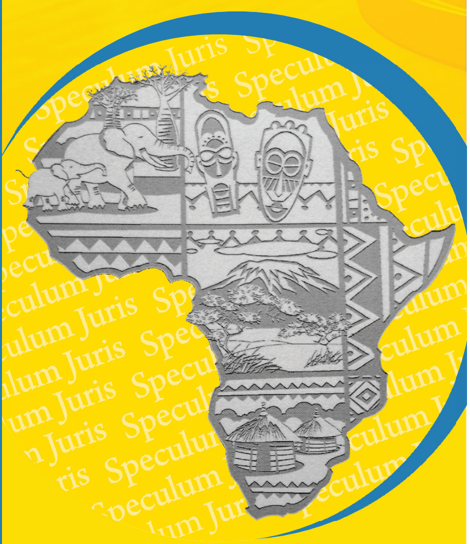

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Corporate Governance – Less is More

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Abstract

Directors and auditors must act ethically if they are to observe their various functions in a company and comply with good corporate governance principles. This article investigates the effect of legislation and auditor independence in relation to corporate governance on directors and auditors respectively. Governance is pigeonholed first and foremost by converging on governing contrivances that do not hinge on official authority and the injunctions of government, as is illustrated with the voluntary sustainability reporting framework that's applicable in South Africa. The more important question engendered here as to whether it is prudent to enact ethical comportment, which prompted this article to contend that more regulations will probably reduce compliance instead of achieving a positive outcome toward good governance acquiescence in both voluntary sustainability reporting and mandatory financial reporting.

Keywords: corporate governance; directors; financial reporting; auditors

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1 INTRODUCTION

Good governance is constantly undermined nationally and internationally. Although it is problematic to regulate and control ethical behaviour, the failure to comply with ethics can certainly not continue with impunity.[1] The twenty-first century witnessed vast developments in corporate governance in an attempt to combat fraud and company failures, of which Enron was the most predominant example in 2001.[2] As far as voluntary sustainability reporting is concerned, the challenge remains to be globally akin to other States. The inherent problem of regulating and controlling ethical behaviour in the face of immense developments in corporate governance, so as to prevent fraud and company failures, has led to increased dissatisfaction among partakers with the ongoing squalid behaviour of directors and company auditors.[3] The result has been an ever-increasing adoption of good governance principles and practices into legislation so as to ensure compliance with good governance as well as accountability and transparency in an attempt to regulate the lack or breakdown in governance control mechanisms. This is also evidenced in South Africa by the Companies Act[4] and the Auditing Profession Act.[5] It occurs notwithstanding the fact that the voluntary sustainability reporting framework originates from a context of self-regulation, where the application of the governance code is voluntary and based on self-declaration, as found in South Africa and several European jurisdictions.[6]

Directors and auditors must act ethically if they are to observe their various functions in a company and comply with good corporate governance principles.[7] This article investigates the effect of legislation and auditor independence in relation to corporate governance on directors and auditors respectively. Governance is pigeonholed first and foremost by converging on governing contrivances that do not hinge on official authority and the injunctions of government,[8] as is illustrated with the voluntary sustainability reporting framework that's applicable in South Africa. The more important question engendered here as to whether it is prudent to enact ethical comportment,[9] which prompted this article to contend that more regulations will probably reduce compliance instead of achieving a positive outcome toward good governance acquiescence in both voluntary sustainability reporting and mandatory financial reporting.

2 REGULATING CORPORATE GOVERNANCE

It is not possible to achieve accountability towards corporate governance without authority and control over the conduct and performance of corporations.[10] To accomplish this implies

1 Schoeman 2019 "Corporate Governance in South Africa – More Bark than Bite" Turfloop Law Conference 4 6.

2 Schoeman 2019 Turfloop Law Conference 5–6.

3 *Ibid*.

4 71 of 2008.

5 26 of 2005.

6 Wymeersch "Enforcement of Corporate Governance Codes" 2005 *European Corporate Governance Institute Working Paper Number 46/2005* http://ssrn.com/abstract=759364 (accessed 10-04-2019) 2–3.

7 Botha "Are Senior Managerial Employees Prescribed Officers in Terms of the Companies Act 71 of 2008 and Are They Treated the Same as Executive Directors?" 2012 *TSAR* 786–800; Studniberg "The Uncertain Scope of the De Facto Director Doctrine" 2017 *University of Toronto Faculty of Law Review* 69–100 indicates that the UK focuses on *de facto* directors is "action-oriented", while the Canadian position includes factors such as representation and appearance in a more holistic approach.

8 Jebe "Sustainability Reporting and New Governance: South Africa Marks the Path to Improved Corporate Disclosure" 2015 *Cardozo J International and Company Law* 240–241; Botha "Evaluating the Social and Ethics Committee: Is Labour the Missing Link? (Part 1)" 2016 *THRHR* 585.

9 https://www.businesslive.co.za/rdm/business/2018-06-18-the-steinhoff-saga-part-two-the-board-that-looked-the-other-way/ (accessed 07-09-2018).

10 Schoeman 2019 Turfloop Law Conference 4.

a standard against which performance can be measured, which accentuates the deficit of senseless implementation of corporate governance practices as mere rules that burden directors and auditors with just another set of compliance impediments, all of which calls for the attentive application of corporate governance in the general well-being of an organisation.[11]

2 1 Directors

The role that directors depict in corporate disclosures and reporting is governed to an extreme extent by their duties and functions. Directors involved in the one-tier board have a positive duty to manage companies in terms of a partially codified system.[12] Their duties and functions are expressly and substantially regulated in the 2008 Companies Act,[13] which concomitant with the Memorandum of Incorporation as well as rules and resolutions taken by the members of a company at the shareholder's meetings, bestows authority on the directors, who are immersed in the day-to-day management of the company.[14] In South Africa, directors have a fiduciary duty towards the company and not towards third parties,[15] and will be held liable according to the doctrines of the common law (now enacted in the 2008 Companies Act) for breach of their fiduciary duties and for claims arising from any loss, damages or other costs suffered by a company as a result of any breach by a director of his or her duty relating to personal financial interests,[16] the directorship position, information attained while acting in the capacity of a director[17] or in the exercise of the powers and performing the functions of a director in good faith and for a proper purpose, as well as in the best interests of the company.[18]

One of the purposes of the 2008 Companies Act is to balance the rights and obligations of shareholders and directors within companies.[19] The business and affairs of a company must be accomplished by or under the command of its board, which has the right to utilise all of the powers and execute any of the functions of the company except to the extent that the 2008 Companies Act or the company's Memorandum of Incorporation provides otherwise. Directors have a positive duty to manage the company in terms of a partially codified system. Partial codification allows for the adopting of general principles of law whilst expanding the common

11 King IV Application and Disclosure https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/684B68A7-B768-465C-8214-E3A007F15A5A/IoDSA_King_IV_Report_-_WebVersion.pdf. (accessed 07-09-2018).

