INSTITUTE OF DIRECTORS

Audit Committee Forum™

Position Paper 12

Guidelines to audit committees on Reportable Irregularities and the impact on the audit committee

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Guidelines to audit committees on Reportable Irregularities and the impact on the audit committee

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Introduction

On 1 April 2006 the Auditing Profession Act (APA) became effective in South Africa with far-reaching consequences for registered auditors, directors and audit committees. Specifically, section 45 of the APA requires the registered auditor to inform the Independent Regulatory Board for Auditors (IRBA) of any instance of Reportable Irregularities[1].

There is no requirement for the auditor to discuss a Reportable Irregularity with the audit committee prior to sending the report to the IRBA and it is vital that the audit committee understands the process of reporting. The consequences of Reportable Irregularities are that the audit report will be modified and unresolved Reportable Irregularities will be reported to "any appropriate regulator".

The role of the audit committee

Traditionally, audit committees fulfill an oversight role over the public financial reporting process, including the risks and controls in that process. Internal control, however, encompasses not only financial reporting but also compliance with laws, regulations and operational controls.

The board is responsible for ensuring that the overall risks are identified and that management has introduced the appropriate controls and control environment. Therefore, the board has the discretion to delegate to the audit committee the responsibility for oversight of compliance with laws, regulations and operational controls.

In light of the requirement for a registered auditor to report irregularities, audit committees should ensure that they understand the implications of Reportable Irregularity reports as well as their role as one of the key players in the corporate governance structure of the entity.

The audit committee should consider implementing the following measures and/or ensuring that the following actions have been taken:

Education regarding Reportable Irregularities

- Management should request the registered auditor, or a preferred provider, to present to the board of directors and audit committee what the APA includes under the term Reportable Irregularities to provide some background information and raise awareness of the implications for the entity.

- The Board should define the level of management within the entity to which the definition of "any person in management" applies and agree this level with the registered auditor. The audit committee should evaluate this definition to ensure that it is appropriate to the nature and size of the business of the entity and is in terms of the objective of the APA.

[1] Section 1 of the APA defines Reportable Irregularities as:
- an unlawful act or omission to act by any person in management,
  – that has caused or is likely to cause material financial loss to the entity, partner, member, shareholder, creditor or investor of the entity in respect of his, her or its dealings with that entity, or
  – is fraudulent or amounts to theft, or
  – represents a material breach of any fiduciary duty owed by such person to the entity, partner, member, shareholder, creditor or investor of the entity under any law applying to the entity or the conduct or management thereof.

Engagement contracts

- The audit committee should ensure that all engagement letters (for audit and non-audit services) with the registered auditor are updated to ensure that the responsibility of the registered auditor to report in terms of section 45 of the APA is clearly outlined as well as the process of reporting to be followed.

- The audit committee should be aware of the registered auditor's policies for encouraging employees and registered auditors within the audit firm to bring information relating to potential Reportable Irregularities to the 'designated' auditor's attention.

The reporting process

Once the designated auditor is satisfied or has reason to believe that a Reportable Irregularity has taken place, a written report has to be furnished to the Independent Regulatory Board for Auditors (IRBA) without delay. Please refer to Appendix A for the detailed reporting process.

The audit committee may be required to participate in the reporting process by:

- Reviewing the policies of the auditor to discuss and evaluate issues before reports are made to the IRBA.

- Discussing matters resulting in the potential Reportable Irregularity with the registered auditor and providing further information, if required, during the investigations performed by the registered auditor.

- Informing the board of directors of the nature of the discussion with and representations made to the registered auditor during the investigation process.

- Enquiring from the registered auditor regarding actions or omissions to act by persons not in management that may have been reported to management and/or the board. In cases where appropriate corrective actions are not taken by management and/or the board a Reportable Irregularity may result.

- Enquiring from the registered auditor regarding their conclusions reached after the 30 day period from the initial report to the IRBA. In cases where the registered auditor concludes that a Reportable Irregularity still continues, the audit committee should determine the reasons why management or the board have not implemented appropriate corrective action.

Finalising the audit and the financial statements

The audit committee should ensure that the directors' report contains sufficient information regarding any Reportable Irregularities and that the audit opinion is appropriate in the circumstances.