12 Hefer *Notes on South African Companies Act* (2015) 177.

13 Sections 66, 75 and 76 of the 2008 Companies Act.

14 Section 66(1) of the 2008 Companies Act.

15 See Botha and Barnard *De Serie Legenda Developments in Commercial Law* Volume III Entrepreneurial Law (2019) for various references and discussions on the fiduciary duty of directors towards the company and third parties; For a discussion of the breach of a fiduciary duty see Havenga "Breach of Directors' Fiduciary Duties: Liability on What Basis?" 1996 *SA Merc LJ* 366–376; Havenga "Directors in Competition with Their Companies" 2004 *SA Merc LJ* 275–286.

16 Section 75 and 77(2)(a) of the 2008 Companies Act.

17 Section 76(2) of the 2008 Companies Act.

18 Section 76(3)(a) and (b) of the 2008 Companies Act. In terms of s 76(3)(c) and s 77(2)(b) of the 2008 Companies Act a director of a company will also be held liable according to the doctrines of common law relating to the principles of delict for any loss, damages or costs sustained by a company, as a result of the director's breach of a provision of the company's MOI, any other provision of the 2008 Companies Act, or a breach in his or her duty to exercise the powers and perform the functions of a director with a degree of care, skill and diligence that may reasonably be expected of persons carrying out the same functions relating to the company as those carried out by that director and with the general knowledge, skill, and experience of that director; For a discussion of delictual liability of directors see Havenga "Directors' Co-Liability for Delicts" 2006 *SA Merc LJ* 229–237.

19 Section 7(i) of the 2008 Companies Act.

law.[20]

Directors act together as an organ of the company relating to internal transactions, which refers to transactions or acts between functionaries within the company. Division of powers between the general shareholders' meeting and the board of directors is established and controlled primarily by the rules. The legal position of a director relating to external transactions is regulated by the law of agency, and directors act as agents of companies.[21] External transactions involve those transactions or acts between third parties and the company. The only exception to the general rule of agency is in delictual matters, where directors may be held personally accountable.[22]

2 1 1 Corporate Reporting and Disclosure

Even though voluntary sustainability reporting is considered to be primarily the duty of directors, directors are required in terms of corporate legislation, to present the financial statements of the company at the annual general meeting of shareholders and take responsibility for its contents.[23] In general, corporate reporting and disclosure are buttressed by good governance principles, which are primarily the responsibilities of the company's board of directors.[24] The members of the audit committee must all be non-executive directors of the company, which effectively brings the supervision of the internal company auditors within the ambit and control of directors' governance.[25]

Corporate governance disclosure is centred on the "apply-and-explain" approach where principles and intended outcomes form the essence of the governance code. Non-compliance with the voluntary principles and leading practices suggests as indicated by the King IV Application and Disclosure, legal liability for directors and where a court has to decide whether they complied with their governance duties.[26] It is a concern that the possible determent of this implied liability is too distant from the daily operations of directors, and will only serve as a probable remedy for a breach of governance principles, namely failing to prevent non-compliance thereof.

Irrespective of the Global Reporting Initiative Standards (GRIS) report registration system's good intentions of offering free sustainability reporting standards, compliance with voluntary sustainability reporting often does not yield good corporate governance and is exploited by companies to deceive shareholders and other partakers instead.[27] The non-existence of the external auditing of reports[28] and the need for expressed processes and standards of disclosure[29] resulted in the existence of a tension between formal compliance and substantive compliance, which remains problematic. Companies attempt to curtail the lack of qualitative disclosure by including corporate responsibility information in their annual financial reports,[30] and expect their external company auditors to independently verify the corporate responsibility

20 Hefer 177.

21 Section 20(1) to 20(5) of the 2008 Companies Act.

22 Section 77(2)(b) of the 2008 Companies Act.

23 Section 30(3)*(c)* and s 30(3)*(d)* of the 2008 Companies Act.

24 Section 29 and s 30 of the 2008 Companies Act.

25 Section 94(4)(*a*) and s 94(4)(*b*) of the 2008 Companies Act.

26 King IV Application and Disclosure.

27 Naudé *et al.* "2018 Part One - The Steinhoff Story" https://www.businesslive.co.za/rdm/business/2018-06-15-the-steinhoff-saga-part-one-the-making-of-a-corporate-giant/ (accessed 07-09- 2018); Naudé *et al.* 2018 "Part Two - The Board that Looked the Other Way" https://www.businesslive.co.za/rdm/business/2018-06-18-the-steinhoff-saga-part-two-the-board-that-looked-the-other-way/ (accessed 07-09-2018).

28 Sarfaty "Regulating Through Numbers: A Case Study of Corporate Sustainability Reporting" 2013 *Virginia Journal of International Law* 580–581.

29 Lydenberg, Rogers and Wood "Transparency to Performance: Industry-Based Sustainability Reporting on Key Issues" 2010 *Initiative for Responsible Investment* Harvard University 58.

30 Jebe 2015 *Cardozo J Intl and Company L* 235.

information. However, a challenge remains around the verification of the substance of the matters reported and, therefore, the company's directors should be legally responsible for the voluntary sustainability reporting and not the external auditor.[31]

2 1 2 Companies Act

In an endeavour to enhance good corporate governance, the legislature increasingly pronounces and describes the connection between directors and companies in such a manner that they have become more involved in the role of managing companies rather than the originally intended caretakers, as depicted by the earliest concept of directors in the sixteenth century.[32] A further consequence of espousing good governance principles and practices into legislation is that other stakeholders' interests will be considered, resulting in the development of the 2008 Companies Act to evolve to an enlightened shareholder approach, calling for it to be inclusive of other interests, which accentuates a pluralist approach.[33] The fact that public and state-owned companies must appoint a social and ethics committee only creates the perception that corporate social responsibility forms part of company legislation. More should be done to regulate employee partaking and environmental corporate social responsibility principles, for instance, thus to reaffirm the call that companies should be legally compelled to comply with corporate responsibility in order to keep them accountable to the public.[34]

The cutting-edge procedures that particularize the status,[35] quantity,[36] procedure for appointment,[37] duties, functions, the relationship with the company and shareholders as well as liabilities and termination of directors[38] underscore the importance of good corporate governance that the legislator confers on directors. Continuous escalation of directors' standards appears to be an international phenomenon and burdens them increasingly with additional obligations. This is evidenced, for instance, in the USA, where directors' fiduciary duties turn out to have become gradually decentralised. The fiduciary duties of directors who serve on audit committees responsible for monitoring auditors' work are outlined, while securities exchanges proceed to increase the duties placed on directors of listing members, controlling the definition of independent directors and creating independent corporate governance and compensation committees.[39] Since board structures are as effective as methods of control, it is clear that the causes for the negligence of directors boil down to a conflict of serving diverse interests and an attempt to harmonise exploiting profits for shareholders against discharging public accountability.[40]

31 Wymeersch 2005 European Corporate Governance Institute Working Paper Number 46/2005.

32 Section 66(1) determines that "The business and affairs of a company must be managed by or under the direction of its board, which has the authority to exercise all of the powers and perform any of the functions of the company, except to the extent that this Act or the company's Memorandum of Incorporation provides otherwise."; Molano-Léon, "The Roles of the Board of Directors: The Unresolved Riddle" 2011 *Pontificia Universidad Javeriana Colombia* 546–547.

33 Botha 2016 *THRHR* 582–583.

34 Viljoen "An Analysis of Some Environmental Law Provisions and Alternative Governance Approaches for the Promotion of Corporate Social Responsibility in South Africa" (Mini-dissertation in partial fulfilment of the requirements for LLM, NWU, 2007) 39.

35 Section 69 of the 2008 Companies Act.

36 Section 66 of the 2008 Companies Act.

37 Section 66 to s 71 of the 2008 Companies Act.

38 Section 71 to s 78 of the 2008 Companies Act.

39 Block and Gerstner "One-tier vs. Two-Tier Board Structure: A Comparison between the United States and Germany" 2016 *Penn Law: Legal Scholarship Repository Comparative Corporate Governance and Financial Regulation Select Seminar Papers 1* 14–15.

40 Botha "The Role and Duties of Directors in the Promotion of Corporate Governance: A South African Perspective" 2009 *Obiter* 703.

2 2 Company Auditors

Audit scandals contributed their fair share to the reasons for the extensive increase in legislative regulation that the accountancy profession has undergone in the past decades, including the establishment of the International Federation of Accountants (IFAC), which issued the International Ethics Standards Board for Accountants (IESBA) Code of Ethics, while the latter was partially adopted into the Independent Regulatory Board for Auditors (IRBA) Code of Professional Conduct for Auditors in South Africa.[41] Audit scandals further fortify the view that the best transparent supervision system can still fail to prevent financial fraud when it is mostly auditors who are complicit in fraudulent actions.[42] This is despite the fact that the market for collective demand for audit services is inelastic due to legislative requirements that public companies must audit their financial statements by certified public audit firms,[43] all of which places auditors in a significantly auspicious position.[44] Even internal auditors experienced a significant shift in their role, away from traditional purpose of assurance to a new role that incorporated the supervision and the enhancement of risk management processes and corporate governance, as suggested by the recommended practices 48 to 51 of the King IV Report.[45] Principle 8 of the report recommends these practices as "arrangements for delegation within its own structures to promote independent judgement, and assist with balance of power and the effective discharge of its duties", in relation to committees including the audit committee of a company.

Since directors administer shareholders' interests, a need has evolved for the supervision of such administration and for the auditing of the accounts that resulted from such administration.[46] This is even more important for mandatory financial disclosure and reporting of public companies in view of the fact that shareholders form part of the public community and users of the financial statements primarily so, as well.[47] During the past years, the auditing profession has witnessed a phenomenal proliferation of rules and regulations in a growingly globalised business world, while these have been imperative to the development of the profession, certainly also as a ramification of ostensible manipulation in corporate disclosures and reporting.[48] Today, corporate financial disclosures and reporting are meticulously regulated. Public and state-owned companies have to audit their annual financial statements.[49] Even as it emphasizes corporate governance issues, the 2008 Companies Act surprisingly does not specify much about the role and liability of auditors relating to corporate disclosures and reporting, regardless of the fact that mandatory financial reporting originates from the involvement of internal and external auditors.[50] The fact that directors may rely on the information and recommendations prepared or presented by

41 https://www.ifac.org/about-ifac/membership/country/south-africa (accessed 22-04-2020).

42 Ruichao "Role and Liability of the Auditors in the EU and In China: From Supervision Perspective" 2015 *Review of European Studies* 170–178 170.

43 McKinnon "Auditing the Auditors: Antitrust Concerns in the Large Company Audit Market" 2015 *New York University Journal of Law and Business* 536; Ascher and Foer "Financial Reform and the Big 4 Audit Firms" 2010 *American Antitrust Institute Working Paper* Number 10-01 4.

44 Odendaal "Regulering van die Ouditeursprofessie in Suid-Afrika" (D Com (Accounting)-thesis, UP, 2006) 10.

45 Vadasi, Bekiaris and Andrikopoulos "Corporate Governance and Internal Audit: An Institutional Theory Perspective" 2019 *Emerald Publishing Limited*; King IV Code on Corporate Governance.

46 Van der Zanden and Van der Zanden "A Description of the Historical Developments in Standard Setting and Regulations for Auditors and the Audit Firms in an International Perspective" 2013 *Dovenschmidt Quarterly* 89.