The registered auditor is unable to express an unqualified opinion in situations where:

- The reporting process to the IRBA is incomplete;

- A Reportable Irregularity existed, even if the act or omission was corrected; or

- A Reportable Irregularity existed which has not been corrected.

Conclusion

As part of the corrective and preventative actions implemented by management, additional internal controls may be required.

The audit committee's oversight responsibility around an entity's risk and controls environment will necessitate an evaluation of the appropriateness of these internal controls.

Audit committees should keep in mind that the overall responsibility for the reporting of irregularities is that of the registered auditor and that the board of directors are ultimately responsible for making representations and taking corrective action, assisted by the audit committee.

Please refer to Appendix A for more details on section 45 of the APA.

Appendix A

The IRBA issued a guide to auditors in July 2006 which may be useful to audit committees in increasing their understanding regarding Reportable Irregularities and what to expect from the process.

The following will provide more information to audit committees.

Definition of any person in management

There has been much debate regarding the definition of any person in management. "Management" is not defined by this Act although "Management Board" is defined as: "the board of directors of a company and, in relation to any other entity, means the body or individual responsible for the management of the business of the entity."

The debate revolves around the fact that the Act does not refer to "Management Board" in section 45 and only to "any person in management". This implies an intention by the regulator to broaden the scope of this section beyond the board of directors.

Legal opinion contained in the IRBA guide to auditors suggests "any person in management" to be:

- In relation to companies:
  - the board of directors of the company including 'alternate and/or shadow[2]' directors and holding companies in group situations; and
  - any person who is a principal executive officer of the company for the time being, by whatever name he/she may be designated and whether or not he/she 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 relation to any other entity:
  - the board of the entity; and
  - the individual grouping 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 applying the section, the registered auditor should determine if the person in the organisation is responsible for planning, organising, leading, coordinating or controlling of the business affairs of the entity.

An action by an employee with the knowledge or direction of a person responsible for management would be viewed as the result of an action by the person responsible for management.

Process of reporting

Once the registered auditor is satisfied or has reason to believe that a Reportable Irregularity has taken place, a written report (a section 45 report) has to be furnished to the Independent Regulatory Board for Auditors (IRBA) without delay.

The auditor must notify every member of the management board of the section 45 report no later than three days after the date of the original report to the IRBA. A copy of the report to the IRBA must accompany this written notification.

Within 30 days of the original Reportable Irregularity report date the registered auditor must:

- Take all reasonable steps to discuss the report with the "management board".
- Afford the management board the opportunity to make representations regarding the Reportable Irregularity.
- Send another report to IRBA where a conclusion is reached that:
  - No Reportable Irregularity existed; or
  - The Reportable Irregularity is no longer taking place and appropriate corrective action(s) have been taken to recover/prevent loss; or
  - The Reportable Irregularity continues.

[2] Shadow director can be defined as a person acting in the capacity of director but with a different title.

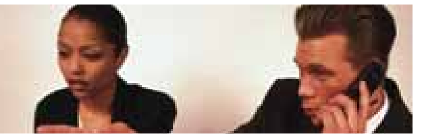
Impact on the external audit

The concept of materiality in the Reportable Irregularity definition relates to the affected person/entity and not the overall materiality of the financial statements of the entity. The materiality must be evaluated in terms of the affected person in his/her dealings with the entity e.g. if an amount of R5 000 is owed to a creditor and the act or omission results in a loss of R3 000 of the balance owing, this will be considered a material loss in terms of section 45.

Fraud and theft no longer require a level of materiality before determining whether or not to report in terms of section 45. Should any person in management perpetrate fraud, even of an immaterial amount, a Reportable Irregularity should be reported.

Material Irregularities in terms of section 20(5) of the previous Public Accountants' and Auditors' Act related only to irregularities identified during the conduct of the audit. Section 45 requires the registered auditor to have regard to all information which comes to his/her knowledge from any source. This legal provision overrides the confidentiality requirements with respect to knowledge the registered auditor gains when providing services of another nature to the audit client.

Further, the registered auditor must consider matters which come to his/her knowledge from third party sources. For instance, criminal charges, allegations of non-compliance raised, press coverage of suspicions or inquiries directed to the registered auditor would be information which the registered auditor should consider in determining whether a Reportable Irregularity exists.



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