47 Odendaal Thesis 1.

48 Van der Zanden and Van der Zanden 2013 *Dovenschmidt Quarterly* 89.

49 Section 30(7)(a) and s 30(2)(b)(i) of the 2008 Companies Act.

50 Schoeman "The Role and Liability of Auditors in Corporate Disclosures and Reporting: A Legal Analysis" (LLD-thesis, UP, 2022) 95 294.

auditors to assist them to discharge their governance duties, including financial statements and other financial data, may lead to the exploitation of information provided by auditors, subject to certain qualifications. Auditors should therefore ensure clear and precise financial information for directors to avoid complicity in fraudulent transactions.[51]

To safeguard compliance with good corporate governance principles of transparency and accountability, the 2008 Companies Act unambiguously regulates access to company records, with specific reference to accounting records.[52] For purposes of the annual general meeting of shareholders, the financial statements have to include the auditor's report and a report by the directors about the state of affairs, the business and profit or loss of the company, and any other substantial matter affecting shareholders when it comes to comprehending the company's state of affairs.[53] The financial statements must be approved by the company's board of directors and must be presented at the shareholder's meeting.[54] The act stipulates requirements for financial statements that companies must comply with[55] and the Minister of Trade and Industry may, after consultation with the Financial Reporting Standards Council, issue regulations enforcing financial reporting standards (FRS) to uphold "sound and consistent accounting practices" that are coherent with international financial reporting standards (IFRS).[56] The seriousness of correct financial reports resounds in the statutory offence created against persons who have knowledge or any part whatsoever in any financial statements of a company that do not comply with such requirements or that are substantially false or misleading.[57] Ancillary to the regulations contained in the Auditing Profession Act, Part C of the 2008 Companies Act contains specific codifications regarding the appointment, resignation, vacancies, rotation, rights, and limited functions of auditors for public and state-owned companies.[58]

Should auditors be responsible for auditing voluntary sustainability reporting, the essence of the theory holding that that which gets measured gets done befits the situation since,[59] as has been indicated, auditors need to have a standard against which compliance of good corporate governance can be appraised. In return, the auditing profession is confronted with new challenges around developing unique skills to comply with their voluntary sustainability reporting assurance.[60] Unprecedented pressure will be placed on the demand for capable voluntary sustainability reporting auditors and additional education and training courses will have to be developed, constraining the already diminishing auditing profession further.[61]

2 2 1 Auditing Profession Act

The Auditing Profession Act includes several good governance principles aimed at protecting the public interest, and it regulates the audits performed by "registered" auditors.[62] The establishment of the IRBA is a core step for the independent governing of auditors and regulating registration, termination of registration, the functions of auditors and candidate auditors, including the

51 Schoeman Thesis 99.

52 Section 24(1) and s 26(1) of the 2008 Companies Act.

53 Section 30(3)*(b)* of the 2008 Companies Act.

54 Section 30(3)*(c)* and s 30(3)*(d)* of the 2008 Companies Act.

55 Section 29 of the 2008 Companies Act.

56 Section 29(4) of the 2008 Companies Act.

57 Section 29(6) of the 2008 Companies Act.

58 Section 90 to s 93 of the 2008 Companies Act.

59 Sarfaty 2013 *Virginia JIL* 576.

60 Ackers "Corporate Social Responsibility Assurance: How Do South African Publicly Listed Companies Compare?" 2009 *Meditari Accountancy Research* 14.

61 Schoeman Thesis 97.

62 Section 2(a) of the Auditing Profession Act.

prescribed minimum qualifications, competency standards and requirements for registration of auditors, supplementary to the requirements of the Auditing Profession Act.[63] Except for total independence, the regulatory framework for the auditing profession serves the public interest and operates in congruence with the international auditing profession.[64]

The importance of good governance principles is accentuated when the legislator states that methods of progressing the functioning of proper standards of competence and ethics must exist in the auditing profession, and the legislator provides for the establishment of a committee for auditor ethics by the IRBA.[65] The Auditing Profession Act empowers the IRBA to promote the integrity of the auditing profession and prescribes standards of professional competence, ethics, and conduct for auditors so as to protect the public interest.[66] The setting of internationally accepted auditing standards is important, and the IRBA is encouraged to get involved with international regulators on matters concerning audits and auditors. Actions of auditors are regulated, and disciplinary processes can be taken against those auditors who engage in improper conduct, the latter of which is clearly defined.[67] The IRBA complies with the requirements for a competent regulator, given a variety of membership, which includes auditors and representatives from the community who exhibit specialist knowledge in auditing and the required understanding of the public interest.[68]

The recurring themes that haunt the auditing profession are listed by the IRBA to be wrong audit opinions, failure to obtain enough suitable audit evidence, issues of independence, inadequately executed audits of attorney trusts, failure to apply professional competence and due care, and, finally, the non-reporting of reportable irregularities.[69] Most of the recurrent leitmotifs are precipitated by a failure to comply with or adhere to the criteria stated in section 44(3) of the Auditing Profession Act. The criteria are relevant to the appropriate qualifications to the auditor's opinion that a client's financial statements or the enclosed information thereto are well prepared in all material aspects based on the accounting and financial reporting framework and that it "fairly presents in all material respects" its financial position. The failure to obtain sufficient suitable audit evidence lies at the heart of the predicament that Steinhoff finds itself in.[70]

Persons who contravene sections 41, 43, or 44 of the Auditing Profession Act are guilty of a statutory offence and liable to a fine or, in default of payment of such fine, to imprisonment not exceeding five years, or to both such fine and imprisonment.[71] Concomitantly, all the auditors liable for the improper conduct, as publicised in the IRBA 2019 Report on its annual inspections of auditors' compliance, should have been charged and criminally prosecuted, yet the report is conveniently silent about reporting auditors to the national prosecuting authorities. This article contends that the IRBA's failure to proceed with criminal charges against the auditors identified in its report, amounts to a breach of its statutory mandate and neglects to protect the public's

63 Part 4 of the Auditing Profession Act regulates auditors' duties and liabilities by means of the IRBA. Sections 11 to 19 of the Auditing Profession Act regulates the appointment and governing of the IRBA, while Chapter 2 of the act deals with the establishment and status of the IRBA.

64 Odendaal and De Jager "Regulation of the Auditing Profession in South Africa" 2008 *SAJAAR* 5.

65 Section 21 of the Auditing Profession Act.

66 Section 4 of the Auditing Profession Act.

67 Section 24 of the Auditing Profession Act.

68 Odendaal and De Jager 2008 *SAJAAR* 5.

69 IRBA 2019 Report 34.

70 Steinhoff's 2019 Overview of Forensic Investigation https://docs.google.com/viewerng/viewer?url=https://cdn.24.co.za/files/Cms/General/d/8637/28d45d9efd9e477d8dd8ff4f9ad6709c.pdf (accessed 04-10-2019) 4–7.

71 Section 54(1) of the APA.

interest. It is reminiscent of the global trend among regulators in 2002 not to act or not to act sufficiently against auditors who committed improper conduct.[72]

To conclude the corporate-governance legal framework for corporate disclosures and reporting, the 2008 Companies Act provides for the appointment of an audit committee.[73] This originated from a need for oversight in the United States corporate law[74] and was adopted in the South African company law when most of the duties of the audit committee found their way into a separate statutory committee through the 2008 Companies Act, as recommended in the King III Report.[75] Only non-executive directors of the company can be members of the audit committee of a company, hence the company auditor will be appointed by the non-executive directors of the company, who will determine their fees and the terms of their engagement, and supervise the entire internal and external financial control of the company. In return, the auditor will supervise the directors' administration of the company and audit the accounts affected by such administration. Add the providing of non-audit services to their clients and notwithstanding attempts to regulate and restrict the criticisms attributed to auditors around this, the resultant negative influence on the independence of auditors remains contentious.[76]

2 2 2 Regulating Auditor Independence

Independence is imperative to the public interest and impacts the acuity of quality and integrity of audited financial statements.[77] It is the fulcrum to the execution of the audit purpose, and one of the traits of the accounting profession, holding the promise that the auditor will be unbiased in procuring, verifying, and reporting client information.[78] Whether auditor independence is attainable in light of auditors' working relationship with their client, client's management and their revenue source, is a matter that forced the realisation that auditor independence is relative, and that auditors can only strive for the highest possible degree of independence.[79] Auditor independence can therefore be quantified in terms of getting the balance of incentives right, which entails that the auditor is convinced that the financial inducements offered with a view to acquiescence to management pressure do not surpass the restraints or deterrents to concede.[80]

Globally, the changing character of the accounting profession demands an updated approach to deal with auditor independence issues, and this has resulted in the piecemeal development of independence rules, which unfortunately ensued to be vague and considered a failure of the regulatory process, which then needed to be clarified at a later time by issuing more regulations.[81] It is a universal prodigy that vague rules that are supposedly intended to assist auditors end up causing more uncertainty. Auditors' independence in South Africa is defined by the IRBA Code, engendering the same uncertainties as their international counterparts, while attempting to provide copious safety measures directed at securing auditor independence by constantly establishing principles, rules, and examples to cover as many scenarios as possible,

72 Odendaal Thesis 128.

73 Section 94(2) of the 2008 Companies Act.

74 Van der Zanden and Van der Zanden 2013 *Dovenschmidt Quarterly* 103.

75 Harris "Corporate Governance Law Reform in South Africa" (LLM Dissertation, UP, 2016) 18.

76 Schoeman Thesis 100–101.

77 Odendaal Thesis 85.

78 Schoeman Thesis 296.

79 Green "Whither and Whether Auditor Independence" 2008 *Gonzaga Law Review* 369.

80 Kershaw "Waiting for Enron: The Unstable Equilibrium of Auditor Independence Regulation" 2006 *Journal of Law and Society* 390.

81 Brown, Calderon and Lev "Administrative and Judicial Approaches to Auditor Independence" 2000 *Seton Hall Law Review* 445–446; Schoeman Thesis 159, 297.

hence following in the footsteps of internationally recognised standard setting organisations.[82] Regulators in the USA experienced similar predicaments around illustrating independence with the provision of selective, extremely vague, and uncertain examples that were considered not to be of much assistance regarding this.[83] These rules cause greater uncertainty around that which is expected from auditors by introducing conflicting concepts, ill-defined principles, and a lack of providing examples of possible circumstances or measures, while these definitely are not able to cover all possible scenarios, leaving the interpretation thereof to the prudence of the auditor.[84]

2 2 2 1 Reduplication and Circular Reasoning Phenomena

The overuse by regulators of the term "registered auditor" in the Auditing Profession Act, the IRBA Code, and auditing standards only emphasizes the regulators' lack of meticulous proficiency in developing principles and values to enhance a struggling profession.[85] Section 41(2) of the Auditing Profession Act clearly indicates those who may and those who may not operate as auditors in public practice, and contravention of this section constitutes a statutory offence as regulated by section 54(1) of the Auditing Profession Act, which makes it inherently impossible to be an auditor in public practice unless one is registered with the IRBA. Since all auditors in public practice are therefore registered with the IRBA, it is unnecessary to refer to *registered* auditors 231 times in the Auditing Profession Act.[86]

Another example of reduplication, coupled with circular reasoning, is found in the 2014 IRBA Code's reference to "competent professional service"; as professional services already entail that the services will be proficient. Even the further elaboration that such services "[require] the exercise of sound judgment", which can normally be expected from professionals "in applying professional knowledge and skill", involves repetition of the professional character of such services and embodies a further instance of circular reasoning.[87]

The intention of the regulator is not clear around the over-regulation of certain concepts, for example, the explanation of a "competent professional service". It is common sense that it is necessary to first achieve and maintain professional competence before such a service can be offered. It does not justify the tautological duplication by referring to "professional knowledge and skill".[88] The mere fact that the regulator refers to "sound judgment" and "professional or business judgment" without qualifying the concept leaves uncertainty in the minds of auditors about the expectation inferred by these concepts, and the reason why the auditing profession does not stick to the generally accepted objective reasonable-man tests coupled with professional auditing knowledge and skill remains uncertain. This includes the fact that the objective and reasonable auditor is referred to in case law, while this is a familiar concept in common law.[89] Fortunately, the improved structure of the 2018 IRBA Code now provides a description of

82 https://www.ifac.org/about-ifac/membership/country/south-africa (accessed 22-04-2020); S 400.1 and S 900.3 of the 2018 IRBA Code 80, 146. The exact same contents are repeated in ISA 200 Paragraph A17, which lists the five fundamental principles that an auditor needs to comply with in terms of the IESBA Code, which final pronouncement was made in April 2020, stipulating the auditor's role in dealing with the stated threats. Propitiously, the 2018 IRBA Code now directly refers to ISQC 1 in its general notes when it comes to applying the conceptual framework for the independence of auditors for audit and review engagements, as well as for assurance engagements other than audit and review engagements.

83 Green 2008 *Gonzaga LRev* 369–370.

84 Schoeman Thesis 127, 159.

85 Schoeman Thesis 159.

86 Schoeman Thesis 159–160.

87 Schoeman Thesis 124–125, 160.

88 2014 IRBA Code 40.

89 *Thoroughbred Breeders' Association of South Africa v Price Waterhouse* 2001 4 All SA 161 (A) para 42.

professional judgment.[90] Unfortunately, in the same breath, and for no explainable reason, it has changed the definition of acceptable levels by implying that auditors have special privileges around the "level at which a *registered auditor*" may apply the reasonable and informed third-party test, and this creates uncertainty and will elicit future discrepancies between auditors' and judges' application of the reasonable and informed third-party test in relation to auditors.[91]

The Auditing Profession Act is clear about confining the duties of auditors to the actual duty of audit and reporting on irregularities that he or she might discover during the audit process.[92] The role and functions of company auditors are also restricted in such a manner that they are not allowed to perform any services for a company that will create a conflict of interest, as stipulated or established by the IRBA in terms of section 44(6) of the Auditing Profession Act, or as may be established by the company's audit committee in terms of section 94(7)*(d)* of the 2008 Companies Act.[93] The IRBA code stipulates that, when auditors discover a conflict of interest that threatens objectivity or any other of the fundamental principles around engaging in professional activity, then they must abstain from compromising professional or business judgment.[94] Since professional or business judgment will be compromised by a conflict of interest, it evokes the same criticisms that are applicable to competent professional services as discussed above.

2 2 2 2 Key Aspects of Auditor Independence

Analysis of the key aspects that consistently confront auditors, such as mandatory auditor rotation, constraints on providing non-audit services, gatekeeper expectations, and the expectation gap, points to the need for greater clarity about the role of auditors in corporate disclosures and reporting, as illustrated by divergent opinions in favour of and against the success of these concepts in terms of regulating the role of auditors, especially in corporate governance.[95]

For example and notwithstanding justified arguments that oppose mandatory auditor rotation, the main reason for its implementation has probably been the argument that it will serve as a publicly acceptable band-aid on damaged investor confidence caused by financial scandals, as precipitated by the role of auditors.[96] The success of mandatory rotation instituted for listed companies in Italy did not take into account Italy's unique corporate governance structure.[97] In the USA, auditor rotation was particularly opposed by the auditing industry, based on cost-implication arguments, though it was clear that, even in 2006, many large companies engaged the services of a single audit firm for an average of 22 years, and did not have any audit firm rotation policies.[98] Auditors are not comfortable with the logic of the argument that auditor independence will attenuate where auditor rotation is not implemented, due to favouritism by management, and that mandatory auditor rotation does justify the costs involved when regarded in terms of investor confidence lost to incorrect or fraudulent financial statements.[99]

Following the international trend and hassled by the government, South Africa introduced

90 Section 120.5 A1 of the 2018 IRBA Code 3.

91 2018 IRBA Code 14; 126, 160

92 Section 44 and s 45 of the APA.

93 Section 93(3) of the 2008 Companies Act.

94 2018 IRBA Code 35.

95 Schoeman Thesis 160.

96 Healey and Kim "The Benefits of Mandatory Auditor Rotation" 2003 *Regulation* 10.

97 Vadasi, Bekiaris and Andrikopoulos 2019 *Emerald Publishing Limited*.

98 Mark "Accounting Fraud: Pleading Scienter of Auditors under the PSLRA" 2007 *Connecticut Law Review* 1196–1197.

99 Schoeman Thesis 161.

the concept of mandatory rotation of corporate auditors into the 2008 Companies Act.[100] Notwithstanding the total lack of evidence that auditor rotation would indeed contribute positively to audits while, on the contrary, it is not unlikely that the mammoth practical and operational bearing of this on the newly appointed auditor who must get acquainted with the audit client's business, so that it can just as well increase the possible failure to discover material misstatements.[101] The illogical presumption that the objective of improving audit quality by the termination of the relationship between a company and its auditor is supported by research which confirms that audit quality improves over the duration of an auditor's tenancy with a specific client, and that failure to discover accounting anomalies increase significantly in tandem with an auditor's lack of acquaintance with a specific audit client.[102]

The failure of Steinhoff in 2018, despite the fact that auditor-rotation legislation was in fact in place, underscores the arguments against auditor rotation and accentuates that South Africa over-eagerly followed international trends.[103] Another far more important concern, which in the long run will have a severe influence on auditor independence, is the fact that mandatory audit firm rotation regulations in South Africa have caused the deterrence of potential candidates, who have refrained from becoming part of the auditorial work environment in the face of a less alluring situation.[104]

Still shaken by the more recent collapse of other large corporations and banks, the International Auditing and Assurance Standards Board (IAASB) typically amended the IESBA Code in April 2020 to enforce rotation of the engagement partner, the engagement quality control reviewer, and other key audit partners in the case of financial statement audits of listed entities.[105] Yet again, a desperate move to cure the illness of the lack of confidence in the auditing profession, despite empirical evidence confirming that the extent of an issuer's earning accruals is inversely correlated to the duration of the auditor–client relationship, has been implemented, while it is clear that mandatory auditor rotation is indeed detrimental to audit quality.[106]

Another example of over regulation that sparked controversy is the tendency among large audit firms to complement their audit services with supplementary non-audit services and the occasioned upsurge in fees earned for non-audit services in comparison with the fees earned for audit services. Large audit firms cooperatively morphed from audit firms to business-consulting ones that also offer audit services and questions around their independence have rapidly increased, followed by justifiable arguments in favour and against placing a restraint on the provision of non-audit services.[107] The reality that Arthur Andersen earned more in consulting than audit fees from Enron has strengthened the arguments of supporters in favour of restraining the rendering of certain non-audit services.[108] It is thus not surprising that, as history taught us, another band-aid was placed on the wound of a bleeding auditing profession in the form of more regulations by the Securities and Exchange Commission in the USA during 2003, so as to curb the condemnations by banning the providing of nine different non-audit services

100 Section 92 of the 2008 Companies Act; Odendaal Thesis 102.

101 Van der Zanden and Van der Zanden 2013 *Dovenschmidt Quarterly* 103.

102 *Ibid*.

103 Schoeman Thesis 161.

104 Harber "Exploring the Nature and Consequences of a Possible Decline in the Appeal of the South African Audit Profession" 2018 *SAJAAR* 15.

105 IAASB's Final Pronouncement April 2020 10.

106 Schoeman Thesis 162.

107 Mark 2007 *Connecticut Law Review* 1176–1178.

108 Krackhardt 2005 "New Rules for Corporate Governance in the United States and Germany - A Model for New Zealand" 2005 *Victoria University of Wellington Law Review* 334.

by public accounting firms that serve as auditors to their clients.[109] Even more rules for auditor independence and tax services followed in 2006, provoked by negative publicity on auditors' engagement with tax shelter schemes for their clients. At least, in that case, significant empirical research underpinned the theory that providing non-audit services does have a negative effect on audit quality.[110]

Authors agree about the description of and expectations related to gatekeepers, but maintain opposing opinions on the reasons for gatekeeper failure, while applying different theories to explain these.[111] Some propose an increase of regulations to ensure that gatekeepers are liable for their conduct,[112] while others oppose further regulations, blaming instead industry concentration, suggesting divestment of audit groups, mandatory auditor rotation, and placing a cap on auditors' liability for reducing industry concentration in the belief that these will eventually solve the predicament of gatekeeper failure.[113] The reality is that, on each occasion where the auditing profession is confronted with the misconduct of its members and the ensuing public outcry, regulators respond with an increase of stricter regulations.[114] Notwithstanding the precarious situation in which the auditing profession finds itself, and which it can only blame on itself, it appears that members of the auditing profession remain oblivious to their predicament, as witnessed in the alarmingly high incidence of non-compliance with the regulations revealed by the IRBA 2019 Report on its annual inspections of auditors' compliance.[115] Such an attitude explains why, regardless of the extensive expansion of audit regulation, scandals and corporate failures could not be prevented, and are recognised to be the reason for the existence of the expectation gap.[116]

Divergent opinions about how to avert a further loss of confidence in the profession and to better comprehend the role and duties of auditors, again increased government regulation to overcome the expectation gap is proposed.[117] An opposite opinion that more rules and legislation will only intensify the "tick the box" culture, suggests that more successful outcomes will be obtained when a comprehensive approach on an international level, including a broad comparative study is embarked on by the auditing and legal professions, with a view to addressing corporate governance structures of companies and the role of auditors, audit committees and supervisory boards.[118]

It appears that auditors stand ignorant to the public's expectation, which auditors, rather than the public, seem to consider as misconceptions about their role, which confirms the validity of the comment of Van der Zanden and Van der Zanden that "the accountancy profession is unable to communicate in a satisfactory manner with the users of its services and also seems to serve their needs inadequately". It is further obvious that auditors have been aware since

109 Mark 2007 *Connecticut LRev* 1179.

110 Mark 2007 *Connecticut LRev* 1185.

111 Schoeman Thesis 48, 164, 299.

112 Buthelezi 2019 "Tighter and Costlier Auditing Is on the Way" https://www.businesslive.co.za/bd/national/2019-10-17-tighter-and-costlier-auditing-is-on-the-way/ (accessed 29-10-2019).

113 McKinnon 2015 *New York University Journal of Law and Business* 559, 560.

114 Cox "The Oligopolistic Gatekeeper: The USA Accounting Profession After Enron: Improving Corporate Law and Modernizing Securities Regulation in Europe and the USA" 2006 *Duke Law School Legal Studies Paper Number 117* 275; Chan and Kim "The Legal Liability of Third Party Advice in Australia In Light of Recent Developments" 2005 University of Sydney http://ssrn.com/abstract=986214 4 (accessed 01-10-2019) 3; Odendaal and De Jager 2008 *SAJAAR* 2.

115 IRBA 2019 Report.

116 Harber 2018 *SAJAAR* 20.

117 Labuschagne and Els "Corruption and Fraud: Any Lessons for the Auditor?" 2006 *Meditari Accountancy Research* 30.

118 Van der Zanden and Van der Zanden 2013 *Dovenschmidt Quarterly* 104.

1990 that their clients entertain views about their activities that differ from those of the auditors themselves.[119] So, what has been transpiring since 1990? The auditing profession's reaction towards the expectation gap was the creation of audit committees to monitor the activities of the auditor,[120] passing the buck to the company's corporate governance structures, while the auditing profession, true to the ignorant nature of its members, expected their clients to comply with their expectations.[121] All of this, while the expectation gap is considered to be one of the major reasons for dissuading potential candidates to follow a career in the profession.[122]

The liability that auditors might incur in alleged fraud cases has spawned a vigorous debate in the USA about the rationality of auditors when they acquiesce to fraudulent activities in corporate disclosure and reporting. Discussions focus mainly on whether firmer regulation will serve to act as an incentive for effectively reducing auditor liability. Central to the discourse as to whether auditors are indeed irrational is *DiLeo v EY*,[123] which evoked many divergent opinions. Coffee and Prentice share the view that, regardless of the logic of auditor rationale, practice indicates that auditors do indeed assent to managerial fraud, despite the obvious reputational losses that seem to outweigh the possible gains to be made from the individual client by a considerable margin.[124] Cunningham asks a very important question relating to internal auditors' conduct: are the internal controls or the autonomously honest employees of a company responsible for reporting in accordance with Generally Accepted Accounting Principles (GAAP) and for producing financial reports without committing fraud?[125] This question is just as relevant to external auditors. In contradiction to Ruichao's view that, in most cases, internal auditors assist companies in fabricating false financial statements, McKinnon avers that auditors are not part of many of the major reasons for economic disasters and are, instead, victims of misdirected criticism;[126] an opinion endorsed by this article.

As if the auditing profession is not battered enough by never-ending accusations about and criticisms of their proficiency when it comes to coping with their duties and functions, expanding their role to corporate responsibility assurers certainly has been added, invoking the lifting of eyebrows. This holds true especially in the contentious field of sustainability reporting, in the context of the predicament that companies experience due to severe criticism and pressure from partakers as related to the reliability of data, and supported by unverified indicators.[127] Whether auditors, who were for decades unable even to narrow down the expectation gap in their own field of experience, will be able to fill in the corporate governance expectation gap remains to be seen. The Association of Certified and Chartered Accountants comment that the assurance of sustainability reports should rather avoid declarations that are not supported by convincing and reliable evidence, which should serve as a warning in this respect.[128]

Researchers at the University of Stellenbosch Business School investigated the reasons for the

119 Van der Zanden and Van der Zanden 2013 *Dovenschmidt Quarterly* 92.

120 Van der Zanden and Van der Zanden 2013 *Dovenschmidt Quarterly* 91.

121 Schoeman Thesis 165.

122 Harber 2018 *SAJAAR* 20.

123 901 F.2d 624 (7th Cir. 1990)

124 Coffee "Understanding Enron: It's About the Gatekeepers, Stupid" 2002 *Columbia Law School Working Paper Number 207* 6; Prentice "The Case of the Irrational Auditor: Behavioral Insight into Securities Fraud Litigation" 2000 *Northwestern University Law Review* 138, 141, 142, 219.

125 Cunningham 2003 *Research Paper 18* 59.

126 McKinnon 2015 *New York University Journal of Law and Business* 567; Ruichao 2015 *Review of European Studies* 170.

127 Schoeman Thesis 167.

128 Sarfaty 2013 *Virginia JIL* 580–581.

possible failure of Steinhoff by examining certain questions relating to corporate governance.[129] Disturbingly similar to the case of Enron, they found that it appeared as though Steinhoff complied with all the legal and listing requirements in the different jurisdictions where it conducted its business, which generated a beguiling assurance to its partakers and investors. The non-executive directors did not comply with the independence criteria. When Steinhoff relocated its primary listing from South Africa to Germany, it had to change from a one-tier to a two-tier board structure but, despite the requirement of replacing non-executive board members with a supervisory board, Steinhoff kept its nine directors intact. The mere fact that most of the suspected wrongdoing transpired before the dual board structure was implemented suggests that the board structure ought not to have been considered a substantial cause for Steinhoff's failure. It was, however, found that there was no real transparency in the disclosure and reporting, which stemmed from a lack of ethical substance.[130]

3 CONCLUSION

The proliferation of directors' regulations and standards since the corporate collapse of Enron did not prevent similar corporate collapses as illustrated by the failure of Steinhoff and only highlight that ethics are the fulcrum of good corporate governance. The ease with which Steinhoff's directors misused the current regulations to mislead its partakers and investors indicates that more regulations will probably reduce compliance instead of achieving a positive outcome towards good governance. Directors will tend to engage in box-ticking to comply with the burden of regulations, and to discharge their legal and listing requirements.

The only effective way to prevent unethical behaviour is the implementation of proper action against offenders to deter other potential offenders. It might as well be argued that criminal prosecution by the IRBA against the auditors identified in its 2019 report could have served as sufficient deterrence that could have led to the avoidance of the collapse of Steinhoff and other corporate bodies.

The 2008 Companies Act contains a number of provisions for assisting auditors and bestowing certain rights on them which, again, is precipitated by the public's expectations, as founded in good corporate governance principles, while making it possible and convenient for auditors to do their work, nonetheless, even empowering them with certain enforcing rights.[131] True to its nature, the IRBA issued additional regulations and expanded on the duties of auditors, though the Auditing Profession Act and 2008 Companies Act already contained specific provisions relating to auditors' duties, and notwithstanding case law and countless available discourses on the duties of auditors. Attempts to elaborate on the duties of auditors by introducing sloppy definitions, only open the door for misinterpretations and ambiguities and should be done away with. The separation of professional services into three groups of expansive unlimited listed activities does not improve the understanding of duties and, since the IRBA can certainly not foresee all circumstances and activities, auditors are left in the dark and to their own devices, and often demise, in terms of determining whether a non-listed activity qualifies for inclusion in the list. It would have served a better purpose to provide a list of prohibited services but, since such a list does not exist and the lists of activities are not conclusive, any other activity should

129 Naudé *et al.* 2018 "Part Two - The Board That Looked the Other Way".

130 Naudé *et al.* 2018 "Part Two - The Board That Looked the Other Way".

131 Section 93(1)*(a)*, s 93(1)*(b)*, s 93(1)*(c)* and s 93(2) of the 2008 Companies Act. A court can make any order that is just and reasonable, including an order for costs against any director or prescribed officer, found to have deliberately and knowingly frustrated, or endeavoured to frustrate, the accomplishment of the auditor's functions.

be acceptable, and this is certainly not sustainable.[132]

Legislation is the primary source of a statutory auditor's rights and obligations,[133] and the audit function cannot be divided into distinct sections, which explains why judges keep to the predominantly clear provisions of the Auditing Profession Act and 2008 Companies Act to determine the role and duties of auditors, without engaging in the specific rules of the IRBA Code, effectively rendering the IRBA Code redundant.[134]

It is doubtful that auditors can comply with public expectations of providing reports that their clients can rely on and acting accountably in relation to corporate responsibility matters. They should not attempt to get involved in issues where there is already a growing expectation of this kind, while their own house relating to ethics is not in order. The provision of standards as auditing guidelines creates an unreasonable expectation among auditors that they will be able to fulfil the role of acting as corporate responsibility assurers.

Neither one of the opposing views about the reasons for gatekeeper failure is agreed with, since it is clear that solving the predicament of gatekeeper failure is intimately connected to the ethical behaviour of individual auditors and directors. In reality, the answer to the essential question as to whether the internal controls or the autonomously honest employees of a company are responsible for reporting in accordance with GAAP, and for producing financial reports without committing fraud, is the obvious point that no control mechanism can prevent fraud.[135]

These instances prove that more regulations do not have the anticipated effect of preserving auditor independence, and suggest a review of regulations to identify rules which can be done away with, while these only place an unreasonable burden on auditors to begin with. An independent auditor is not *per se* an honest one, and an honest auditor is not necessarily independent. It is important that there is a change in focus when it comes to the role of auditors in corporate disclosure and reporting, shifting away from "newsworthy" perpetrations of fraud and corruption to the majority of honest auditors who deliver numerous trustworthy financial reporting and disclosures. Emphasis should be placed on ways in which to prevent the few dishonest auditors from committing fraud, instead of burdening most honest auditors with additional regulations to comply with.[136] The only effective way to do this is the infliction of penalties with proper detrimental effects. One is completely flummoxed by the dichotomy of the IRBA's call for more regulations while it is not even implementing the legislation at its disposal that can efficiently serve as a detriment to potential offenders. Cultivating an unsavoury culture of futile compliance with more regulations will certainly not produce good corporate governance or ethical behaviour as is evident by the recent corporate failures.

132 Schoeman Thesis 166.

133 *PricewaterhouseCoopers Incorporated v National Potato Co-Operative Ltd* 2015 JOL 32954 (SCA) para 65.

134 Schoeman Thesis 167.

135 Cunningham "The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills" 2003 *Boston College Law School Public Law and Legal Theory Research Paper 18* 59.

136 Schoeman Thesis 299.